# PBSS COLLOQUIUM SEPTEMER 2011 – ROUND UP

## Thoughts on the future of pensions

When we started to plan for this conference, a year ago, although the world economy appeared to be beginning to recover from the financial crisis in 2008-9, there was a strong consensus that there was a general need for individuals and organisations, in the financial sector in particular, to plan to be robust enough to survive similar events in the future.

The focus of the conference agenda – around the adequacy of retirement provision, making systems sustainable and managing the risks inherent in those systems, was driven by this: issues that have been discussed over the past two days include:

- How to extend coverage to groups excluded from private saving and, where necessary, encourage additional saving;
- The challenges faced by pension providers – both state and employer – and ways different scheme designs can help, or hinder, sustainability; and
- Measures that can be taken by external agencies, such as regulatory authorities and those with professional oversight of advisers, by encouraging those responsible for provision to identify and be clear about their objectives and to adopt thoughtful and responsive risk management strategies to target achieving those objectives.

These areas have been discussed with regard to both historic and future provision. None of us will ever start with a clean sheet – any approach to future design will be affected by what has gone before, and in any one country there is likely to be several historic models for providing pensions, including mixtures of funded and unfunded, state and private, defined benefit and defined contribution provision. As we've seen from many of the workshop sessions, different countries have adopted different mixtures of these various features, with the result that changes in demographic profiles and financial or market conditions are likely to give rise to different issues, needing different reactions and solutions, throughout the world.

The great attraction of an event like this is that we can share ideas and learn from one another, rather than stay within our regional boxes, which is vital as economies and employment patterns become a more and more global phenomena.

However, there are also similarities – in particular, regardless of how pensions are established, their existence depends on employment:

- Design and eligibility often depend on an individual's employment status and terms, although, particularly in state provision, other features might be taken into account;
- Financing, however, depends solely on employment:
  - Contributions towards state and private provision come from employers and employees, whether directly through deliberate saving or social insurance, or indirectly via taxes; and
  - Returns on investment, needed to supplement contributions in funded arrangements, require companies to remain productive.

So what does this mean for the future of pension schemes?

Regardless of how pensions are provided – that is, whether financed via funded or pay as you go (PAYG) arrangements – pensioners rely on younger generations to remain sufficiently productive to generate enough taxes or investment returns to finance their incomes. If one generation's rights to pension – sometimes referred to as deferred pay – becomes excessive relative to the incomes of subsequent generations, the cross generational subsidy will fail. Take home pay for those employed will be depressed by the cost of meeting pensioners' incomes, the incentive to continue to work and pay taxes will reduce, productivity will reduce and pension security will fail.
This argument is easiest to see in the context of what is normally termed 'defined benefit' provision – for members to get the pensions their employers' targeted, the investments underlying it need to remain productive and, in some jurisdictions, the contributing employers need to remain solvent, for the scheme to be able to deliver.

But it also applies to 'defined contribution' schemes since, just like defined benefit arrangements, they also create expectations and, for these to be met, the underlying investments need to perform adequately.

Some of the colloquium sessions have been to do with how benefits can be reliably targeted, but if the financial turmoil experienced over the past few years tells us anything, it's that financial certainty is hard to come by. Of course, financial systems can provide guarantees to a degree – but determining what the degree is seems to elude us. Products such as insurance and hedging instruments can help provide security, but they can only do so up to a point - it seems unlikely that there is sufficient secure capital in the world to successfully collateralise everyone's retirement dreams.

This means that a degree of risk is inevitable in pension provision, so determining the level and understanding that risk, and how it is shared, will be key to ensuring it is sustainable. In particular, for retirement saving to have a future, we (by which I mean advisers and public and private sector providers) have to be clear to our advisees and to scheme members about the extent to which pensions can, or cannot, deliver 'certainty' and, indeed, exactly what it is we are being 'certain' about.

As discussed in the sessions on ERM, to be able to determine the level of risk it's reasonable for a scheme to carry, you first need to establish and understand its objectives – but these will vary, depending on the perspective taken. For example, individual savers will have different objectives to employer providers, although a key objective for both of them will be around the level of benefit targeted. Financial regulators and governments are also likely to have different objectives in relation to pension provision, which could include, for example, confidence in savings products. Whilst these objectives might complement each other, they are not at all the same thing.

This brings us back to the social contract between employees and pensioners. Since pensions are often characterised as deferred pay, it seems a reasonable objective that pensions should, to a degree, reflect the terms and conditions of those in employment.

This works to the advantage of members and pensioners if there is demographic stability and economic growth. For those coming up to retirement in times of growth the outcomes from private and public DB schemes and from DC schemes and the state can be great for scheme members, and employees and employers should be comfortable with the cost. In developed economies, during the second half of the 20th century, this pattern of relatively stable and consistent growth perhaps raised the expectations of what such schemes can deliver and led to the view that, in DB schemes at least, 'deferred pay' represents a certain level of guaranteed return. But in some cases at least this view is having to be revisited.

When, for example, rising life expectancy alters the relationship between time spent in work and time spent in retirement – and particularly when this cost is exacerbated by less buoyant economic growth, as we are now experiencing, the current view that is held in the UK, for example, of deferred pay as a protected right, regardless of the economic cost it imposes, becomes more difficult to defend.

A further wrinkle is that, as expectations become heightened, governments and regulators, understandably, want to ensure continued confidence in savings products, which further consolidates those expectations. This introduces a regulatory risk that might prioritise the government's objectives over the providers and so crystallise individual member expectations to the high levels that have been achieved in benign market conditions.

This creates intra, as well as inter-generational conflict, as those within schemes become better sheltered than those outside.

In turn, this can ultimately destabilise the social contract, and many of the presentations given considered how it would be reasonable to introduce more risk in DB design, or less into DC design, to try and restore balance. So perhaps the future of pensions depends on finding a new paradigm for 'deferred pay' that infers less entitlement on pension scheme members than appears to have become the case.

However, whilst any solution we think of now will need to have sufficient flexibility to accommodate future changes to working and non-working lives, there is also value in certainty.

Although pure defined contribution schemes provide the flexibility to ensure affordability is not an issue for providers and include helpful incentives in the face of increasing longevity, the risk is solely borne by the member. And whilst financial markets might be able to mitigate the risk of investment losses, access to 'certainty' is expensive. So a common model is for the state to provide a defined benefit, often flat rate, sometimes means tested, with DC provision acting as a supplement – some of the workshop sessions considered how a balance between state and private provision should be struck.

Where the element of certainty is provided via material private sector defined benefit provision, countries have found that the conflicts between employer providers' objectives and regulators' objectives have proven difficult to manage. This morning's session illustrated some of these points, and the earlier plenary about how the Irish government and regulator have chosen to act in the face of some extreme fallout from the credit crisis show how compromise can be needed from all parties.

However, employees also don't have certainty. If you buy the argument that, ultimately, successful pensions outcomes rely on successful employment outcomes, then sustainable pensions will reflect this uncertainty. But is should also reflect that many employees have choices that aren't available to pensioners – effectively, although their exposure to savings capital might be low, they can compensate for this via their own personal capital, that is, their largely easier access to the workplace which provides further opportunities to add to their savings.

Pensioners' choices, on the other hand, are more limited, particularly at older ages. Although it might actually be reasonable, in some circumstances, to expect younger retirees to go back into the workplace if their savings underperform, at some point on moral and practical grounds this becomes unsupportable.

As was touched on in the session on decumulation, I expect there is an age range when, as personal capital diminishes, it must be right that individuals' entitlements should be regulated to the extent that their reasonable objectives can be met with a high degree of certainty, although the objectives might still be made proportionate to the experiences of the generations of workers that are explicitly or implicitly paying for them. This requires some flexibility in the design, where individual member risk is not static, but is age related and perhaps, looking at retirement income overall, also a function of individual circumstances, even through the decumulation phase.

The continuing financial and economic uncertainty is testing different models of retirement provision, although hopefully not to destruction, and many concerns are being raised about the bi-polar approach many countries have so far taken to pension provision – that is, providing expectations that in some schemes everything is guaranteed, and in others, nothing. As has been discussed over the past few days, new models, that make the way risk is shared more transparent, that address intergenerational transfers more fairly, and are underpinned by robust risk management to increase the likelihood that objectives are met, are being considered.

Even so, so long as life expectancy continues to increase, the bottom line for future retirement provision will be that, for those still in or able to work, the most obvious solution to underperforming pension provision, and perhaps the most effective risk and liability management strategy, will be to carry on, or expect to carry on, working for extra years.

This would mean some of those close to, or already retired, might also have to swallow bitter pills, including some conditionality in the type of benefit provided. But this conditionality has to be designed in the context of pensioners becoming an increasingly vulnerable group as they age.

The challenge, particularly for us, as advisers to providers, to government and to individuals, will be to ensure that each party understands the checks and balances built into retirement provision, so is able to plan, as far as possible, to manage their particular uncertainty.

The information and experiences that have been shared over the course of the past few days should help us to achieve this. I certainly have learned a lot and am grateful to all the speakers fro the very high standard of their presentations and to the audience for some very thought provoking contributions.

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