The crisis and its Impact on pension schemes and benefits

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Presentation in the seminar series

"Crisis management in Central, East and Southeast Europe: What is to be done?"

The Vienna Institute for International Economic Studies

May 10, 2010, Monday, 5 p.m.

EUROPEAN CENTRE FOR SOCIAL WELFARE POLICY AND RESEARCH
AFFILIATED TO THE UNITED NATIONS
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Let's start with a macroeconomic synopsis…!

Source: Economic Forecast, Spring 2009

Crisis and its impact on pensions – An Overview

Started as the financial sector crisis, leading to a collapse in stock markets and affecting private pensions

- Strong impact in those pension funds where the portfolio choices were in favour of equities rather than Bonds (IRE, USA, UK, CAN).
- For people who are approaching retirement and had long periods in DC-type pension schemes (USA, UK) / For retirees who did not take an annuity on retirement
- For employers who provide DB type schemes and facing solvency issues.
- For countries where the private pension system is already mature and private pension incomes are an important part of old-age incomes (UK, USA, NED).

The financial crisis lead to economic crisis

- Output and economic activity falling, and thus unemployment / inactivity rising
- For employed, wage cuts and/or shorter working hours observed
- The above leading to a reduction in revenues from pension contributions
- Increase in the demand for social benefits and possibly also early retirement / disability pensions.
- Fiscal stimulus expenses and reduced tax revenues and higher deficits: less resources for ageing-related demands.

Key issues arising…!

1. Whose pension **benefits** have an impact and how much?
2. Which pensions **schemes** are affected most and why?
3. Does the crisis imply **new challenges to pension policies,** or does it merely highlight the existing ones?
4. Any **new directions for pension strategies**? Or, should countries stay on course to reforms / diversification!
5. What **policy responses to the crisis** and their impact (e.g. interest rate cuts / special adjustments to pensions)?
6. What **future analytical work** required to understand better the impact of such economic fluctuations on pensions and pensioners?

Contents of this presentation

1. **The impact on pension benefits**
    - By age groups
2. **The impact on pension schemes**
    - Public pensions, particularly the impact on public pension expenditures
    - Private pensions, particularly the effect of pension funds returns
3. **Policy responses and their suitability**
    - General fiscal and monetary policy responses to the crisis
    - Pension-specific public policy responses
4. **Additional pension policy challenges for the future**
    - Challenges
    - Lessons learned
5. **Concluding discussion**
    - Areas for further research
    - Conclusions

1

The impact on pension benefits

(by age groups)

1. Impact of the crisis by age groups

.... showing how different age groups in different pension settings may be affected

	Younger/prime-age	Nearing retirement	Pensioners
Strong impact		Individuals with long periods in defined contribution private plans Especially if heavily exposed to riskier assets (USA, UK)	Individuals who did not take an annuity on retirement Especially if retirees exposed to riskier assets (USA)
Moderate impact	Many individuals will have disruptive working careers and thus their pensions will be lower	Individuals in defined-benefit, private plans Especially if plans have solvency problems (IRL, NDL, UK, USA) In some public schemes Especially where public pension spending is high (ITA, AUT, FRA, GRC) Also, where old-age safety nets are weak (DEU, USA)	Retirees in schemes with automatic adjustment of benefits (SWE, NLD, DEU, CAN)
Little impact	Individuals coping with the shock over the longer time horizon	Many individuals	Most retirees (with public or private pensions)

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The impact on pension schemes

2.1 Public pensions

2.2 Private pensions

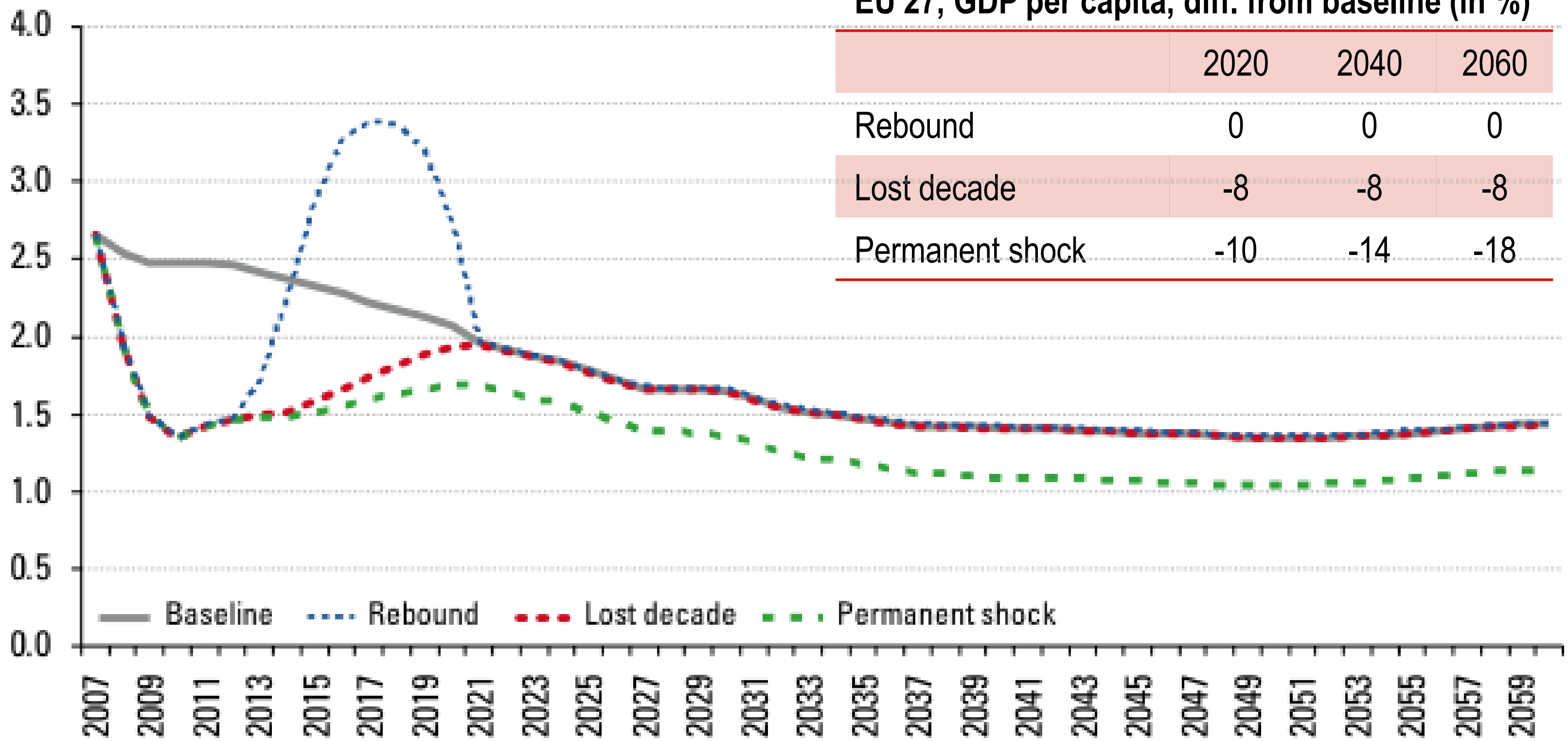
2.1 Public pensions

What are various sources of pressures on public pensions?

- **Revenue side of public finances:**
  - fall in contribution revenue as well as in tax revenues
- **Expenditures side:**
  - Minimum pension guarantees and/or social assistance
  - Government sponsoring (partially) funded schemes
  - Government obliged to provide guaranteed returns
  - Provision of explicit guarantees to either employer-sponsored plans or individual accounts—examples include PPF in the UK and PBGS in the USA

Impact of crisis on economic output - AWG

... this chart shows the impact on GDP growth of three scenarios of impact of crisis



EU27 - GDP growth

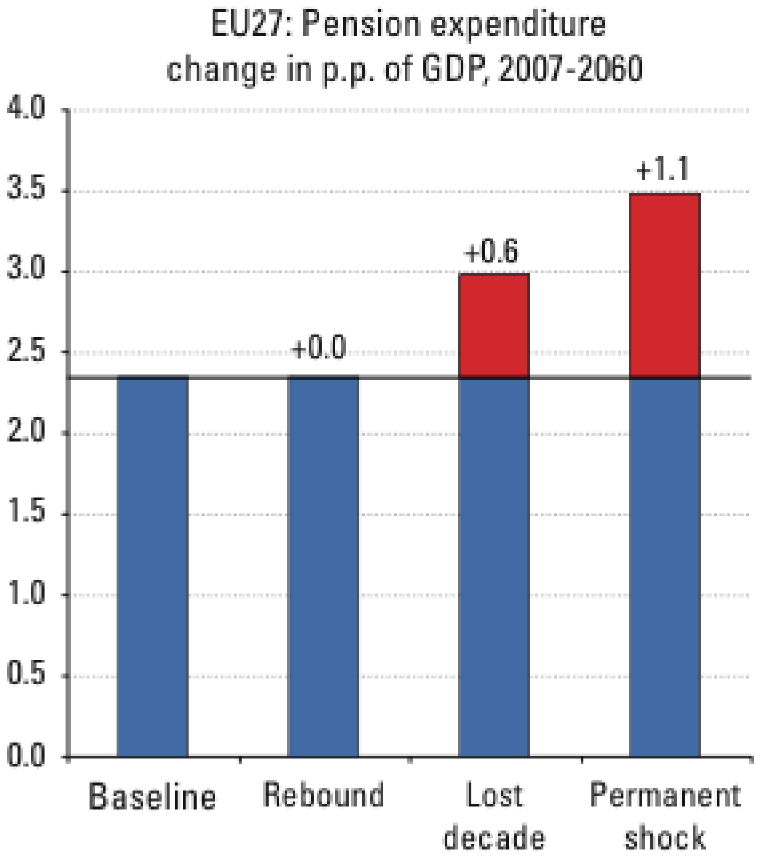
EU 27, GDP per capita, diff. from baseline (in %)

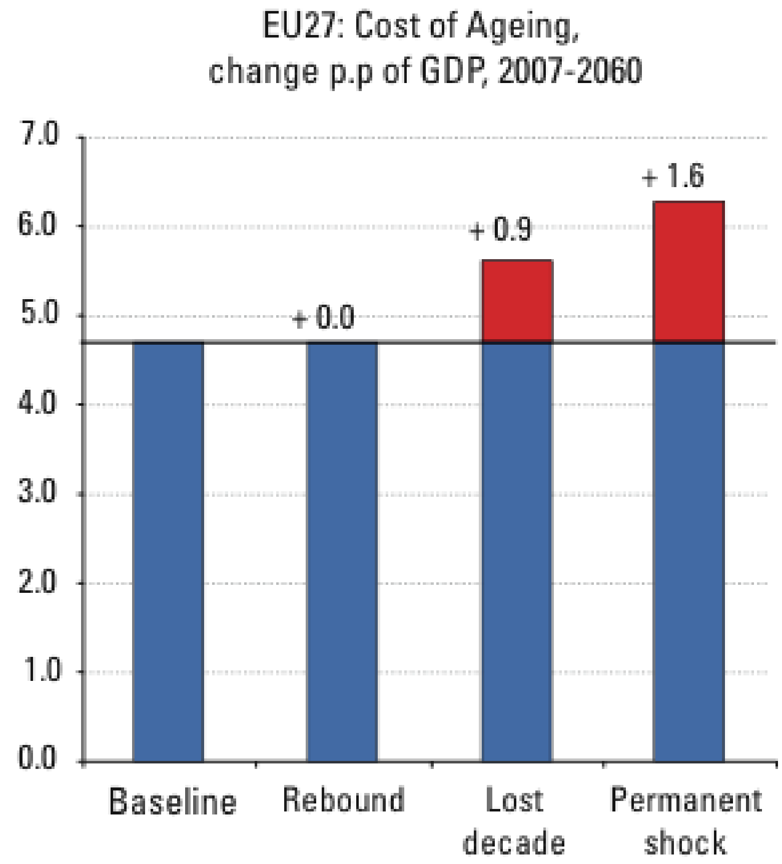
	2020	2040	2060
Rebound	0	0	0
Lost decade	-8	-8	-8
Permanent shock	-10	-14	-18

Source: The 2009 Ageing Report

Impact of crisis on ageing-related expenditures

... this chart shows the impact on public pension expenditures and total costs of ageing

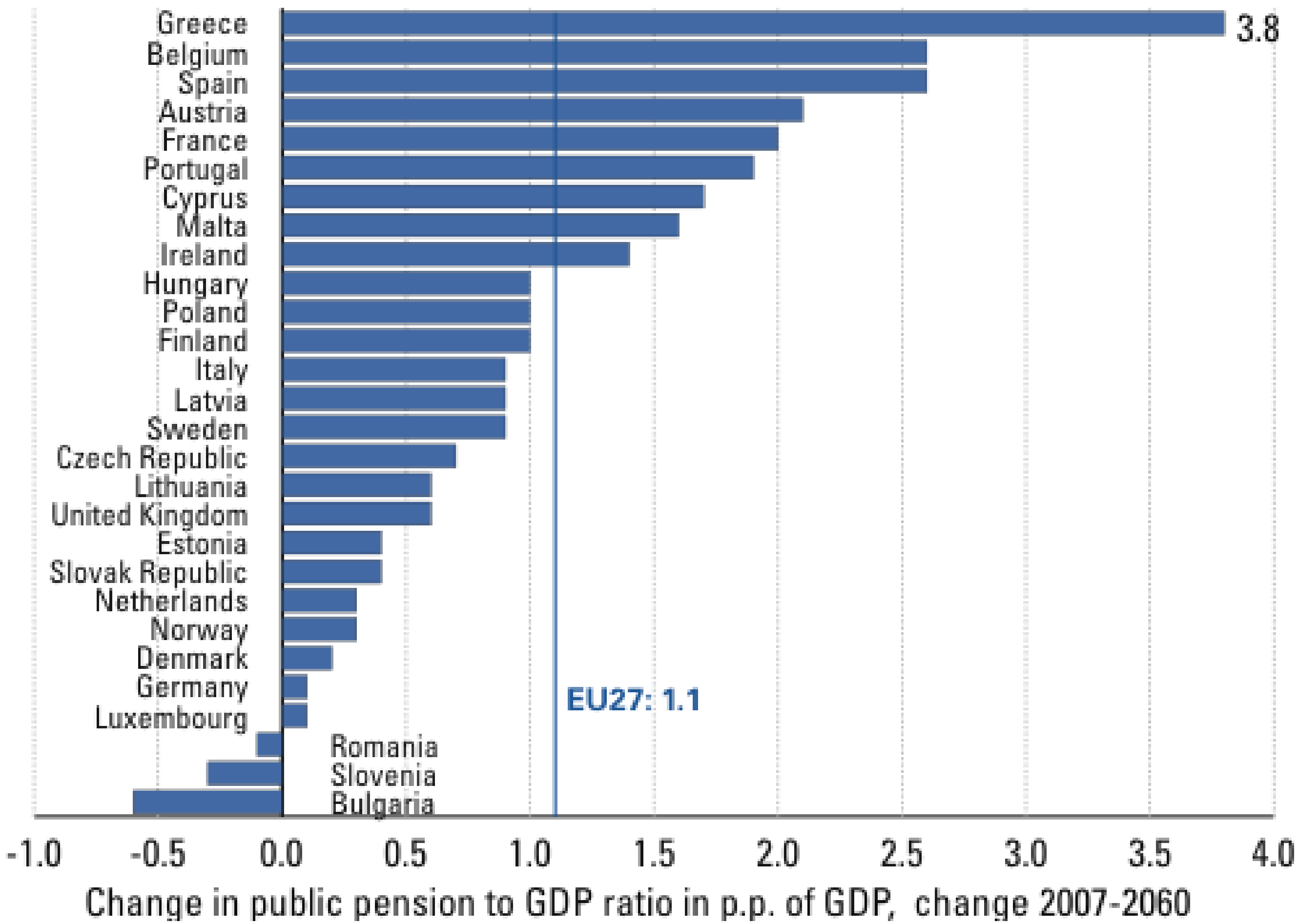




Source: The 2009 Ageing Report

Change in Public pension expenditures

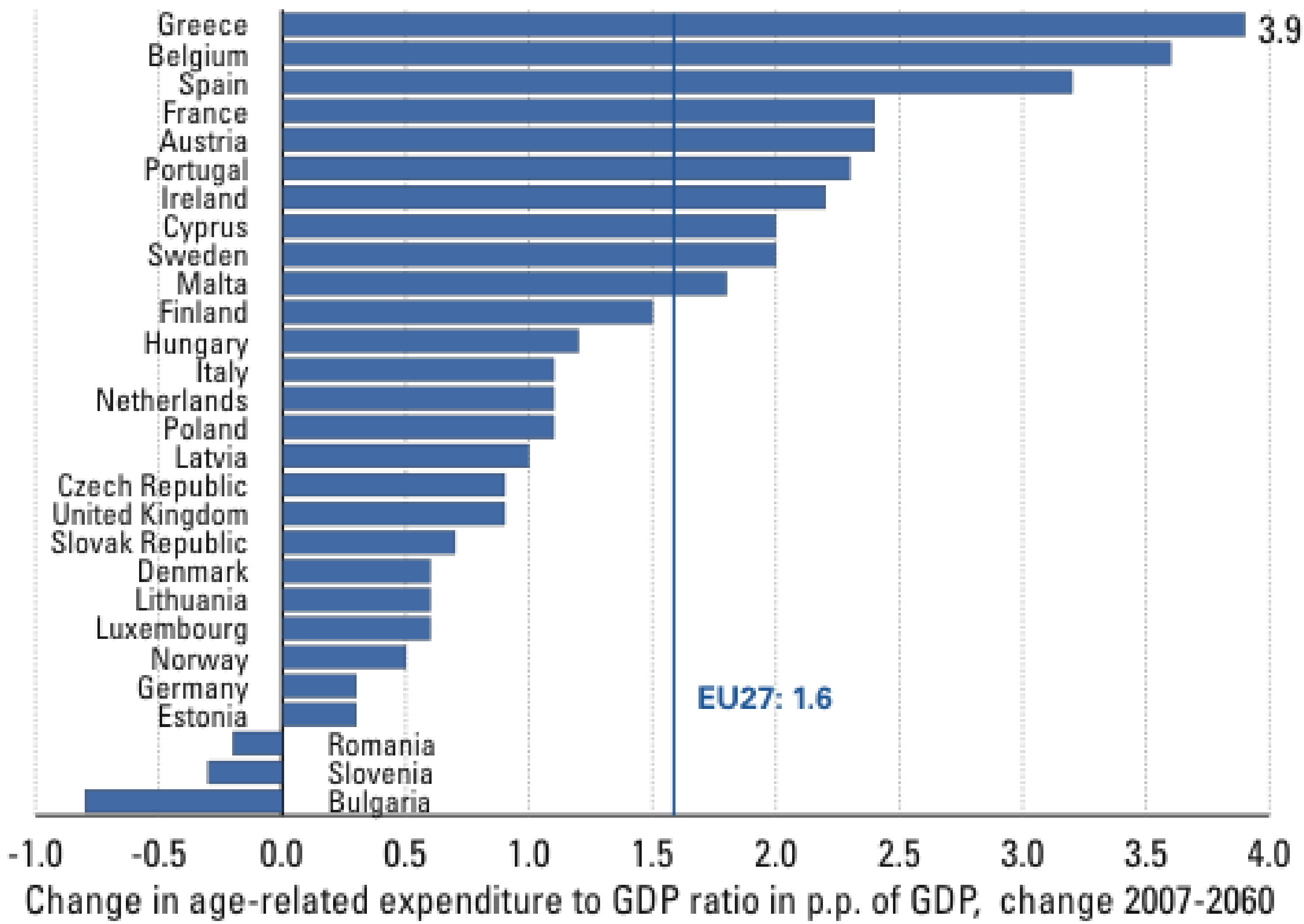
Crisis scenario: permanent shock



Source: The 2009 Ageing Report, pp. 271

Change in age-related expenditures

Crisis scenario: permanent shock

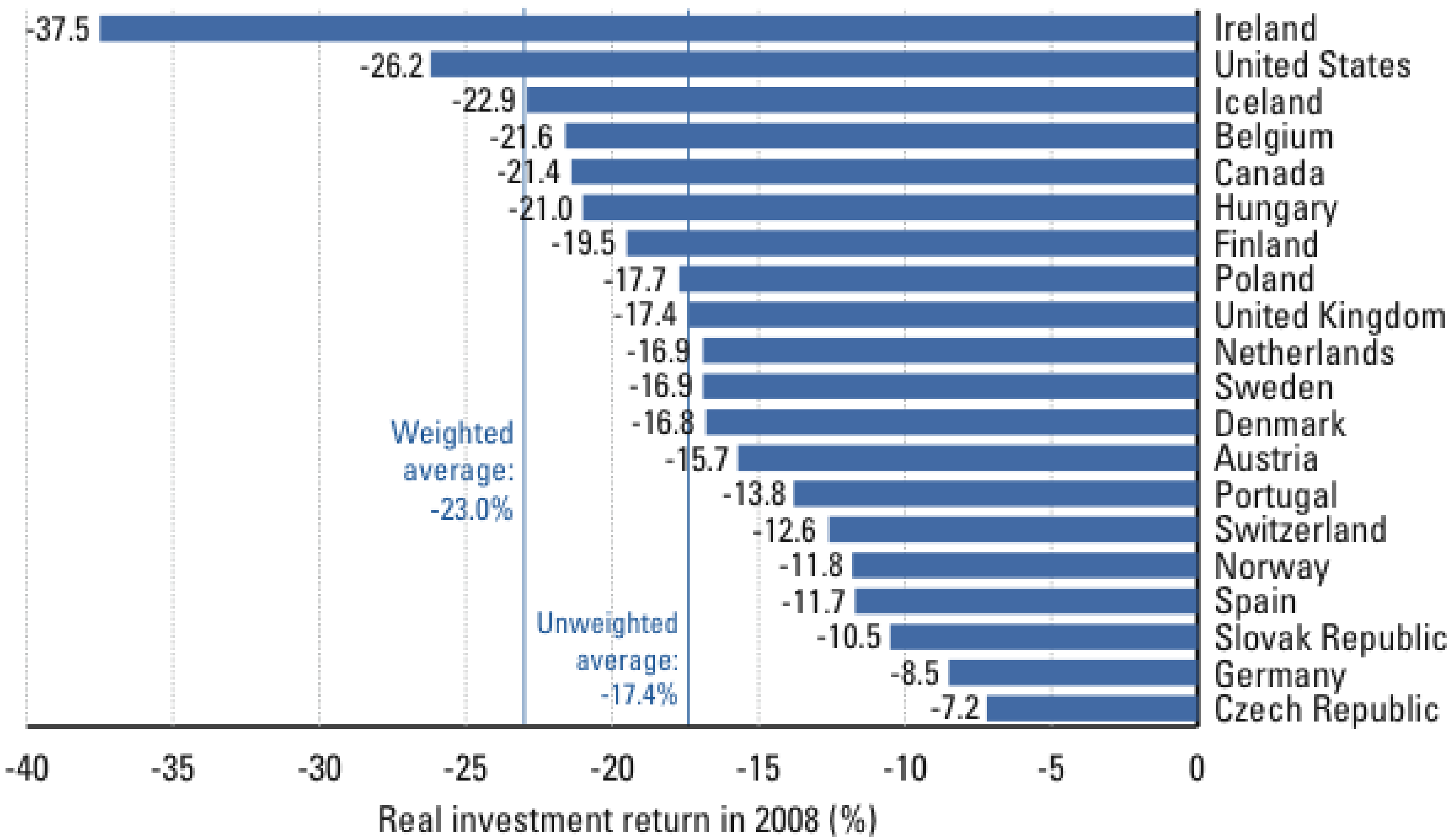


Source: The 2009 Ageing Report, pp. 271

2.2 Private Pensions

Performance of pension funds in 2008

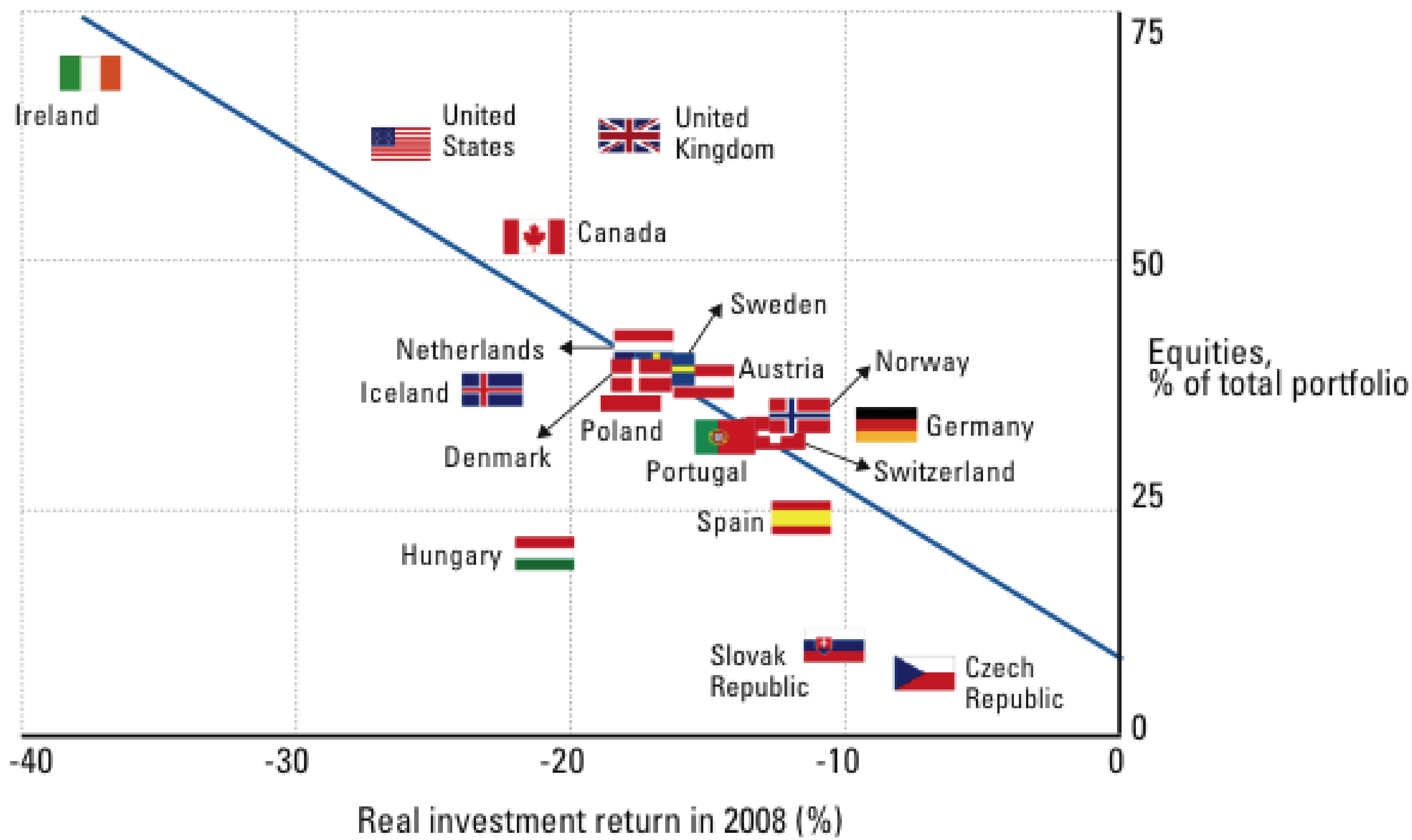
(real investment returns in %)



Source: OECD (2009)

Why differences in returns?

.... this chart shows how asset allocation towards equities is an important factor



Source: OECD (2009)

3
Policy responses and their suitability

3.1 General fiscal / monetary policy responses

3.2 Pension-specific public policy responses

3.1 General fiscal and monetary responses to the crisis - Some examples

1. Interest rate cuts (downside: reducing income from assets, annuity rates and willingness to save, and with impact on discount rates for DB liabilities)

2. Bank recapitalisations and tighter regulation (downside: regulations are expensive; trust is reduced on functioning of financial sector / thus affecting trust in moving towards private personal accounts)

3. Public debt build-up (downside: stimulus package expenses limit scope for increased age-related spending in the future...!)

3.2 Pension-specific public policy responses

Some examples

1. Relaxing of solvency rules (funds-liability ratio in the NL)
2. Diversion of contributions from individual accounts to the social security account (e.g., Lithuania; also Estonia)
3. Cutting public-sector pension benefits (Ireland, also increasing tax on pensions)
4. Allowing access to pension funds to help people over severe crisis (e.g., Iceland, 3rd pillar; Denmark, SP)
5. Taking steps towards cutting down pension benefits (Hungary)

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Additional pension policy challenges for the future

4.1 Challenges arising from the crisis

1. Danger of resorting to early-retirement/ disability benefits
   - but little evidence of this so far (watch out for the lagged effect!)

2. Automatic pension adjustments not implemented
   - Germany has overridden these for 2008 and 2009 (which would have reduced pension increases by 0.6%-0.7%)
   - Sweden is likely to postpone the 3.3% cut required 2009/2010

3. Backtracking on previous reforms
   - Switch-back option in Slovak Republic; benefit reductions and pension-age increases repeatedly postponed in Italy

Challenges (continued)

4. The stock market drop have reduced the trust in the functioning of the financial sector, thus people less willing to save in private personal schemes!

5. Declining value of assets to annuitise (unless strong recovery to happen; exceptions: life-cycle options)

6. Increased deficits in DB schemes (public or private) and thus greater risks of benefit reduction (public) or closures in favour of DC schemes (private)

4.2 Lessons learned....

- "improve life-cycle asset allocation"
  - necessary but by no means sufficient; rather be a default option
- "greater care with alternative investments"
  - more regulation / observation of pension fund practices
- "improve financial education"
  - recognise cognitive deficiencies, improve reliability of information
- "underwriting" deposits / savings
  - government-promoted safeguarding of private savings

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Concluding discussion

5.1 Areas for further research

- To study how persistent is the impact of the crisis on employment prospects? Could it be accompanied by productivity growth slowdown, which would have far more serious effects?
- For EU-wide policy actions, it is important to move beyond projections to policy simulations about key triggers to avoid expenditure crisis while delivering pensions

Investing in developing dynamic microsimulation models so that the impact of the crisis at the micro level be investigated

5.2 Conclusions

1. **Although** pensions are long-term investments, a buffer is indeed required for shorter term economic fluctuations; and for a large unprecedented downfall such as the current one!
2. Diversified **public/private pensions can only be maintained** if lessons learned are converted into actions (and also confidence restored in private pensions through better regulation, transparency and better information)
3. **Social pensions** provisions should be further strengthened (promoting income rights of older people in a targeted manner)
4. **Cause for concerns:** fiscal implications of crisis dwarfed by fiscal implications of population ageing (and this should be kept in mind!)

Demographic change and the population ageing challenges still present more serious issues than the current crisis