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"Pension Prospects"

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1. Introduction

- Thank you for the opportunity to talk about pension prospects
  - a contentious issue e.g. public v. private
  - involving structural change e.g. the transition from DB to DC pensions
  - and the global financial crisis.

Today I sketch what I think are crucial issues for the future of employer-sponsored pensions in the UK so as to prompt debate and comment.

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2. Structure of Presentation

- Here, I will comment on 3 issues
  - private sector interests in pension provision
  - the transition to defined contribution pensions
  - and lessons from the global financial crisis.

I will also comment on the findings of recent research at Oxford on pension and retirement savings as well as plan governance.

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3. Private Sector Considerations I

- We have surveyed 'stakeholders' in DB pensions to identify the crucial issues that might explain the decline in DB pension provision
  - involving <u>Pensions & Investments</u> (USA)
  - with a significant international flavour (eg. Japan)
  - seeking 'expert' opinion on what has been driving the long term decline of DB pensions in the private sector and its continuing significance in the public sector.

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4. Private Sector Considerations II

- We found strong agreement on crucial issues around the world (US, UK, Japan etc.)
  - increasing global competition is the single most important consideration (costs of provision)
  - followed by changes in accounting standards and regulations (again the costs of provision)
  - <u>then</u> uncertainty over future costs including longevity, salary, inflation etc.

5. Private Sector Considerations III

- We also found awareness of significant dilemmas and conflicting interests in DB pensions
  - the pension ‘promise’ has become a ‘guarantee’ rather than a contingent commitment
  - older workers value DB much more than younger workers — especially close to retirement!
  - trustees are more committed to the DB institution than their plan sponsors (even though plan sponsor nominated trustees are more aware of the costs of provision).

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6. Private Sector Considerations IV

- We drew a number of implications from these findings, none of which are encouraging
  - market competition is the single most important driver of plan sponsor concern about DB pensions
  - issues such as longevity amplify these concerns, especially if it is perceived that there are conflicts between investment, shareholder returns, and pension contributions
  - employers recognise that the demand for DB is also fraught with conflict and debate amongst participants.

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7. Transition to DC Pensions I

- Turning to DC pensions, it is important to acknowledge current unease over their ‘value’
  - typically, contribution rates (employer & employee) are too low given income aspirations
  - to the extent that participants are aware of the value of DC pensions, the investment industry has implied a significant equity premium on modest contributions
  - in any event, the costs of provision, retirement-date vulnerability, and low levels of contribution discount the ‘value’ of the institution.

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8. Transition to DC Pensions II

- Even so, there are standard-bearers of best practice suggesting that the institution could be a reasonable alternative to DB
  - ➢ high rates of matching contributions — e.g. 6% by employees matched by twice that amount by the employer
  - ➢ target-date investment funds that dampen the vulnerability to switch points in life-cycles
  - ➢ the logic of ‘opt-out’ instead of ‘opt-in’—ie. the promise of libertarian paternalism.

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9. Transition to DC Pensions III

- However, it is clear that many employers embraced DC pensions to discount their costs <u>and</u> their responsibilities!
  - ➢ just as DB pensions require 'investment' in fund governance, DC pensions could make heavy demands on institutional commitment
  - ➢ especially given the increasing evidence about the cognitive biases of the average participant
  - ➢ as well as the potential costs to employees if the DC institution was to fail (eg. fraud, the value of pensions, etc.).

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10. Transition to DC Pensions IV

- There is a pressing need to understand better <u>both</u> the standards of best practice DC provision and the engagement (or lack thereof) of plan participants in planning for retirement
  - ➢ the field is dominated by US research
  - ➢ often ignores crucial issues like age, gender, income, household circumstances, and experience
  - ➢ suggesting the need to target education and advice with greater sensitivity.

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11. Lessons from the Financial Crisis I

- I now close with some comments about the apparent implications for pensions of the global financial crisis
  - many DB funds, their trustees, and consultants are ‘bystanders’ to current events
  - in early phases of the crisis, this was justified by expectations of a ‘rebound’
  - increasingly clear that the ‘rebound’ will be short-lived, even still-born
  - we have to think <u>very</u> seriously about 5 to 10 year scenarios of survival.

12. Lessons from the Financial Crisis II

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- Turning to the DC environment, it is apparent that <u>many</u> participants have lost a great deal of their modest savings
  - most critical for those 5-10 years short of retirement given the lack of the time to make-up losses
  - catastrophic for those retiring about now and having to purchase annuities
  - and very difficult for trustees that otherwise tended to ignore or be complacent about their DC responsibilities.

13. Prospects for the future I

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- I should end with comments on the future of employer-sponsored pensions
  - there is an important role for employer-sponsored pensions compared to state social security
  - most likely DC rather than DB in the private sector, although there will be agitation for change in the public sector as well
  - with increasing inequality between working men and women in pension provision and pension value.

14. Prospects for the Future II

- Employer-sponsored pensions will have to be of more ‘value’ to employers
  - ➢ this could mean greater variation is the nature and value of pensions offered to different classes of employees
  - ➢ recognition that the pension ‘promise’ is contingent rather than a guarantee (eg. inflation-proofing)
  - ➢ while some employees would be better served by a national, multi-employer, even public scheme (the NPSS).

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15. Prospects for the Future III

- Is a single government authority the best means for providing the NPSS?
- Will the NPSS be able to innovate, especially as regards the investment performance of its 'default' fund?
- Will the NPSS crowd-out willing and able employers or will superior benefit schemes promote a new era in private pension provision?
- Who's willing to march on the streets to protect the benefits of public sector employees?

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15. Further Reading

- Clark, G. L. The new paternalism, consultation and consent: expectations of UK participants in defined contribution and self-directed retirement savings schemes. <u>Pensions: An International Journal</u> 2009, 14(1) 58-74 with Janelle Knox-Hayes
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- Clark, G. L. Best-practice investment management. <u>Journal of Asset Management</u> 2008, 9(1) 2-21 with Roger Urwin
- Clark, G. L. Conceptualizing the defined benefit pension promise. <u>Benefits Quarterly</u> 2008, 25(1) 7-18 with Ashby Monk