

The Quiet Revolution: developments before the financial crisis and current challenges

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Agenda

- The “silent revolution”, a strong and well grounded trend before the crisis
- Major threats-
 - Equity premium disappears?
 - Back to a one pillar retirement system?
- Recent public comments and their implications

Crises are “moments of truth”

Mutual Fund , overall stronger July 2007- June 2008

	Italy	Germany	UK	France	US	Asia
<i>bn €</i>						
Equity	-33	-4	-12	-15	58	107
Bond	-55	-12	5	-5	82	28
Money Market	7	-1	2	-54	529	27
Other	-18	37	7	-39	-9	72
Total	-99	20	1	-113	660	234

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- **Finding ways of increasing participation to DC plans**
- Different countries / different solutions
- The quiet revolution

From the '90ies onwards.

The need for accelerating pension reform...

- In 1994 a path-breaking report from the World Bank highlighted the need to move, globally, towards a three pillar system in retirement (a pay as you go government first pillar, an occupational second pillar, a voluntary third)
- The slow pace of implementation of the reform has however been a matter of concern.
 - Governments are worried that many retirees may end up in poverty
 - Too many workers are still out of the system and, for those in, the level of savings often is often insufficient and the quality of portfolio diversification unsatisfactory.
- Policy makers, workers and companies have been designing and experimenting solutions.

UK Myners' Report

Pensions Commission findings

- 50% more pensioners by 2050
- At least 7 million under-saving for retirement

Recommendations

- Wider, fairer State Pension coverage
- Automatic enrolment and employer contribution
- Personal accounts

... default solutions and other ways of encouraging participation and higher long-term savings are being enacted ...

- Voluntary participation has generally failed
- Some countries (Chile, Mexico, Sweden for the capitalization component of the first pillar) have gone directly for mandatory solutions
- Mandatory solutions are however often deemed socially and politically unacceptable, default devices have been enacted as an alternative
- Default solutions represent the normative outcome of the behavioural critique of the microeconomic assumption of individual rationality

The key concepts: substitute “good biases” to “negative biases”, give guidance without eliminating freedom of choice

- Negative biases include tendency to procrastinate the necessary but difficult decision to save for retirement, home bias, insufficient diversification, inability to rebalance portfolios across time....
- Defaults are simple automatic solutions, from which opting out is always possible, they aim at providing satisfactory solutions that have very high chances to be superior to the outcome of current behaviour
- Simplicity is the key to the success of defaults

The three levels of defaults- the amount to be saved, the portfolio to be invested in, the de-accumulation plan to pursue

All three levels are key:

- Entry defines the way the present (and future) level of contributions is determined
- Portfolio choice and its adjustment across time is key to the quality of returns
- De- accumulation paths need to answer “flexibility” needs for pre-retirement, retirement and very old age

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An assessment of progress can be attempted

- Robert Wescott has a special report on the USA
- We will look at select European countries highlighting the different impact of alternative solutions
- This is necessarily a partial analysis that does not take into account the full blown scope of measures being adopted at various levels (first, second and third pillar) and for various professional categories

Sweden- a model of rationality?

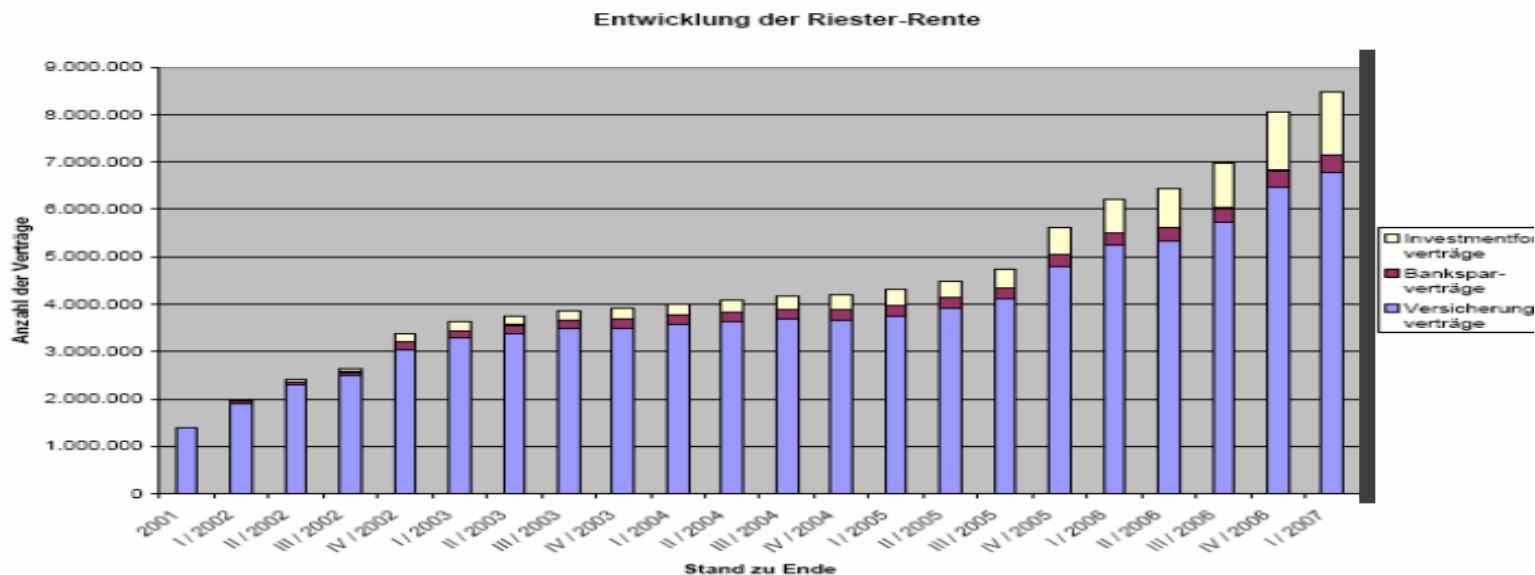
- The Swedish system is close to compulsory at entry level, The premium fund is a capitalization component of the first pillar, but the Swedes also sign in corporate pension funds quasi automatically as they become employed.
- The default solution for the premium fund portfolio is very interesting: a global equity fund-no home bias, risky because the rest of first pillar is secure, maximum diversification
- Full information for planning de-accumulation. Yearly info on expected level of retirement level, measures to allow extension of work life

Germany- Riester Plans a voluntary system that looks at the population as a whole

- Germany encourages second pillar occupational pension fund
- However the real success story are third pillar retirement vehicles, over 11 million Germans have bought in in just a few years, anybody can enter
- The key: information (on declining substitution rates), the right incentives (tax rebates), simplicity (easy to do while filing taxes)

The Riester success

Figure 1: Development of Riester pensions



Source: Federal Ministry of Labour and Social Affairs (2007)

“It is striking that the acceleration in Riester saving only really kicked in after *substantial simplifications* had been made to the scheme. This contraindicates complex savings models which are not immediately understood by customers. It also takes time to make up for the damage which may be caused by excessive complexity even such complexity is merely 'felt' to be such by the customer”.

THE SAVINGS BEHAVIOUR OF GERMAN HOUSEHOLDS: FIRST EXPERIENCES WITH STATE PROMOTED PRIVATE PENSIONS

Axel Börsch-Supan, Anette Reil-Held and Daniel Schunk 2007

Italy- The very long transition

- Entry default in 2007 has been a partial success:
 - it has brought a million new members to corporate pension plans, total participation close to 4 million (11 million private sector employees)
 - However smaller companies (less than 50 employees) virtually totally excluded
 - Public employees and part of the self.
- Default portfolio is capital guaranteed- the opposite of Sweden

UK – Myners' Report follow-up

LEGISLATION

- The 2007 Pensions Act:
- State Pension reforms and higher State Pension age
- Advisory personal accounts delivery authority
- Current Pensions Bill (upon Royal Assent):
- Employer duty: auto-enrolment and 3% contribution
- Framework for the personal accounts scheme
- Executive personal accounts delivery authority & its principles

THE DEFAULT FUND

- Most important investment decision
- Desire to reduce risk will tend towards diversification
- Desire for low costs will tend towards a passive
- management
- Will consider risk and allocation over the lifecycle

Towards a Dutch solution (at least in part) ?

- Automatic enrollment at the corporate level for any sort of employee would be the ultimate default

- It is true that DB is out but DC is also in doubt, people want protection

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A quiet revolution

We are living a transition

- from a world with an all-encompassing welfare state and lifetime employment in big business
- to a flexible world where the individual must take responsibility

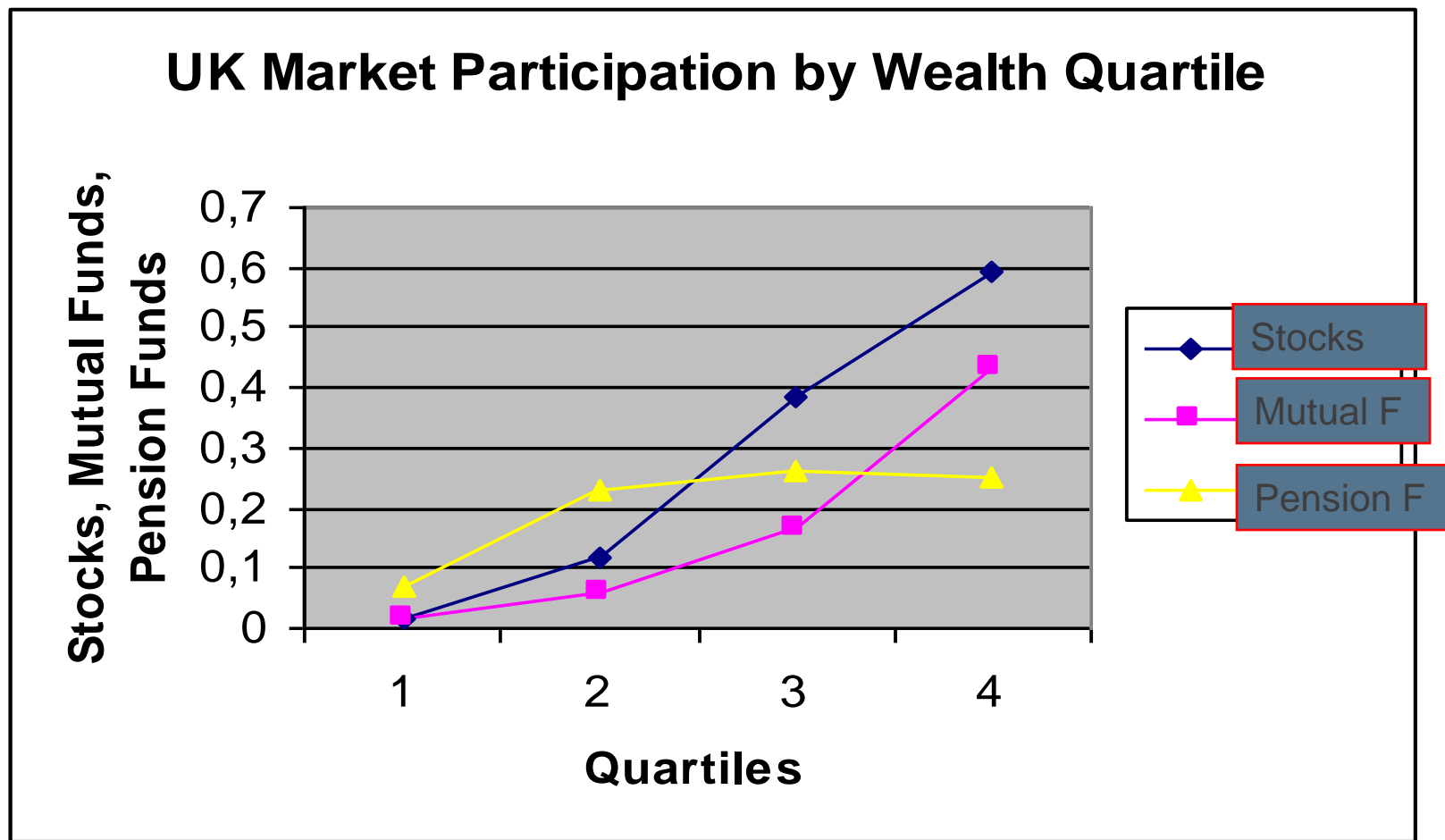
Key features

- Democratisation of finance
- Flexibility in accumulation and drawdowns in pre-retirement, and retirement in its various phases
- Need for guidance and support for the “individual”

Democratisation of finance

- In the UK pensions have broadened the participation to financial markets
- Riester Plans effectively have created new market participation in Germany
- The Netherlands and Sweden have virtually full working population participation

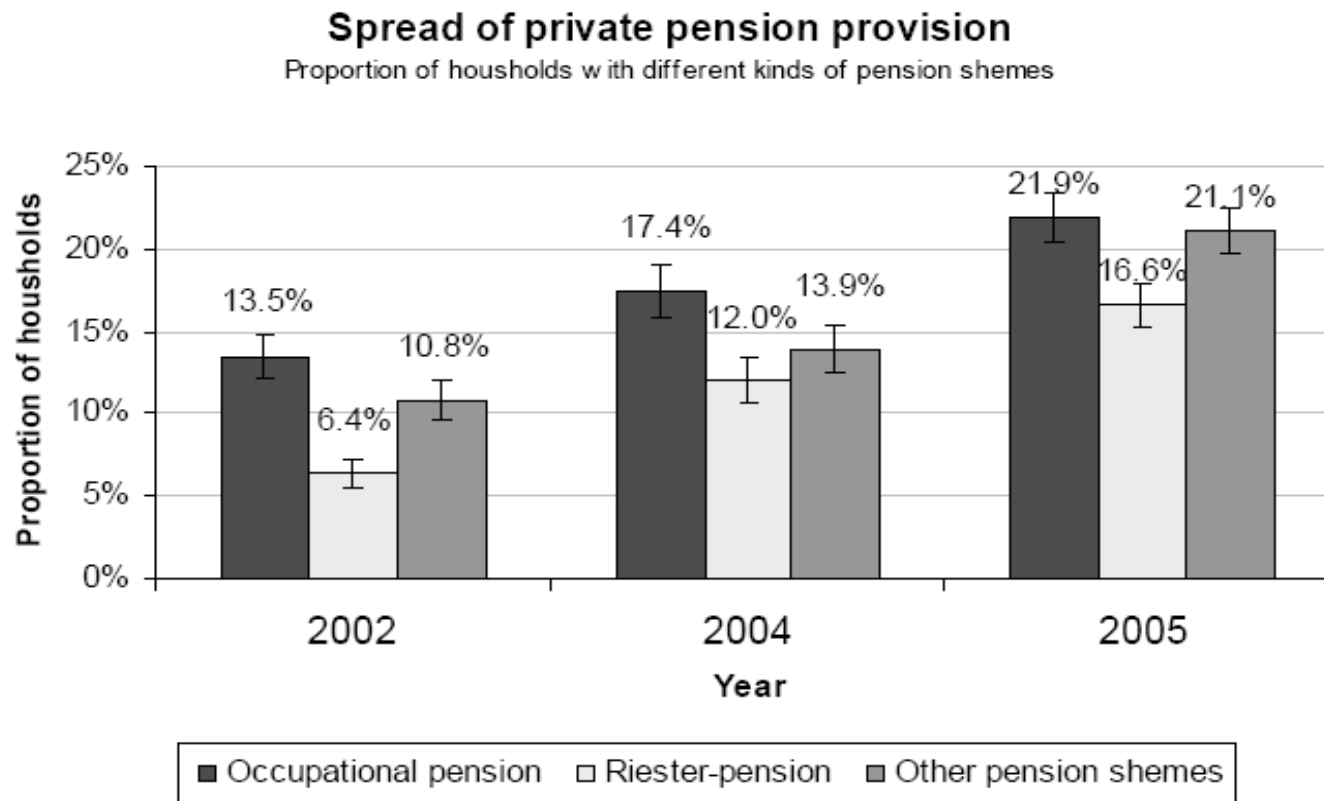
Democratisation of finance (1): broadening the access is an issue...



Source: James Banks and Mathew Wakefield – Stock Market Participation in the UK-
In Luigi Guido, Tullio Jappelli, Michael Haliassos Stockholdings in Europe OEE 2003

The spread of pension provisions in Germany

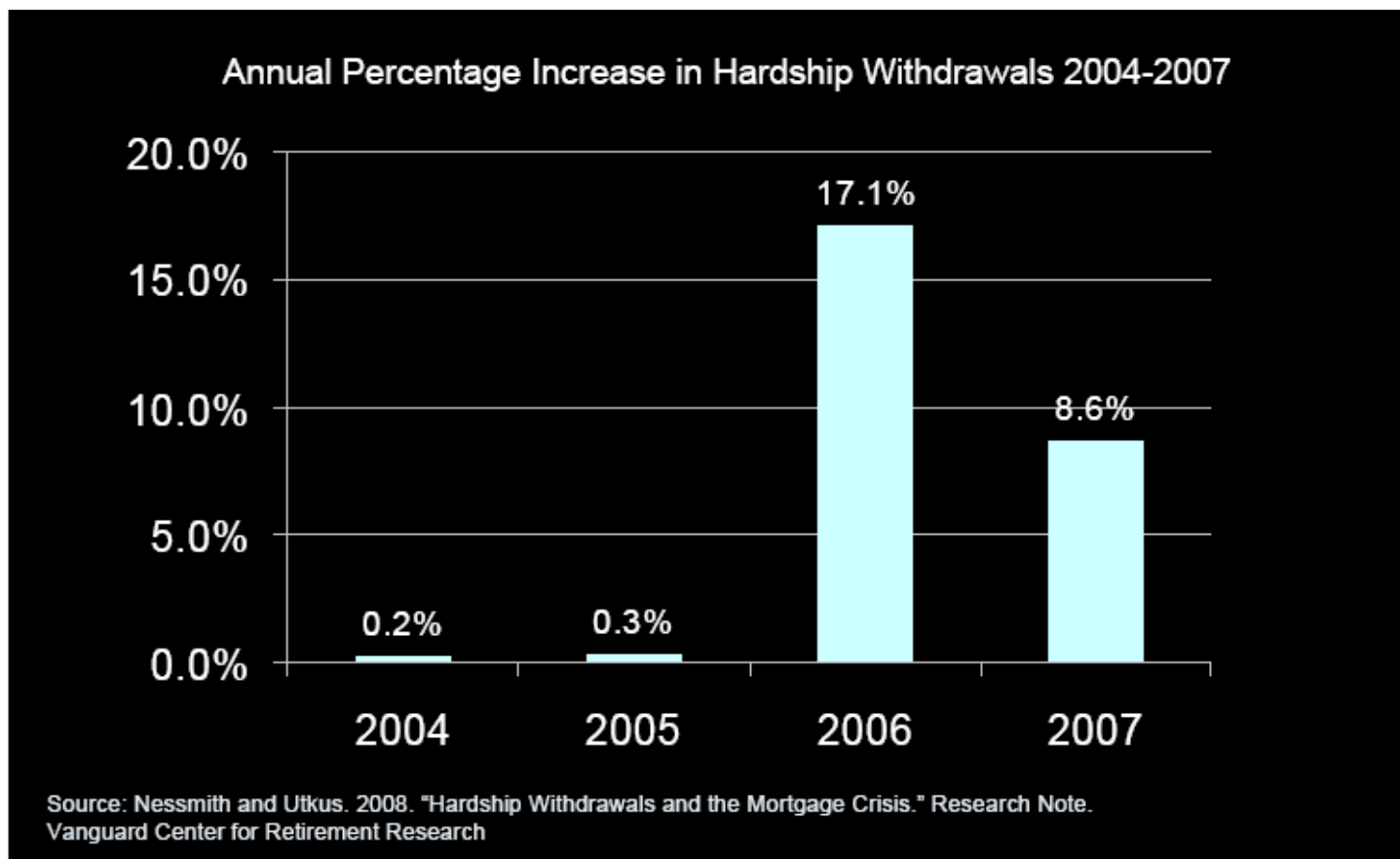
Figure 3: Spread of different private pension instruments



People learn to manage flexibility in accumulation and de-accumulation

- You may need to borrow on your pension fund and this, given proper regulation, may not lead to misbehaviour
- You may have a “fuzzy” pre-retirement period in which you start working less and de-accumulate little or nothing
- Regulators are pushing for postponing annuities closer to “very old age”

Hardship withdrawals on 401 ks....



Why 401(k) Loans?

- Positive effect on participation and contributions
- But, could reduce retirement saving
Undermines the effort and expense of creating tax-preferred savings

Guidance and support to the “instividual”

- The risks and impossibilities of totally compulsory solutions
- The long way to investor education
- Dilemmas on default solutions