THE OECD ROADMAP FOR THE GOOD DESIGN OF DEFINED CONTRIBUTION PENSION PLANS

This roadmap has been approved and endorsed by the OECD Working Party on Private Pensions in June 2012

Defined contribution, private pension plans are increasingly an integral part of most countries’ overall pension system, while for some countries they are the main component of their pension system. Therefore, overall retirement income adequacy depends importantly on the pension benefits stemming from these plans.

In seeking to assist countries to strengthen retirement income adequacy in a defined contribution environment, the OECD Working Party on Private Pensions has identified elements of good design and public policy. This roadmap for the good design of defined contribution plans consists of the following recommendations:

1. **Ensure the design of DC pension plans is internally coherent between the accumulation and payout phases and with the overall pension system.** Consequently, the target retirement income in DC plans should be determined consistently with the benefits provided by the other components of the pension system. To define and achieve this target, all possible risks (i.e., labour, financial and demographic risks) affecting retirement income of DC pension plans should be monitored.

2. **Encourage people to enrol, to contribute and contribute for long periods.** Where mandatory enrolment is not considered opportune, mechanisms such as automatic enrolment, with the possibility for individuals to opt out, are particularly useful, together with setting adequate default contribution rates. Making sure people contribute for long periods with sufficiently high contribution rates is the most effective way to improve their chances of obtaining an adequate replacement rate from DC pension plans. This goal needs to be complemented with “work longer” policies.

3. **Improve the design of incentives to save for retirement, particularly where participation and contributions to DC pension plans are voluntary.** An appropriate structure of tax incentives (including financial subsidies for those who pay low or no income taxes) and/or matching contributions can both be efficient mechanisms to encourage participation and increase contributions.

4. **Promote low-cost retirement savings instruments.** Policymakers need to ensure that there are incentives in place to improve efficiency and reduce costs in the pensions industry. Disclosure-based initiatives should be promoted, but may need to be complemented with more effective solutions such as appropriate tender mechanisms or default allocation to low-cost providers, especially in compulsory or auto enrolment systems. In certain pension’s structures, cost issues can be addressed by establishing large pension schemes, run on a non-profit base.
5. Establish appropriate default investment strategies, while also providing choice between investment options with different risk profile and investment horizon. As many members may be unwilling or unable to choose investments, default options need to be carefully designed following the lessons learnt from behavioural economics. But if they wish, people should be allowed to choose the investment strategy best suited for them according to their risk profile and their level of risk tolerance, as well as their different overall pension arrangements.

6. Consider establishing default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes. Life-cycle investment strategies reduce the impact of market risk on the account balance as the member ages. Such a design is consistent with economic rationale and risk attitudes and is therefore well-suited for default strategies.

7. For the payout phase, encourage annuitization as a protection against longevity risk. A certain level of annuitization of balances accumulated in DC pension plans should be set as the default mechanism for the payout phase, unless pay-as-you-go public pensions or the old-age safety net already provide for sufficient regular pension payments. A combination of programmed withdrawals with a deferred life annuity (e.g. starting payments at the age of 85) that offers protection against inflation could be seen as an appropriate default. The demand for annuities could be also promoted by financial education initiatives stressing that they are insurance products designed to protect people from outliving their resources. Lump-sum payments may have to be discouraged as a form of benefit pay-out, except for small DC account balances.

8. Promote the supply of annuities and cost-efficient competition in the annuity market. Different providers, such as public schemes, non-profit occupational plans, and insurance undertakings may provide different arrangements of risk-sharing in the payout phase that may help strengthen benefit adequacy and diversify risks in retirement income. Competition among different providers in the market for individual and group annuities should be promoted to ensure cost-efficient provision for plan members and to help develop the annuity sector as a whole.

9. Develop appropriate information and risk-hedging instruments to facilitate dealing with longevity risk. The market for annuities would benefit from certain actions aimed to making the management of longevity risk easier. Firstly, reliable life tables should be made available by public statistical agencies; they should be regularly updated and incorporate stochastic forecasts of future improvements in mortality and life expectancy. Secondly, capital market solutions to longevity risk management could be promoted by producing standardised, publicly and readily available longevity indices. While there has been no successful example of longevity bonds thus far, governments could additionally consider in certain contexts issuing longevity indexed bonds and issuing very long-term bonds in enough quantities.

10. Ensure effective communication and address financial illiteracy and lack of awareness. Effective communication includes providing regular individualised benefit statements. In addition, clear benefit projections under prudent assumptions, informing members about the possible impact of higher contributions or later retirement on their benefits could also be made available. Plan members should also have free and ready access to comparative information about costs and performance of different providers, and the language used in disclosed materials should be readily understood by them.