THE GENEVA ASSOCIATION

An insurance solution to people outliving their retirement savings

Ronald Klein, Director, Global Ageing research programme, The Geneva Association

World-wide life expectancy is at a record high and expected to increase. Fertility rates are at a record low. This puts extreme financial pressure on government-supported social retirement (Pillar I) plans, leading to increasing contribution rates, decreasing benefits, or a combination of both. It is therefore more important than ever for individuals to provide for themselves through occupational pensions (Pillar II) and personal savings (Pillar III).

The paper focuses on Pillar II pensions in three countries: the U.S., the U.K. and Switzerland. These countries have different regulations and different savings cultures, that make a comparison quite interesting. Although there is no one-fits-all approach that will work in all countries, learning the benefits and drawbacks of specific systems can certainly assist with new and better approaches to retirement solutions around the world.

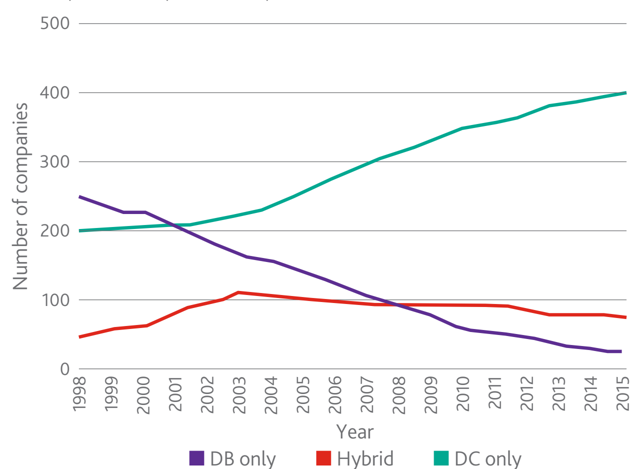
The U.S.: Transferring retirement risk from employers to employees

There are two basic types of occupational pension systems: defined benefit plans that are usually funded by the employer, and provide a monthly pension on retirement depending on length of service, age and salary; and defined contribution plans, where both employer and employee make equal contributions, and on retirement the employee has to decide whether to withdraw the monies as an annuity or as a lump sum. Some companies offer hybrid pension plans that are a mixture of the two types.

During the past two decades, corporations have been switching from defined benefit pension plans to defined contribution plans.

Figure 1: Pension plans of Fortune 500 companies

DB: defined benefit / DC: defined contribution



Source: Willis Towers Watson, A Continuing Shift in Retirement Offerings in the Fortune 500 Companies, 2016.

There are many advantages to defined contribution plans: the funds are held on behalf of the individual employee instead of being lumped together as pension assets for all employees; there is less credit risk for the employee as default by the employer could cause some reduction in defined benefit plans payouts[1]; these plans are typically offered to a greater proportion of employees than defined benefit plans were; the the accumulation of funds is more transparent, which might in some cases encourage the employee to save more; the funds are completely portable (the assets can be transferred tax free to another employer if the employee changes companies or into an Individual Retirement Account); and the employee has the ability to change investments, within broad parameters, to better suit his or her individual needs.

1 The Pension Benefit Guaranty Corporation (PBGC) mitigates most of this risk by managing failed pension plans with a combination of the failed plan assets and premiums it collects from all pension plans.

However, corporations made the switch to save money and reduce the longevity and investment risk. Economists will argue that a reduction in costs for employers will find its way back into the pockets of employees through the increase in other benefits or higher wages. Even if this were true, the risk once borne by the employer now rests squarely on the shoulders of the employee.

It is relatively new for people to retire with defined contribution plans instead of defined benefit plans in the U.S. While regulations allowing tax-deferred savings plans were created with the best intentions, these regulations did not fully take into account the difficult decisions employees need to make on retirement. The Employee Retirement Income Security Act of 1974 (ERISA) makes it very difficult for employers to offer advice or lifetime annuity options within the savings plan, so employees have to determine what to do with their savings accounts with little or no assistance. However, new and proposed legislation is leaning in the direction of making advice and 'in-plan' annuities possible.

The U.K.: More freedom for retirees, more pressure on the government

While the U.S. seems to be moving in the right direction, the U.K. seems to be moving in a different direction. A new regulation that became effective in 2015, known as the Freedom and Choice in Pensions Act or simply pension freedoms, repealed the requirement to annuitise Pillar II retirement savings. Now employees are free to spend retirement savings as they wish after a certain age, as in the U.S., but with two important differences.

First, U.K. plans have been phasing in a mandated automatic enrolment feature since 2012. Automatic enrolment means that if employees do not specifically opt out of the plan, they would be enrolled by default. This has caused a dramatic increase in the number of people enrolled in Pillar II plans (see Table 1). However, this automatic enrolment feature places the employee in the lowest contribution category causing a decrease in the amount of combined employer and employee contributions (see Table 2).

Table 1: Percentages of eligible employees with workplace pensions: by banded rate of employee contribution in the private sector, 2010 to 2016, Great Britain

Banded contribution rate	2010	2011	2012	2013	2014	2015	2016
Zero	17.3	17.9	17.9	12.6	9.2	7.1	7.7
0-2%	5.0	5.0	4.7	9.6	29.9	37.1	38.8
2-3%	10.4	10.0	10.2	10.4	9.0	8.8	8.8
3-4%	11.8	12.4	11.7	11.7	10.1	9.1	9.3
4-5%	12.7	12.2	12.2	11.7	9.6	8.8	8.7
5-6%	12.8	12.8	12.7	13.1	9.8	9.2	8.2
6-7%	15.8	16.0	11.1	10.1	7.1	6.4	5.3
7 and over	14.2	13.6	19.5	20.7	15.3	13.4	13.4

Source: Department for Work and Pensions estimates derived from the ONE ASHE, GB, 2010-2016.[2]

Table 2: Percentages of eligible employees with workplace pensions: by banded rate of employer contribution in the private sector, 2010 to 2016, Great Britain

Banded contribution rate	2010	2011	2012	2013	2014	2015	2016
Zero	4.7	3.8	3.5	3.3	2.3	1.8	1.6
0-2%	2.8	2.7	2.6	6.9	26.6	33.3	34.9
2-4%	10.9	10.9	11.2	11.9	11.9	12.3	12.9
4-6%	16.5	16.0	15.5	15.6	12.9	12.0	12.5
6-8%	11.1	11.6	11.6	11.9	9.4	8.4	8.5
8-10%	8.9	9.4	10.5	9.4	7.1	6.3	6.0
10-15%	21.1	23.2	23.9	21.5	15.8	14.5	10.6
15+ %	24.0	22.5	21.2	19.6	13.9	11.4	13.1

Source: Department for Work and Pensions estimates derived from the ONE ASHE, GB, 2010-2016.[2]

2 Department for Work and Pensions (2017) Automatic Enrolment Review Report, ISBN 978-1-78659-003-9, December.

Second, as a result of pension freedoms, all participants of defined contribution plans aged 50 and over need professional retirement guidance. This currently takes the form of general guidance from government workers on the options available. The next step is paying for an advisor.

There were many political and financial reasons for the enactment of the pension freedoms regulation. While the outcome is not yet clear, spending money that is meant for retirement on other goods or services may put pressure back on the government.

Switzerland: The benefits of automation

The Swiss Pillar II retirement system makes full use of 'Nudge Theory', first described by Nobel Prize-winning behavioural economist Richard Thaler.[3] The Swiss system has automatic enrolment into the plan, automatic escalation of benefits with age and duration of employment, and automatic annuitisation into a lifetime annuity. This dynamic combination of automatic features causes the average Swiss employee to save more for retirement than his or her counterpart in the U.S. or U.K (see Table 3).

Table 3: Employee and employer contribution rates to Swiss Pillar II pension plans

Age	Basic option - Employee contribution (%)	Standard option - Employee contribution (%)	Top option - Employee contribution (%)	All three options - Employer contribution (%)
21 to 23	2.0	4.0	6.0	6.0
24 to 27	3.2	5.2	7.2	7.8
28 to 32	4.4	6.4	8.4	9.6
33 to 37	5.6	7.6	9.6	11.4
38 to 42	6.8	8.8	10.8	13.2
43 to 47	8.0	10.0	12.0	15.0
48 to 52	8.8	10.8	12.8	16.2
53 to 65	9.6	11.6	13.6	17.4
66 to 70	4.0	6.0	8.0	9.0

Source: BVK, www.bvk.ch, 2017.

The power of these nudges can be seen by the fact that about 57 per cent of people in Switzerland at least partially annuitised their pension in 2015, according to Schweizer Pensionkassenumfrage statistics. While the percentage of people converting Pillar II defined contribution pensions plans at least partially to annuities in 2015 was lower than the 2010 annuitisation rate, the percentage of funds annuitised increased from 75 per cent in 2010 to 83 per cent in 2015.

3 Thaler, R.H. and Sustein, C.R. (2009) Nudge: Improving Decisions About Health, Wealth, and Happiness, ISBN: 978-1-101-65509-2, Penguin Books 2009

Conclusion: Incentives, incentives, incentives

It is difficult to construct one system of occupational pensions that would work in every country. Not only do the demographic and economic environments differ but, more importantly, savings cultures differ. It is clear that in the current low interest rate environment, it is much more difficult to 'sell' the idea of a lifetime annuity.

The governments of most developed countries offer their residents an incentive to save for retirement as part of a social programme, through employment, individual savings, or as a combination of all three. This is mainly accomplished through a system of deferred or even waived taxation. Since governments are offering this option, they should have some say in how the money is used. Allowing the participant to use the money for purposes other than retirement places the burden of old-age poverty back onto the state.

It seems reasonable to require that at least some of the savings be used for lifetime income. How much is certainly a debatable issue, but requiring that residents annuitise enough so that they live above the poverty line can only be beneficial to all parties.