

The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

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PENSION REFORM:

TOWARDS A GLOBAL PENSION ‘GOLD STANDARD’

When it comes to pensions, the buck has been passed from employers to employees. But too few workers realize how much they need to contribute to guarantee a decent retirement, or feel confident enough about how to invest their funds....”

from “Falling Short”
The Economist,
June 12, 2008

Spotlight on Pension Reform

Pension reform seldom gets the public attention it deserves. This should not surprise us. Public policy issues requiring long horizon perspectives are predictably crowded out by their more spectacular ‘here-and-now’ counterparts (e.g., the price of oil breaking \$140/barrel). So we applaud *The Economist* for its recent comprehensive article on ‘the trouble with pensions’ (cited above). We also applaud the recent initiatives by some governments to better understand ‘the trouble with pensions’, and in some cases, to actually take steps to improve the future pension prospects of their citizens. The UK currently leads the pension reform parade, with the impressive Turner Commission reports of 2004 and 2005 followed by legislation to implement its key recommendations in 2006 and 2007. However, more recent initiatives in the EC, and by a number of American states and Canadian provinces are also worthy of note.

All this gets us to the goals of this *Letter*. It is to create a framework that can be used as a guide to discover the direction in which effective pension reform lies, and then to use that framework to establish a global pension ‘gold standard’ against which to judge the likely effectiveness of actual pension reform measures being proposed, or that are in the process of being implemented.

A Global Pensions ‘Gold Standard’

We start by noting the convergence of an exciting series of developments that are finally bridging long-standing pensions theory-practice gaps in such critical areas as pension design, pension delivery, and pension rules and regulations. For example:

- Pension Design: while the life-cycle theory of personal finance has been around for decades, it is finally being used effectively to take a critical look at enhancing pension design. There are, after all, important linkages for every adult between maintaining a target standard of living over a lifetime, and such factors as work-life length, savings rates, investment returns, and longevity. Important new insights have also come from the fertile field of ‘behavioral finance’. Studies confirm that most people are not equipped (either emotionally or technically) to make the kind of financial decisions life-cycle theory demands. The implication is that effective pension system designs have a series integrated ‘default’ rules related to auto-enrolment, target pension, risk-pooling, investment policy, and implied contribution rate. Logically, such systems should cover the entire workforce.