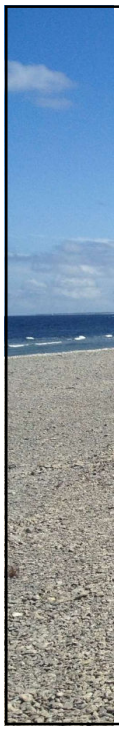

Beier Research

Free choice and choice architecture in Danish occupational pensions

Pensions, financial planning and Choice Architecture
Amsterdam, Netherlands 3 October 2018

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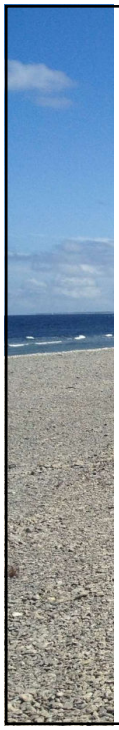
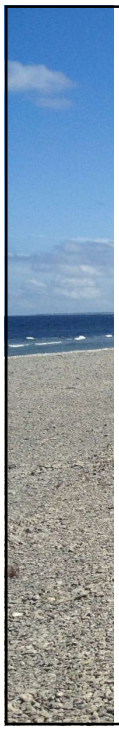


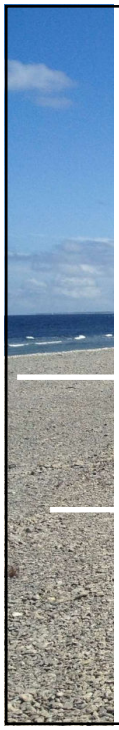
The agenda

- The Danish pension system – a quick guided tour
- The space and scope for choice
- Choice options and choice architecture
- Free choice and market dynamics
- A personal perspective – life around age 60

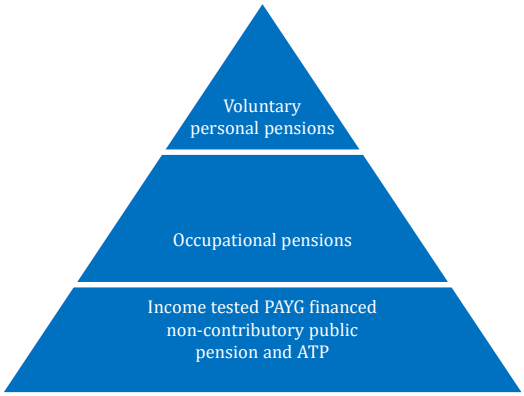


The Danish pension system…

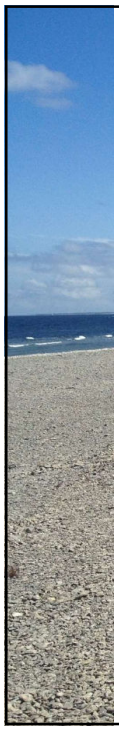
- Pillar 1: A twinned basic pension:
  - The state funded basic pension: a flat PAYG financed, non-contributory, universal basic pension subject to an income test
  - ATP: A mandatory, contributory DC insurance scheme based on flat rate contributions.
- Pillar 2: Occupational pensions
- Pillar 3: Individual personal pensions
- Pillar 0: Housing benefits and other social assistance provide further security



…is often described as a pyramid

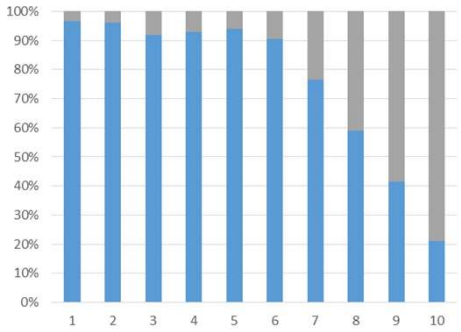


- Sustainability, adequacy and flexibility…
- …all objectives matter!!
- Components play different roles,…
- …their importance vary across income,…
- …gender and age

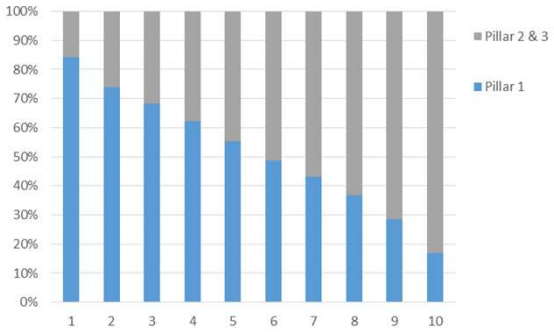


Consider the income compositon in old-age…

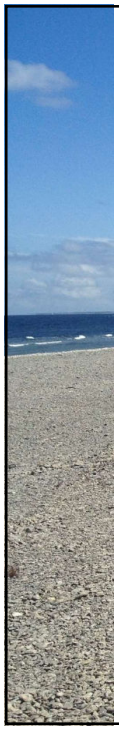
Income composition among pensioners 2013



Forecasted income composition among pensioners 2040

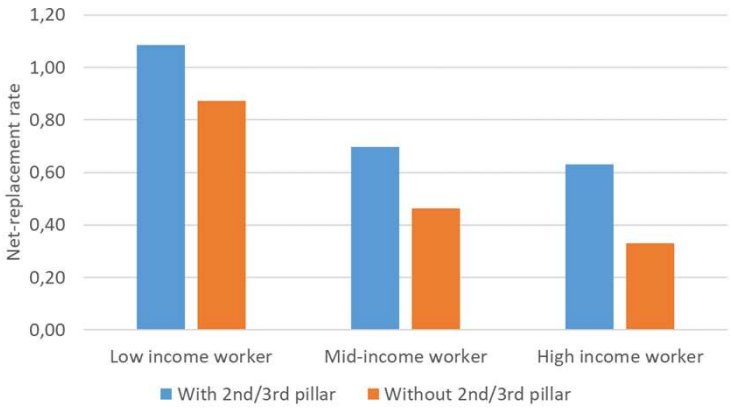


Source: ATP 2014.

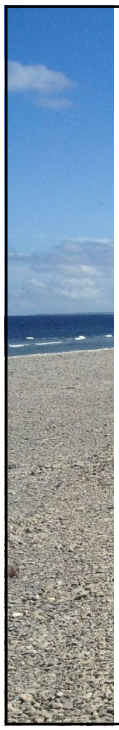


…and the expected TRRs

Theoretical net-replacement rates in the mature Danish pension system

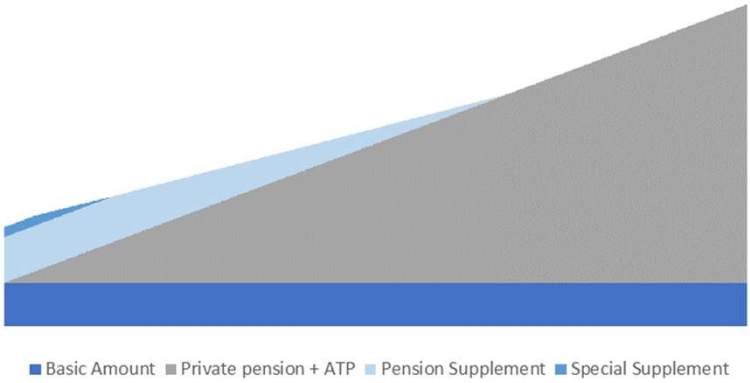


Source: Beier Sorensen et al. 2016.

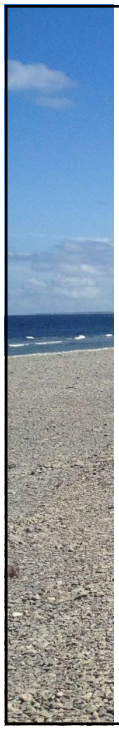


Public and private pensions interact and affect private pension planning and design

The basic public pension is income-tested

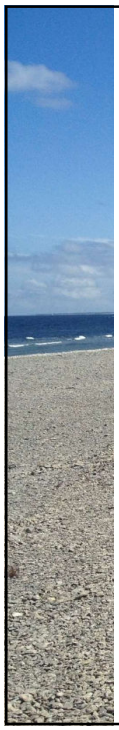


Source: Beier Sorensen et al. 2016.



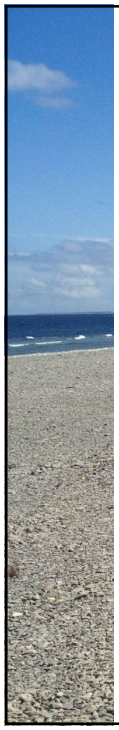
Choice options

	Universal PAYG- and tax-financed public pension	Mandatory funded DC pension - ATP	Quasi-mandatory occupational DC insurance based pensions	Individual voluntary DC pensions
Pension age	Pension age currently 67. Indexed to longevity going forward. Actuarial increase in the event of deferred retirement		Minimum pay-out age currently 60 years moving to statutory pension age minus 3. Actuarial decrease/increase in the event of early/deferred retirement	
Savings rate			Collective agreement sets standard - often possible to increase	Individual decision
Type of savings vehicle			Scheme defines default with some flexibility - tax codes define the framework	Individual decision - tax codes define the framework
Investment strategy			Scheme defines default often with some flexibility	Individual decision
Pension provider			Collective agreement decides	Individual decision
Withdrawals before pension age			In practice not possible	Possible subject to a tax-rate of 60%



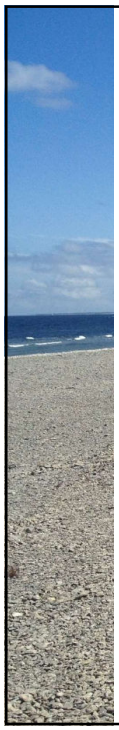
Tax rules, collective agreements and free choice

- Savings contracts are categorized by their end product when issued
- Pension savings enjoy a lower tax – 15% - on returns to investments
- Tax rules limits the space for free choice
  1. Life-long annuities – contributions are deductible from the taxable income (at the marginal tax rate) without limit
  2. Terminating annuities – contributions are deductible from the taxable income (at the marginal tax rate) subject to a cap
  3. Lump sum savings - – contributions are paid after tax subject to age related caps (low maximum up untill the sage of 60)



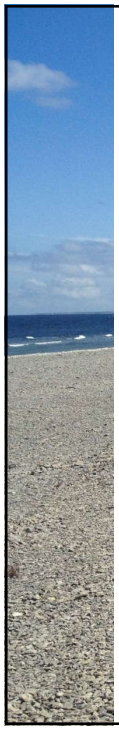
Recent regulatory changes affect free choice

- Axiom: Public and private pensions must be aligned
  - Saving for retirement must pay
  - Saving for retirement should focus on retirement
- The extensive use of income tests provide risk sharing at the cost of high implicit tax rates
  - Focusing access on older workers eases the tax wedge
- Terminating annuities should not be used for tax planning
  - Cap on contributions for terminating annuities limit tax planning
- The minimum pay-out age for private pensions must increase with the statutory pension age – i.e. longevity



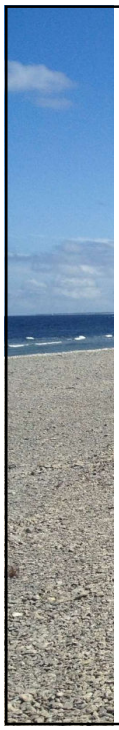
Recent product changes affect free choice

- Free choice and flexibility have climbed the agenda…
- …and the low interest environment somehow drive in the same direction
- Typical responses:
  - Increased focus on information and transparency
  - Lump sum payments from the old age deposit to the estate in the event of death
  - Possibility to reduce or opt out of survivors coverage
  - Possiblity to increase focus on terminating annuity savings
  - Possibility to forego guarantees and adopt a more return seeking investment strategy – often with a structured fund choice option
- Free choice of occupational pension provider is ruled out



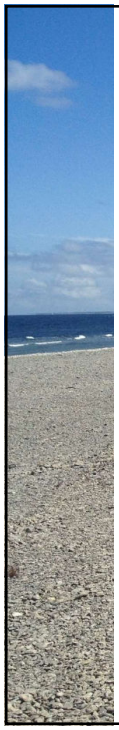
A collective approach…

- Some 85-90% of the private pension market is occupational…
  - …based on collective agreements, most of which are group specific…
  - …providing a well defined starting point for design considerations
- The design rationale and the need – and request - for free choice options will differ accross groups
- The socio-economic characther of the group affects the priority given to costs, product variability and flexibility, client services…
- Accross groups: Cost and efficiency benefits are very high…
- …while the use of free choice options is very limited



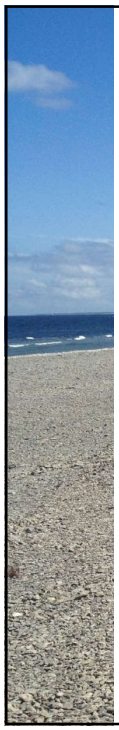
…- high powered and strongly competitive…

- Low costs, strong pension products and attractive investment results
- Competition supplorted through transparency and reporting…
- …targeting the specialist press, industry research and academic research as much as individuals
- Experience: Free choice is not a precondition for competition,…
- …and neither does free choice automatically strenghthen competition and lead to better performance and products



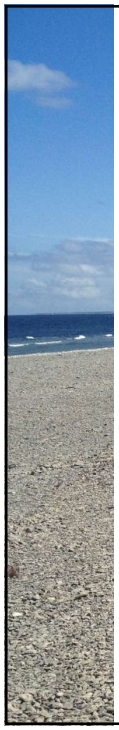
…with limited free choice

- The Danish experience:
  - Free choice is not a precondition for competition,…
  - …and neither does free choice automatically strenghthen competition and lead to better performance and products
- Sweden has extensive free choice, but the experience is the same:
  - Market development is not driven by individual free choice as such,…
  - …but rather by the use of collective platforms to define, negotiate and survey choice options and terms



Life around age 60

- Too late to fundamentally change conditions in retirement,…
- …other than by deferring retirement
- Existential and financial questions dominate:
  - When do I think, I would like to retire? – attitudes have changed
  - What should the last 10 years of the work life look like?
  - Health conditions?
  - Family relations?
  - What does the financial situation look like and can it be influenced? – supported by pensionsinfo.dk on pensions, but other wealth must also be considered



The longer term – living 10, 20, 30 or even 40 years in retirement?