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Annual DC Pension Statements and the Communications Challenge

Pablo Antolín, Debbie Harrison

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Abstract

ANNUAL DC PENSION STATEMENTS AND THE COMMUNICATIONS CHALLENGE By Pablo Antolín and Debbie Harrison

This paper examines and evaluates the content and design of the annual pension statement sent to members of funded defined contribution (DC) pension schemes in a selection of OECD and non-OECD countries. The aims of the research are to identify the potential shortcomings in statement planning and design processes, to consider potential barriers in communications to members, and to highlight trends and models of good practice in these critical areas. The overarching objective is to develop recommended guidelines for organisers, so that the statement can be developed as an effective (impact) and efficient (cost-benefit analysis, value for money) medium to deliver essential member information and to encourage appropriate member actions.

JEL codes: D14, D18, G23, G28, I28, J26, O16, O19

Keywords: Pension statement, defined contribution, financial literacy, financial education, communication.

Résumé

RELEVES ANNUELS DE RETRAITE DES PLANS A COTISATIONS DEFINIES ET LE DEFI DE LA COMMUNICATION

By Pablo Antolín and Debbie Harrison

Ce document examine et évalue le contenu et la forme du relevé annuel de retraite envoyé aux adhérents des plans de retraite par capitalisation à cotisations définies dans certains pays de l'OCDE et hors OCDE. Les objectifs de la recherche sont d'identifier les éventuels défauts dans les processus de planification et de conception du relevé, de considérer les barrières potentielles dans les communications aux adhérents et de souligner les tendances et modèles de bonnes pratiques dans ces domaines essentiels. L'objectif global est de développer des directives recommandées pour les organisateurs, de manière à ce que le relevé puisse être élaboré comme un moyen efficace (impact) et efficient (analyse de rentabilité, rapport qualité/prix) pour délivrer l'information essentielle aux adhérents et encourager des actions appropriées de leur part.

Codes JEL:

Mots clés: Relevé annuel, plans de retraite à cotisations définies, alphabétisation financière, éducation financière, communication.

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EXECUTIVE SUMMARY

This paper examines and evaluates the content and design of the annual pension statement sent to members of funded defined contribution (DC) pension schemes in a selection of OECD and non-OECD countries. The aims of the research are to identify the potential shortcomings in statement planning and design processes, to consider potential barriers in communications to members, and to highlight trends and models of good practice in these critical areas. The overarching objective is to develop recommended guidelines for organisers, so that the statement can be developed as an effective (impact) and efficient (cost-benefit analysis, value for money) medium to deliver essential member information and to encourage appropriate member actions.

The key findings of the research are as follows:

1. The primary objectives of many pension statements are confused. Some pension providers appear to use statements largely to comply with regulatory disclosure requirements, while others use the statement to increase understanding and to prompt member action. The key difference here is that the former represents a passive document, while the latter is proactive: it aims to engage members and to encourage them to take important actions to improve their retirement income.
2. The use of evaluation techniques is inconsistent. Quantitative, and in particular qualitative, research on member attitudes and responses to statement content and design is lacking in certain cases. There is a trend towards improved evaluation, however, for example where statement organisers conduct consumer research that tests whether the format and language used in the statement helps to increase member understanding and empowers them to take positive actions.
3. There is a disconnection between the acknowledged need for brevity, clarity, and simplicity, and the perceived need for an explanation of complex DC risks, for example in relation to how future employment patterns, inflation rates, investment returns, and longevity trends might affect the potential retirement income. From the consumer-focused evaluation research examined in this report, it is evident that most members do not read, let alone engage with long and complex documents. Where proactive organisers are using consumer testing to improve statement design, the trend is towards a simple summary of key facts on the first page of the statement.
4. Regulatory disclosure requirements further undermine the objective of producing statements that are brief and simple. Instead of enhancing impact and reassuring members, the language and format of many disclosure statements examined for this report are considered more likely to act as a further barrier to understanding and active engagement.
5. Most pension statements are annual but in a minority of cases they are more frequent. Given the potential volatility of investment markets, it is not clear what purpose is achieved by monthly statements, provided there is an online account that facilitates regular reviews at the member's discretion. An important exception here is the additional statement sent as an alert, for example where it is necessary to draw attention to a new pension reform or to reassure DC plan members in the wake of a financial crisis.
6. The DC projection represents the most contentious area of debate in relation to pension statements. The debate is shaped by the fraught attempt to reconcile regulatory requirements and provider's desire to explain risk and probability with the member's understandable desire to see a simple projected retirement income that is expressed as a monetary value. Without this the member is unable to take action to improve the outcome. All of the statements examined in this

report use deterministic projections, which are based on fairly simple assumptions. Even these appear to cause members difficulty – indeed members might not even understand the term “projection”. Despite these fundamental issues, a minority of countries are considering the introduction of stochastic modelling in order to convey uncertainty more effectively, although this is likely to be restricted to the website. Overall, therefore, current practice and future trends in statement projections present a very diverse picture that requires much more analysis to ensure the primary objective of empowering individuals to make informed choices is achieved.

7. The annual interest rate or investment return assumptions used in projections vary widely, suggesting that in some cases the higher rates are not realistic and do not reflect current market conditions and historical experience. A return assumption of 8%, for example, as found in certain examples in this research, is potentially misleading. Moreover there is a marked inconsistency in the way that supervisors and regulators prescribe projection assumptions and whether or not these should take account of inflation and actual plan charges.
8. The written statement, as the sole means of communicating benefits, increasingly is recognised as inflexible and limited. While a written statement is considered necessary, due to the fact that internet access and usage is not universal, there is a trend towards greater emphasis on internet facilities and in particular the pension calculator. Overall, the internet appears to offer a more flexible delivery format that avoids information overload, as it allows the member to access information in accordance with their needs, while the web calculator is a powerful tool that encourages active member engagement and improves awareness of the connections between contributions and retirement income, among other factors.
9. There is a growing recognition that the value of the pension statement is limited if it refers to a single plan. While the provision of combined statements is considered complicated, there is a slow but welcome trend towards a document that sets out the member’s position in relation to the individual’s main pension sources, including state (public) pensions.
10. The challenges for pension statements reflect certain global trends, such as the increasing government emphasis on funded DC systems to provide a significant proportion of individual retirement income. However, while international comparisons provide considerable insight into planning, design and evaluation processes, such comparisons must always take account of important national differences.

I. DC Pension Statements in Context

The increased importance of the pension statement reflects a major global trend towards funded DC systems. The rationale for the introduction of these systems varies considerably but in many cases this is a political and socio-economic response to the challenge of ageing populations, characterised by improvements in mortality and life expectancy.¹ As a result of these demographic trends governments make the case that they cannot afford adequate and sustainable state (public) retirement incomes based on pay-as-you-go (PAYG) systems financed from taxation and social security contributions. At the same time many private sector employers argue that they cannot afford to bear the risks of defined benefit (DB)

¹ The sharp increase of birth rates in the 1950s and 1960s, followed by the return of birth rates to previous levels, created the “baby boom” generation. The retirement of this generation represents a significant social and economic challenge for all pension systems but in particular for PAYG-financed systems, as there is an imbalance between the cohorts joining the labour market and the baby boom cohorts entering retirement. However, while the baby boom impact is temporary, the impact of improvements in mortality and life expectancy (longevity) appears to be a permanent feature (wars and pandemics excepting), which creates problems for PAYG-funded and funded pension systems alike.

schemes for future cohorts of workers. The overall result is that for an increasing number of countries the success of the funded DC system will be the determining factor in the adequacy and sustainability of old-age incomes for future retirees.

‘Providers’ is a broad term used in this report to describe the pension organisations in different markets that deliver the plans and schemes. This might include a national scheme established and run by the government, plus the schemes and plans for employees, employers and the self-employed run by private financial institutions, such as asset managers, banks, insurance companies, and pension fund entities. The annual DC pension statement is the document used by governments (in the case of national centralised schemes) and by providers (in the case of private individual and employer-sponsored plans), to set out members’ benefits, as required by regulatory disclosure rules. To a greater or lesser extent providers also use the document to improve the member’s understanding of the DC plan in general and in particular to set out member rights, options and obligations. The statement is likely to be the most frequent form of written communication members receive about their private (and in some cases state/public) DC pension fund.

Pension statements reflect the national system, as prescribed in legislation and regulation. The OECD identifies three basic structures for national funded DC systems: voluntary, quasi-compulsory (auto-enrolment of employees), and fully mandatory. Within this tripartite model there are significant variations in the accumulation and decumulation rules. Moreover, once established, these systems continue to be refined. Notable trends include the transition from voluntary to quasi-compulsory systems, the increase of mandatory employee and employer contributions, a rise in the legal age at which benefits can be drawn, and restrictions in the way that benefits can be taken.

There are significant communications barriers that prevent members from making optimal use of their statements. Most providers – including the government in the case of certain national systems – assume that the average member has a low level of financial literacy and does not have access to expert advice.² They acknowledge that the statement should be brief, clear and simple. However, beyond the basic accounting information (the current fund value and value of contributions paid in the statement period, for example), there is little consensus as to what other information should be provided, how this should be presented, and how supervisors, regulators and providers might evaluate its effectiveness in achieving the desired objectives.

Unlike pension systems that provide a defined benefit at retirement, the DC outcome is uncertain.³ Under mandatory and quasi-compulsory systems, among other features supervisors tend to prescribe the minimum enrolment age, the minimum age at which benefits can be taken, and the minimum level of employer and employee contribution (but less frequently the contributions of the self-employed). Unknown or less predictable factors include the member’s future employment prospects, the investment returns net of plan charges, the impact of inflation, and the impact of longevity trends (which affects the annuity conversion rate, for example).⁴ The challenge for the pension statement is to explain these

² OECD (2008): Improving Financial Education and Awareness on Insurance and Private Pensions; Lusardi, A. and O. Mitchell (2007), “Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education,” *Business Economics*, Jan. 2007. See www.financial-education.org for OECD work on this subject.

³ The OECD paper on “Human capital and protecting DC retirement income,” provides a discussion of how labour market, financial market and demographic risk may affect the retirement income from DC pension plans. It provides a range of possible retirement income outcomes with their probabilities.

⁴ In some countries, including Belgium, Denmark, Germany and Switzerland, DC plans offer a minimum rate of return, although the rate can change in response to market conditions.

uncertain factors in a way that improves the member's level of knowledge and understanding and, where appropriate, enables members to take positive action to improve the outcome.

Most notably there is disagreement over the 'forward looking' (pension projection) information, whether this should be included and, if so, how this should be calculated and presented. While in theory projections can act as a powerful call to action – to encourage members to increase contributions or to postpone retirement, for example – they are also the most complex feature of the statement and therefore the most likely aspect to give rise to member confusion. Given the length of the accumulation and decumulation periods, for young members the uncertainty surrounding projections is a particular concern.

II. Definition of Pension Information

The complexity and extent of the risks members bear under a DC system present challenges in relation to the content and design of pension statements. This section examines the types of generic information that might be provided in the statement, while the following sections provide examples of projection calculations and of focused consumer research on their reception and impact.

The information in a typical statement can be divided into two categories.⁵ The first sets out factual accounting details, while the second provides forward-looking information.

Basic Accounting Information

Accounting information, required under regulatory disclosure guidelines, sets out the current facts about the member's DC plan. Typically this section includes:

- The name and reference number of the pension plan
- The provider's contact details
- The current and previous account balance
- The current asset allocation (or name of funds)

It also sets out information about the changes in the account since the last statement date, including:

- Total contributions paid
- Total withdrawals made (where applicable)
- Total fees deducted
- Total investment gains or losses

This type of basic disclosure is necessary to keep the pension system accountable and transparent. It also enables members to verify details such as pensionable salary and contribution payments received by their account. In addition the disclosure of accounting information is thought to help educate members about their pension and to increase employee appreciation of government tax benefits and the employer's contributions, where relevant.

⁵ Larsson, L., O. Settergren, A. Sundén (2008), "Pension Information: The Annual Statement at a Glance".

Ideally, the accounting information provided in the annual pension statement would be comprehensive, covering the member's pension accruals from all private sources and the state pension. However, this type of combined statement is unusual. The reason given for this is the difficulty of coordinating data between different plans and providers, among other factors.

Forward-looking Information

Pension projections are a potentially useful tool that helps members understand what their plan might produce at retirement and the choice and risk variables that might affect the outcome, such as investment returns, inflation, maintaining or increasing contributions, future employment prospects, the date at which benefits are drawn, and life expectancy. This information can help members plan for retirement by giving them a better understanding of what to expect over the long-term.

Choice variables

In theory the pension statement can be much more than a means of disclosing facts: it can help members to make important decisions, such as an increase in contributions or a change in the asset allocation (or fund choice). It can also encourage members to postpone the date at which benefits are drawn and to consider the form in which they take the benefits, for example they might be encouraged to appreciate the advantages of buying a lifetime annuity, as opposed to taking a lump sum, where this choice of offered.⁶

Information on uncertainty (risk)

Pension projections can be calculated and presented on a deterministic or stochastic basis, or even as a combination of the two. The pension projections examined for this survey are deterministic and show the prospective benefits in a simple format, for example the potential income under a single scenario, as a point figure (cash value) and/or as a percentage of earnings. Usually there is a caveat that explains that the results are uncertain and not guaranteed. In some cases uncertainty is conveyed through the provision of more than one scenario, so that members can see the potential impact of continuing contributions (where this is a choice), different rates of investment return associated with varying the asset mix, and different earnings patterns, for example.

While the deterministic model has the advantage of simplicity, there is a concern that it does not convey adequately the probability distribution range; nor does it measure and quantify uncertainty. However, current examples of stochastic modelling that depict a more sophisticated probability range are generally considered to be far too complicated to be of any practical use to members, although this might change in future if suitable models can be presented in a user-friendly way.⁷

Example of deterministic projections

Deterministic projections are based on specific growth rates, among other factors, and typically show pension outcomes under one or two scenarios. For example:

⁶ Previous documents to the Working Party (OECD Pension Outlook, 2012, chapter 6) stress the importance of contributing and contributing for long periods, as well as the beneficial impact of postponing retirement to increase the adequacy of retirement income.

⁷ The OECD is currently working on how to better communicate projected pension benefits and risks in DC pension plans.

*“If you continue to make the same monthly contributions that you are making now for the next X years, and economic conditions vary in a typical fashion, you should expect a monthly income at retirement of **36% of your final salary or X** (where X is a point figure in the relevant currency).”*

Uncertainty might be conveyed through a general caveat:

“However, this amount is not guaranteed.”

The caveat might be further qualified with a worse-case scenario, such as:

*“If you suffer unemployment or achieve lower returns on investment, you should expect a monthly income at retirement of only **20% of your final salary or X** (where X is a point figure in the relevant currency).”*

Example of stochastic projections

Using a stochastic approach the pension statement can more readily quantify and approximate uncertainty, but at the potential cost of added complexity and member confusion. A pension statement communicating the same uncertainty as above, but using stochastic modelling, might state:

*“If you continue to make the same monthly contributions that you are making now for the next X years, and economic conditions vary in a typical fashion, you should expect a monthly income at retirement of **at least 36% of your final salary or X** (where X is a point figure in the relevant currency) **in 5 out of 10 times.**”*

This type of statement provides a more accurate description of probability and might encourage some members to increase contributions or postpone retirement in order to improve their chances of achieving their retirement income goals. However, the pros and cons of such information must be considered carefully, as the inclusion of more sophisticated projections might undermine the fundamental objective, which is that written statements should be brief, clear and simple in order to facilitate engagement and positive actions to improve the outcome.

Alternatively, pension statements could combine both the deterministic and the stochastic approaches, whereby the deterministic model is used to communicate a more straightforward projection, while the stochastic model is used to quantify probability and risk. For example:

“If you continue to make the same monthly contributions that you are making now for the next X years, and economic conditions vary in a typical fashion, you should expect a monthly income at retirement of 36% of your final salary. However, there is a significant degree of uncertainty ... (followed by stochastic modelling and its probability range).”

As with the previous example, it is not clear how this type of information would help members take positive actions. Indeed it might be counter-productive in that it could undermine confidence in the DC system and cause members to reduce or stop contributions, where possible, or to switch their fund into bond-like assets in order to avoid the risk of capital loss.

Another option would be to provide a range rather than a single estimate:

*“If you continue to make the same monthly contributions that you are making now for the next X years, and economic conditions vary in a typical fashion, you should expect a monthly income at retirement **between 25-45% of your final salary.**”*

However, as the stated range aims to provide an outcome range that has a high probability of occurring, in practical terms it might be too wide to be meaningful to the member. To put this point another way, in behavioural terms individuals might not understand mathematical probability and interpret it as ‘blind chance’ or a lottery system. Moreover, it can be argued that a point figure (cash income value) is more immediate and therefore has greater impact than wide percentage ranges.

Future Developments in Projections

Projections, by definition, do not offer any certainty. Nevertheless, if members are expected to plan ahead, they need at least an approximate idea of what their plan might deliver in terms of a retirement income expressed as a monetary value in ‘today’s prices’ (that is, taking account of inflation). These parameters – the provider’s need to explain the scope of the uncertainty and the member’s need for a reasonable approximation of income expressed in simple language – frame the current debate over projections.

Deterministic projections might only have a 50% likelihood of proving accurate and therefore they are accompanied by a caveat that states that figures are estimates and are not guaranteed. This deterministic projection (with the accompanying caveat) is thought to have the advantage of clarity and simplicity.

The provision of different deterministic scenarios might be used effectively to illustrate the impact of different rates of returns on investment (high, medium and low) but it is unclear how the member might respond to these risk variables if they do not understand investment risk in the first place. The same point is true of variables based on life expectancy, which the member will not be in a position to predict, with the possible exception of those who suffer from a life-shortening health condition.

When considering this subject it is important to bear in mind that one of the goals of the pension statement could be to communicate uncertainty in a way that enables the member to take appropriate action. Of more practical use, therefore, are the scenarios that invite member engagement, such as projections that show the impact of an increase in contributions and the deferment of the date at which benefits are drawn. In some cases members in secure employment might also be able to make use of projections that take account of future salary growth.

In the research for this report there were no examples of countries that currently use stochastic projections in the written statement. Stochastic projections of future pension benefits depict probability distributions and therefore provide a wider range of possible outcomes and probabilities. In theory this model enables uncertainty to be quantified and priced but inevitably these projections are more complex to prepare, difficult to illustrate, and can be very difficult (if not impossible) for members to interpret in a way that prompts active engagement. The question, therefore, is whether there is a way to design and deliver more sophisticated projections that are also consumer-friendly?

The Chilean regulator is in the process of developing a stochastic model, in conjunction with a web programmer, using focus groups to test the design and the web tool that implements the facility. The Swedish pension authority is also considering the introduction of stochastic modelling but again only as an online tool because it is concerned that such information might obscure the other important messages in the document. The results of these projects will be of considerable interest.

III. Examples of Projection Calculations in Statements and on Website Calculators

The rules governing the assumptions providers can make in their pension projections in relation to the statement and to website calculators vary from country to country. In most cases the regulator or supervisor sets the assumption or range of assumptions but in some countries there are no specific rules as yet (Slovak Republic) or projections are not permitted due to concerns about the potential for member

misunderstanding (Pakistan). Assumptions used in statements are more limited than those that can be used for website calculators, where the member has the facility to change one or more features in the calculation.

Where supervisors or regulators set the assumptions, the rules might require providers to use a single figure for the investment return (Netherlands) or they might be prescriptive across all choice and risk variables (Mexico). Particularly noteworthy in the examples studies for this report is the variation in the maximum investment return assumption, which ranges from 3.74% in Israel (for all asset classes) to growth fund assumptions of 7% in the UK (9% can be used for the illustration provided at joining) and 8% in Australia and Columbia. Best practice indicates that the interest rates or return assumptions implicit in projections should be in line with current market trends and historical experience.

Table 1: Examples of Projection Assumptions for Statements and Calculators

| Country | Range and Assumptions |
|-----------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Australia | Projections range from 5% (cash) to 8% (growth), with an inflation assumption of 2.5% + 1% rise in living standards. The projected income is based on a payment period to age 90 |
| Austria | Parameters reflect Pensionkasse annual investment income, technical surplus and assumed interest rate, among other factors. |
| Bulgaria | Projections are based on fees, the interest rate, the year of retirement, and the number of years during which the member will be receiving pension. |
| Chile | Projections are member-specific in relation to age, gender and accumulated balance, and are based on the fund's future expected yield, the level of future contributions, and the age of retirement, among other factors. For members with a minimum of 10 years to go to the legal retirement age, the calculation assumes a real annual return of 5% under two contribution scenarios. |
| Columbia | Projection assumptions range from 4% (conservative) to 8% (higher risk). |
| Costa Rica | Projections are based on gender and assumptions about the contribution density. |
| Denmark | Projections (web calculator) are based on the member's choice of assumptions. |
| Estonia | The calculator on the supervisor's website is generic and allows the user to input the expected rates of return, contributions, and investment period, based on a pre-set range. |
| Hong Kong | Projections are based on assumptions about monthly income, investment periods and investment returns, among other factors. The MPFA is reviewing the scope for improving the current methodology. |
| Hungary | The Supervisory Authority's pension calculator is under construction. |
| Israel | Projections are based on the accumulated current value, the expected retirement age, the interest rate (currently 3.74%) and the assumption that 60% of the pension on the member's death will be paid to the widow. |
| Macedonia | Projections are based on the contribution level, the contribution period, the return, and the fees. |
| Mexico | The model assumes an annual compounding process, a real annual net return of 5% and that contributions are made at mid-year. The calculation projects the accumulated balance in the individual's account at retirement (age 65) and is based on the member's salary, current age and the current balance in the pension fund. |
| Netherlands | Funds are required to use an interest rate of 4%. They are free to choose their own mortality table. |
| Pakistan | Due to the recent nature of pension reform, at present the Securities and Exchange Commission does not allow pension fund managers to provide growth assumptions or projections, as it is feared that inaccurate projections would adversely affect the confidence of investors. |
| Poland | A web-based pension calculator is available on an affiliated financial education website http://www.manymany.info . This enables members to estimate future pension and replacement rates from private pension funds and the social security pension, based on different assumption about wages, the rate of return and the labour market. |
| Slovak Republic | There are no specific rules on the calculation method. |
| Sweden | Projections assume two wage growth scenarios: 0% and 2%. The rate of return on the funded individual account is assumed to be 3.5% higher than earnings growth. |
| United Kingdom | Projections are based on a maximum assumed growth rate (7% on annual statements, 9% on illustrations on joining). The rate should be reasonable in relation to the underlying assets, for example a lower rate should be used for cash than for equities. The scheme's charges should be taken into account, with an allowance for anticipated increases. |

Analysis of current projection models

Table 1 shows the wide variety in the bases for projection assumptions in a range of countries, particularly in relation to the investment return (also described as the interest rate). Several countries specify that the return assumption must take account of inflation. Bulgaria, Macedonia and the UK, for example, state that projections must make an allowance for both inflation and charges.

In Australia details about underlying assumptions are included with the calculator (on <http://www.fido.gov.au>). The investment assumptions reflect the investment strategy of the member's fund: 5% (cash), 6.5% (conservative), 7.5% (balanced), and 8% (growth). Inflation assumptions include 2.5% for cost of living and 1% for the rise in living standards. The projected income is based on a payment period to age 90. A similar system is used in Colombia, where the technical interest rate (investment assumption) varies according to the fund risk-rating: 4% (conservative), 6% (moderate risk) and 8% (higher risk).

The Danish Insurance Association uses a range of assumptions for the pension projection tool on its website, which produces deterministic projections based on the member's choice of assumptions. The perceived advantage of this tool is that it is easy to use and the results are shown with the aid of simple graphics. The projections are made using one set of default assumptions. The user can vary the assumptions by selecting from pre-set ranges.⁸

In Chile, the Personalized Pension Projection (PPP) sent to members from age 30 is member-specific in relation to age, gender and the accumulated balance. The PPP is based on the fund's future expected yield, the level of future contributions, the age of retirement, and the pensioner's dependants at the date of retirement. For members with a minimum of 10 years to go to the legal retirement age, the calculation assumes a real annual return of 5% under two contribution scenarios: one in which contributions are paid every month until the legal retirement age, and one in which contributions cease at the date the projection is made. This is designed to help members understand the importance of maintaining contributions and of the necessary actions they might take (paying voluntary contributions, for example), if they consider that the projected pension will be inadequate. The Chilean regulator (Pension Superintendency) requires pension funds to show in their pension statement projections how benefits vary with retirement age. For older members the projection includes an estimate of benefits at the legal retirement age and of benefits where the member postpones retirement for three years beyond this date.

In Mexico there is a single growth projection, which is a net annual return of 5%. The calculation projects the accumulated balance in the individual's account at retirement (age 65) and is based on the member's salary, current age and the current balance in the pension fund. There is a separate calculator to estimate the final balance of self-employed workers, which bases projections on the level and frequency of voluntary contributions, earnings, current age, and the current balance in the fund (Afore).

Sweden requires projections to be net of inflation. In addition projections assume two wage growth scenarios: 0% and 2%. The rate of return on the funded individual account is assumed to be 3.5% higher than earnings growth. By providing different scenarios, the aim is to indicate that benefits will vary with economic growth. Moreover, the "Orange Envelope" (annual statement) presents projections that show how benefits vary with retirement age. Pension benefits for participants under age 60 are shown at the earliest age they can be withdrawn (age 61), at age 65, and at age 70. The purpose is to show that working longer will result in higher benefits. The statement for members aged 60 or older shows benefits for additional ages between 61 and 70. Benefits are automatically adjusted for life expectancy, so the system demonstrates that younger cohorts have to work longer to receive the same replacement rates as older

⁸ See http://www.forsikringogpension.dk/Pension/Dit_behov/pensionsmaaler/Sider/Pensionsmaaler.aspx

cohorts. The Swedish Pension Agency has considered using cohort-specific retirement ages in the projections in the Orange Envelope. This will probably be introduced in 2012. Similar information is available in pension statements in the United States and anecdotal evidence indicates an impact on retirement behavior.

In 2004 the supervisor launched the official Swedish on-line pension calculator (<http://www.minpension.se>). This presents individual projections of the public pension and occupational pension benefits and the total projected pension as well as its components. Since its inception in December 2004, the website has attracted 1.15 million registered users and the number of visits per day on average is around 10,000.

It is interesting to note that Sweden operates a very different approach for the SAF-LO pension plan, which is the occupational DC arrangement that covers most blue-collar workers in the private sector and which currently has approximately 1.6m active employees. No pension projections are provided on the pension statement for the SAF-LO, as they are considered to be unreliable and could give members a false sense of security.

IV. Focused consumer research on projections

Consumer research on the response to pension statements is limited and represents an important aspect of evaluation that requires much more focused attention.⁹ In the research for this report the pension supervisory authorities in the following countries stated that they had evaluated the usefulness and effectiveness of pension statements or other communications sent to pension fund members: Austria, Chile, Colombia, Costa Rica, Hong Kong, Kenya, Mexico, Netherlands, Sweden, and UK. However, in several cases very little detail was provided about the nature of this evaluation. In this section we provide details from selected countries that provided specific information and evidence of consumer testing.

Chile

The Research Division of the supervisory authority has conducted two studies to evaluate the effectiveness of the Personalized Pension Projection (PPP) statement on savings and retirement decisions. Fajnzylber, E., Plaza, G. y Reyes, G. (2009) analysed the impact of this information on saving decisions and found that information increased the likelihood of voluntary contributions to the plan. Miranda, J. (2010) analysed the impact of projections on the decision to retire and found that participants who received the information are more likely to postpone retirement.

There is a separate focus-group evaluation process that assesses the usefulness and effectiveness of the statement. A recent evaluation of the member's knowledge and understanding in relation to the four-monthly personal statement found:

- The language is too technical and it does not consider the normal language people use to discuss these topics.
- The format and design of the information presented in the statement through text and tables are not considered user-friendly.

⁹ The OECD's platform for work on financial education and evaluation is at www.financial-education.org. For general principles, see OECD, 2008, Improving Financial Education and Awareness on Insurance and Private Pensions, http://www.oecd.org/document/8/0,3746,en_2649_15251491_41210376_1_1_1_1,00.html;

- There is too much information and the priorities are poorly identified. Overall there is more information than the member wants and can understand.

Members suggested the following improvements:

- A simple summary of the most important items on the front page of the statement. (Members cited utility bills as a good example of this format.) This might be supported by an annex that provides a more detailed breakdown of the benefits.
- The use of simple language and well-designed illustrations that relate easily to the content.

The summary, members said, should present the initial and final value of savings within the period and the net gain or loss. This information should be presented in the simplest way possible, without breakdowns, for example: "You started the period with initial savings of X and closed the period with total savings equal to Y". The summary should also include a simple contribution statement so members can check irregularities and / or gaps in their contribution history.

Members said they valued the projections of benefits. They felt that the PPP should continue to present projections in the simple style currently used but asked for improvements in the way assumptions are explained to make them easier to understand.

In response to the research reports and to the evaluation from consumer focus groups the supervisory authority proposes to amend the statement as follows:

- To provide a summary on the first page that includes the information most frequently requested by members.
- To simplify the information on pension fund returns and administration fees. The comparative information on returns will relate to the last 12 months and five years.
- To highlight contribution payment irregularities by beginning the relevant section with "IMPORTANT," followed by the amount of the unpaid contributions and the periods to which they relate.

At the time of writing the supervisory authority was evaluating the revised personal statement through a second round of focus groups. The new statement is expected to be introduced in mid-2011.

Costa Rica

Member-focused research revealed that members found the pension statement difficult to understand. The reasons members gave included:

- There were too many figures
- Comparative items, for example on fees and performances, were confusing
- The asset allocation of funds was presented in a confusing manner
- There were too many variables (indicators) about fees, returns and the portfolio structure.

The supervisory authority has changed the statement format to make it more effective. It is in the process of discussing these changes with pension administrators.

Denmark

In 2007, the Danish parliament launched the Money and Pensions Panel as a part of the Financial Supervisory Authority. The purpose of the panel is “to further a more comprehensive knowledge of and interest in financial matters among consumers”.¹⁰ In 2009, the Money and Pensions Panel commissioned a study to evaluate how best to communicate pension information.¹¹ The study used consumer focus groups that were presented with three sample statements from three different (anonymous) Danish pension providers. The participants of the focus groups ranked pension projections as one of the most important items to be included in the pension statements and they made the following observations:

- The most important aspect of the pension projections is that they are easy to understand. Members preferred projections that did not include too much text.
- The key information was what the individual would receive at age 62, 65 or 67.
- Showing projections results in both nominal and real terms was considered confusing.
- Use of the word “projection” was considered confusing. The phrase “expectations of pension payments” was preferred.¹²
- Most members said that disclosure of assumptions used for the projections was important and that it was appropriate to express this point as a caveat.

Mexico

In Mexico a focus group judged the appearance and content of the pension statement before and after it was redesigned. The group found that the older model was:

- Confusing
- Complicated
- Too long
- Included too much information

¹⁰ <http://www.finanstilsynet.dk/en/Om-os/Penge-og-Pensionspanelet.aspx>, “About the Pensions and Money Panel”, 12 August 2009

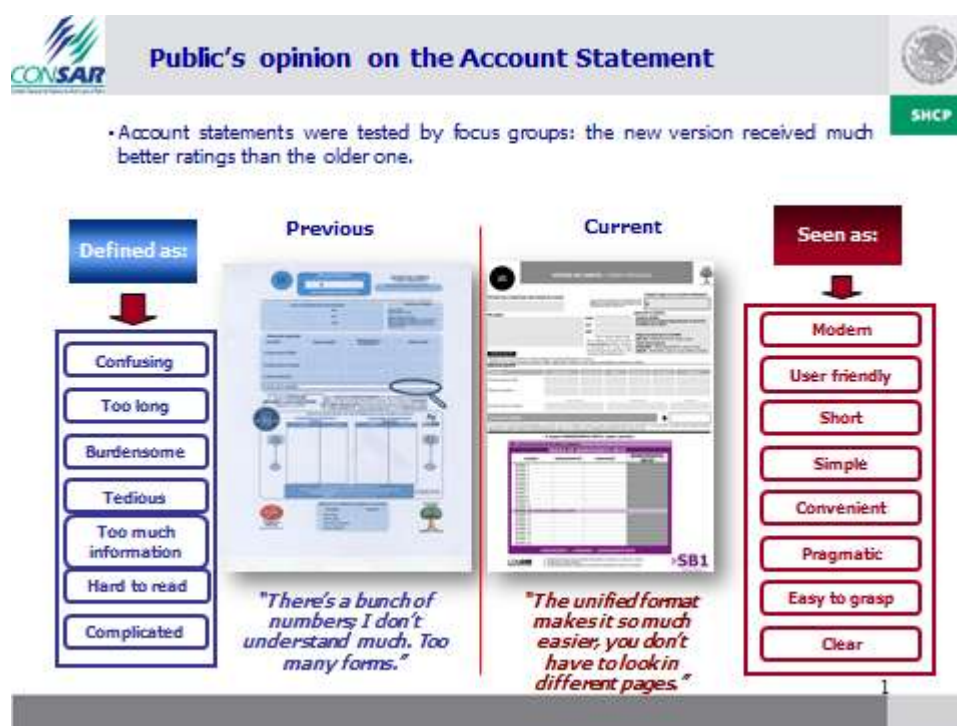
¹¹ Penge- og Pensionspanelet’s report “Undersøgelse af pensionssekskabernes dækningsoversigter” and Capacent’s background report, “Penge- og Pensionspanelet: Fokusgrupper om pensionsdækningsoversigter,” 2009

¹² The actual preferred phrase was “Forventninger til pensionsudbetaling”.

By contrast, the revised version, which adopts a unified format, was considered to be:

- User friendly
- Modern
- Clear
- Short

Figure 1: Mexico's Redesign of the Pension Statement



Netherlands

The supervisor (AFM) has conducted three relevant studies, which revealed shortcomings in the pension statement:

- In 2009 the AFM reported that the cost transparency of DC plans was unsatisfactory.
- In 2010 the supervisor examined the extent to which members understood their pension statement. It found that while in generally people appreciated the statement, members felt that they needed more support to understand it. Comprehension of DB schemes was considerably higher than that of DC plans.
- Also in 2010 the supervisor presented a report on the replacement rate people expected, which it found to be unrealistically high.

Sweden

Sweden's pension authority has conducted annual surveys of member attitudes and responses to the "Orange Envelope" for the past 12 years.¹³ The Orange Envelope – so-called because of its colour – is the name of the annual pension statement sent out for the state (public) pension, which includes a cash-balance component (the Income Pension) and a mandatory DC component (the Premium Pension). The Premium Pension requires annual employee contributions of 2.5% (out of a total contribution of 18.5%).

The 2010 results and comparative information for past years are published in the report "Evaluation of the Annual Statement 2010: The Orange Envelope to Pension Savers 2010".¹⁴ For the 2010 survey, 1,016 members were surveyed. The key findings were as follows:

- 93% of members said they had received the statement
- 80% said they opened the envelope. Of these:
 - 75% read or looked at the pension projection.
 - 7% said they read the entire contents
 - 16% said they had read most of it
 - 35% said they read some sections
 - About 40% said that they understand that lifetime earnings determine benefits, one of the most important characteristics of the pension system.

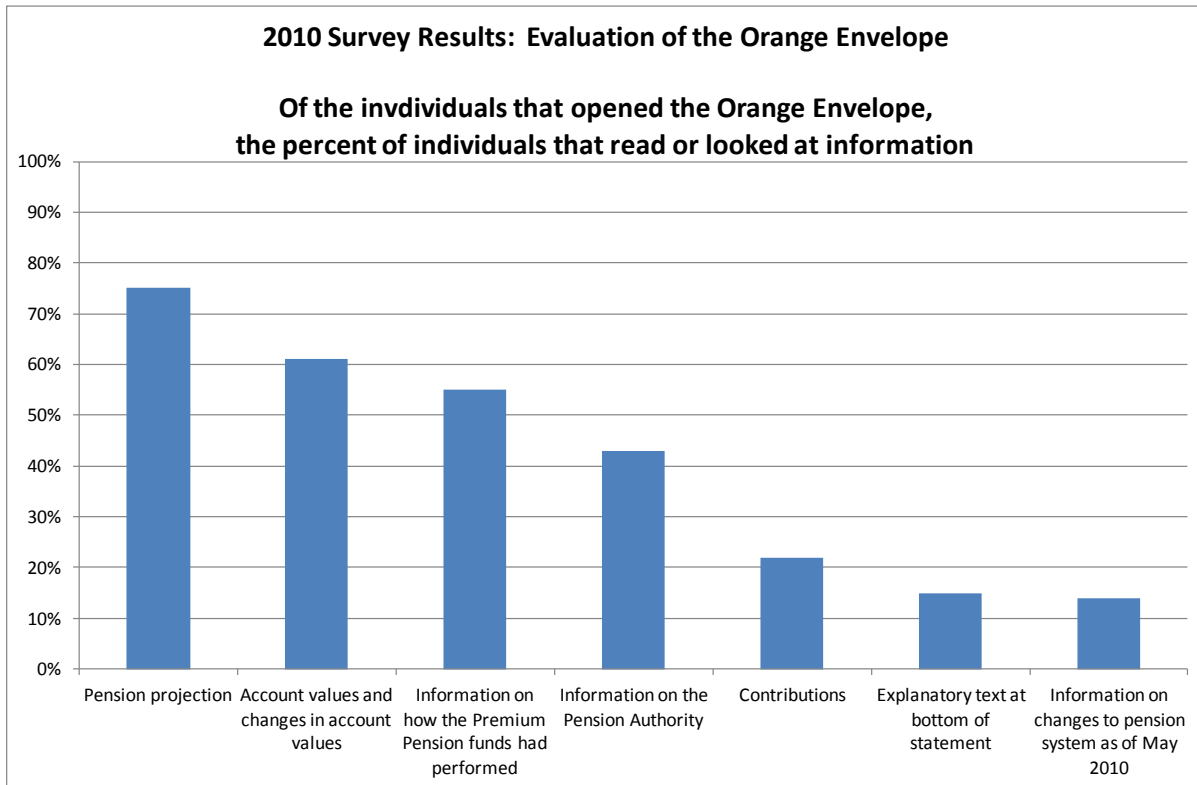
Given the clear identity of the statement, the results indicate the very basic barriers to written communications. Of the various findings perhaps the most significant is the fact that one-in-five members surveyed do not even open the envelope, let alone read its contents. Of those who do open the envelope, fewer than one-in-ten read the full contents.

Most members who read at least some of the content said they looked at the first two pages. Pension projections are shown on the first page of the document, while account values and fund performance are shown on page two.

¹³ In France, the envelope is blue and in Germany it is yellow. Finland was concerned that a brightly colored envelope would be mistaken for advertising and chose white, as this has an official connotation.

¹⁴ The report "Utvärdering av ÅB 2010: Det orange kuvertet till pensions sparare 2010" is available on the pension authority's website at <http://www.pensionsmyndigheten.se/Matningar.html>.

Figure 2: Swedish Survey on Member Response to Orange Envelope



United Kingdom

The UK's Department for Work and Pensions (DWP) has carried out a series of studies on the design and use of pension projections. This is to prepare for pension reform, including the forthcoming auto-enrolment regime, which will be phased in for all employers in the private sector from 2012. Most private sector employer schemes are DC, as is the new national scheme, the National Employment Savings Trust (NEST). NEST is undergoing pilot testing in 2011 and will be open to employees from 2012 primarily to accommodate those whose employer does not have a scheme.

In 2008, a report presented the results of 80 in-depth interviews with DC members. It focused on their response to various aspects of pension projections.¹⁵ The study found:

- Member understanding is poor. This is due to lack of knowledge, difficult language and the perception that pensions are dull. The report stressed that the information presented in the pension statement cannot make up for low levels of financial literacy.
- Point estimates are preferred over ranges. Respondents were shown a range of options for presenting the projections: a specific sum, a rounded figure, or a range. Most respondents preferred a specific number rather than a range because this seemed more “real” and personal. The preference for point estimates over ranges might imply that this group would favour a deterministic rather than stochastic scenario.

¹⁵ Wendy Sykes, Alan Hedges and John Kelly, “Understanding Responses to Pension Forecasts: Qualitative Research”, Department for Work and Pensions, Research Report No 492, 2008.

- Members prefer a narrative focus and simple language. The survey found that pension statements should be “presented as a clear story from the recipient’s point-of-view” and that projection information should be presented before any assumptions or calls to invest more.
- Important explanations about the forecast (for example assumptions) need to be directly and visibly integrated with the forecast itself. The members were confused by the term “today’s value” and the explanation of how inflation could erode their savings.
- Pension statements, therefore should use “Plain English” or simple to understand language.
- Age is a key factor that affects responses to projections. Statements do not seem to tackle the sense of indifference of young people; therefore new approaches to communication may be needed. The survey also notes that projections are less reliable for young members than for older members due to the longer period before retirement. Paradoxically older members have shorter periods of time to correct any forecasted shortfalls in retirement income. The survey suggests that the increased use of online pension projection tools as well as other “youth-friendly” mediums of communication should be considered as a complement to the annual statement.
- Statements should be active not passive documents. The survey conclusion was that “people need to be helped to see the forecast as a management tool and not as routine and essentially passive reports.”

Cross-country research conclusions

These studies demonstrate the critical value of consumer focus groups as a means to understand, evaluate and amend the content and format of the pension statement. The consistent message that emerges is that consumers want a clear and simple statement that avoids “pension-speak” and that provides visual images that relate directly to the narrative content. Importantly, it is evident from these consumer surveys that while DC members do appreciate the pension projections, they prefer a snapshot view of their likely retirement income and not a detailed analysis.

The last point in the UK section above is crucial: “statements should be active not passive documents”. The challenge, therefore, is to convert passive information into an active retirement-planning tool.

V. Guidelines for Pension Statement Evaluation

The first stage of the pension statement evaluation process is to establish the objectives and desired outcomes, which should be specific, measurable, achievable, reasonable, and time-specific. Where the statement has several objectives – for example to raise awareness of the importance of saving for retirement, to encourage members to use the website calculator, and to prompt member actions, such as increasing contribution and/or postponing retirement – it will be necessary to pre-test, monitor and evaluate each component part.

Evaluation is evidence-based and involves several key stages before, during and after the campaign:¹⁶

- Research to establish baseline measures, for example levels of awareness, knowledge and current patterns of active engagement. This should help to identify demographic and/or behavioural profiles of consumer groups.

¹⁶ See <http://www.financial-education.org>

- Consumer testing to determine the suitability of the statement format and content (text and visuals)
- Cost-benefit analysis of the potential communication channels, for example by establishing the number of members that might prefer a very brief statement supported by more detail and further facilities on the website
- The implementation of monitoring processes, for example phone surveys to determine whether members have:
 - Received the statement
 - Read its content
 - Understood the content
 - Taken action
- Measurement of website hits and contact with call centres prompted by the statement
- Post-campaign analysis of the quantitative results, such as the number of people who increased contributions and/or postponed retirement
- Analysis of the qualitative impact through focus groups, interviews and surveys. This might include:
 - Analysis of consumer actions to establish whether they were appropriate and informed (for example the decision to change asset allocation or funds)
 - Published reports on the campaign's effectiveness (impact) and efficiency (cost-effectiveness), including lessons learned for future use

VI. Conclusions and Recommendations

The issues raised in this report highlight the pressing need for further research at a national and international level that clarifies the purpose of the pension statement and the role this performs in the broader context of financial literacy. To further this research, supervisors, regulators, and pension providers should work together to help governments achieve their overarching socio-economic objective, which is to ensure people have adequate and sustainable retirement incomes. The pension statement should be treated as an integral element of the broader financial literacy programme.

Statement organisers should set clear and measurable objectives and introduce thorough evaluation processes. In the absence of robust evaluation, pension statements are unlikely to perform an optimal role in the communication of key information; they will not encourage members to take appropriate actions; nor will they support broader national DC communication programmes, for example in relation to pension reform and national financial literacy campaigns.

The statement should be much more than a passive document that delivers information. Rather, it should aim to engage the member and encourage actions to improve retirement income adequacy. In particular it should focus on demonstrating the potential impact of increased contributions and the postponement of retirement.

For maximum impact the statement should present a clear and simple summary of key facts on the first page of the statement. Information provided for the purpose of regulatory ‘accountability’ and ‘transparency,’ does not readily translate into member empowerment. Supervisors and regulators should consider, therefore, if the statutory information pension providers are required to disclose might be sent in a separate document from the main annual statement.

Much more work needs to be done on the best way to present projections that are meaningful and that also prompt members to take appropriate action:

- Projected *fund values* at retirement should be included but the most important figure for the consumer is likely to be the projected *monthly income*, which should be highlighted.
- Assumptions should be net of actual charges and take account of future inflation, so that the member sees the projected monthly income in ‘today’s prices’
- Overall, the debate about projections should focus more clearly on behavioural issues and the language that consumers use and understand. In particular consumers are unlikely to understand the mathematical concept of probability and might confuse this with ‘blind chance’ or a lottery system. Even the term “projection” might be misunderstood and a suitable user-friendly synonym should be adopted, such as “forecast” or “indication”. Mathematical and technical accuracy should give way to user-friendly language.
- More sophisticated online projection tools might enable some members to make appropriate and meaningful connections between the management of the accumulation and decumulation stages of the DC plan – that is, between assets and liabilities. However, it is unlikely that this type of tool would be suitable for the majority, so it should be restricted to the website and offered as a click-through from the main deterministic projection calculator page.
- Some of the concerns about the uncertainty associated with deterministic projections might be addressed through the use of more cautious investment and inflation assumptions and the use of actual plan charges in projections. Further research might indicate that one of the greatest risks to members’ potential retirement funds are due to the use in statements of unrealistic assumptions and also to the imposition of excessive plan charges, the impact of which is not made evident in the providers’ projections.

Pension supervisors and regulators should collaborate at an international level to achieve greater consistency in the prescribed assumptions to be used by private providers. At present it is not clear that the wide range of investment assumptions used across different countries can be attributed solely to the local rules on permitted DC plan assets and access to capital markets.

Where providers have a significant degree of discretion in their choice of assumptions, this can lead to inconsistencies and member confusion. This point applies to web calculators as well as pension statements. The required use of a single government calculator might be appropriate, with some discretion for providers to make adaptations where these are demonstrated to be beneficial to members.

Future research should consider the statements sent to the self-employed, who comprise a significant proportion of the labour market in most countries. In particular the impact on projected benefits of variations in the level and consistency of contributions should be taken into account.

The written statement, as the sole means of communicating benefits, is inflexible and limited. It remains essential, however, because many people do not have easy access to, or are familiar with the

internet. Nevertheless it is likely that a simplified paper statement could be supported by a message sent to mobile phones, for example, and through the provision of further information on the relevant website. Overall, the internet offers a more flexible delivery format that avoids information overload, as it allows the member to access information in accordance with their needs and to develop awareness and understanding through the use of the web calculator, which is an active pension-planning tool.

The value of pension information to the individual is significantly diminished if information only relates to a single plan. Therefore there is an urgent need for combined pension statements that take account of the all sources of pensions, including state (public) systems. Moreover the inclusion of all private plans would also draw attention to 'forgotten' accounts from previous employment, for example, and would prompt individuals to consolidate plans where appropriate. Supervisors and providers should work together to achieve this essential longer-term objective.

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