Recent Developments in Privately Managed Pensions: Institutional Arrangements and Regulation

Conference on the Future of the Pension Industry in the Caribbean

Will Price 4 May 2012

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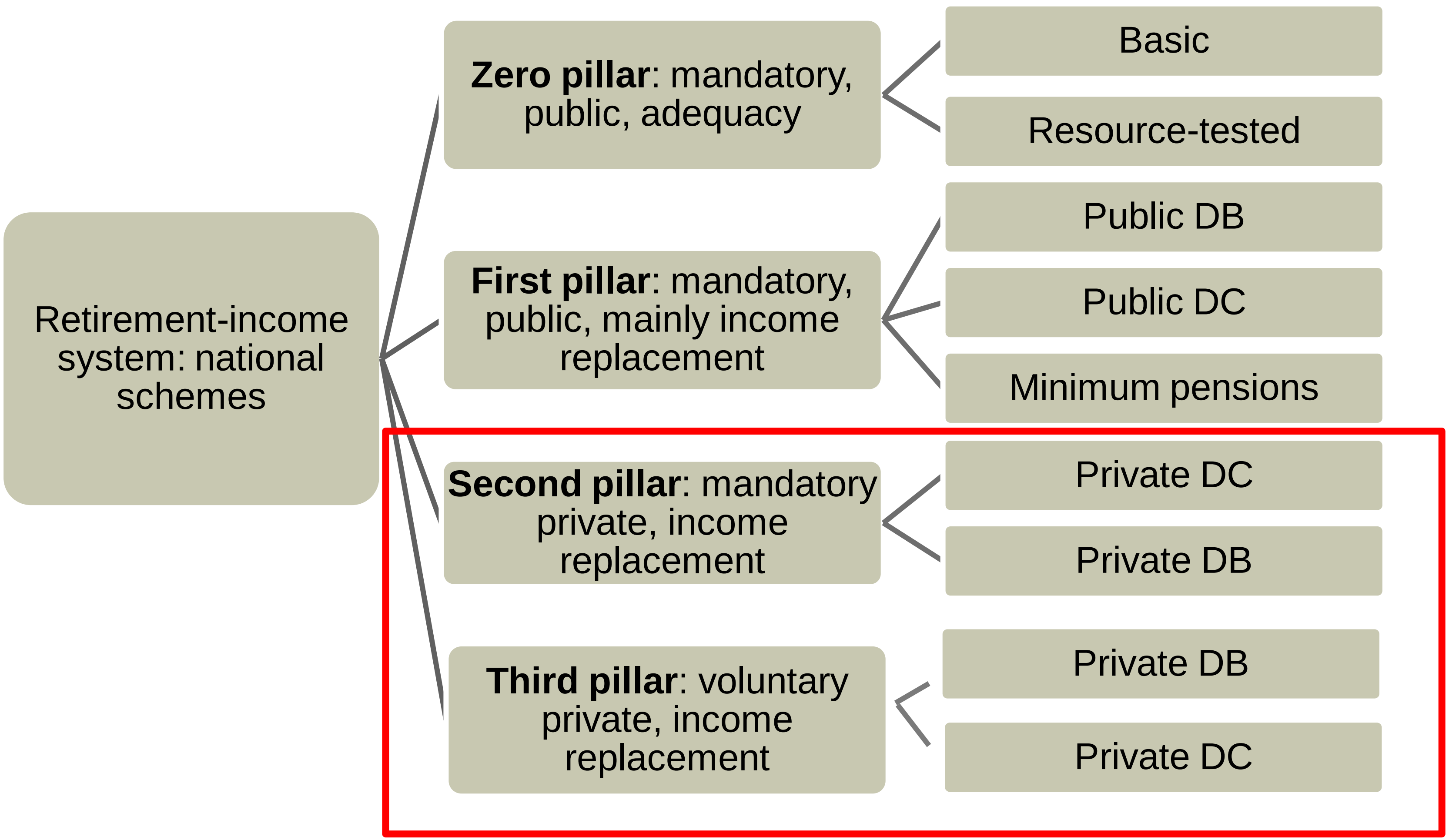
Overview

1. World Bank pensions framework
2. Recent developments in funded pensions
3. Focus on Defined Benefit issues

The World Bank uses its ‘pillars’ model – to distinguish between different types of pension provision



If relevant consideration should also be given to levels of and access to debt which can serve to undermine attempts to build positive savings – and is typically far easier to access than saving into a pension

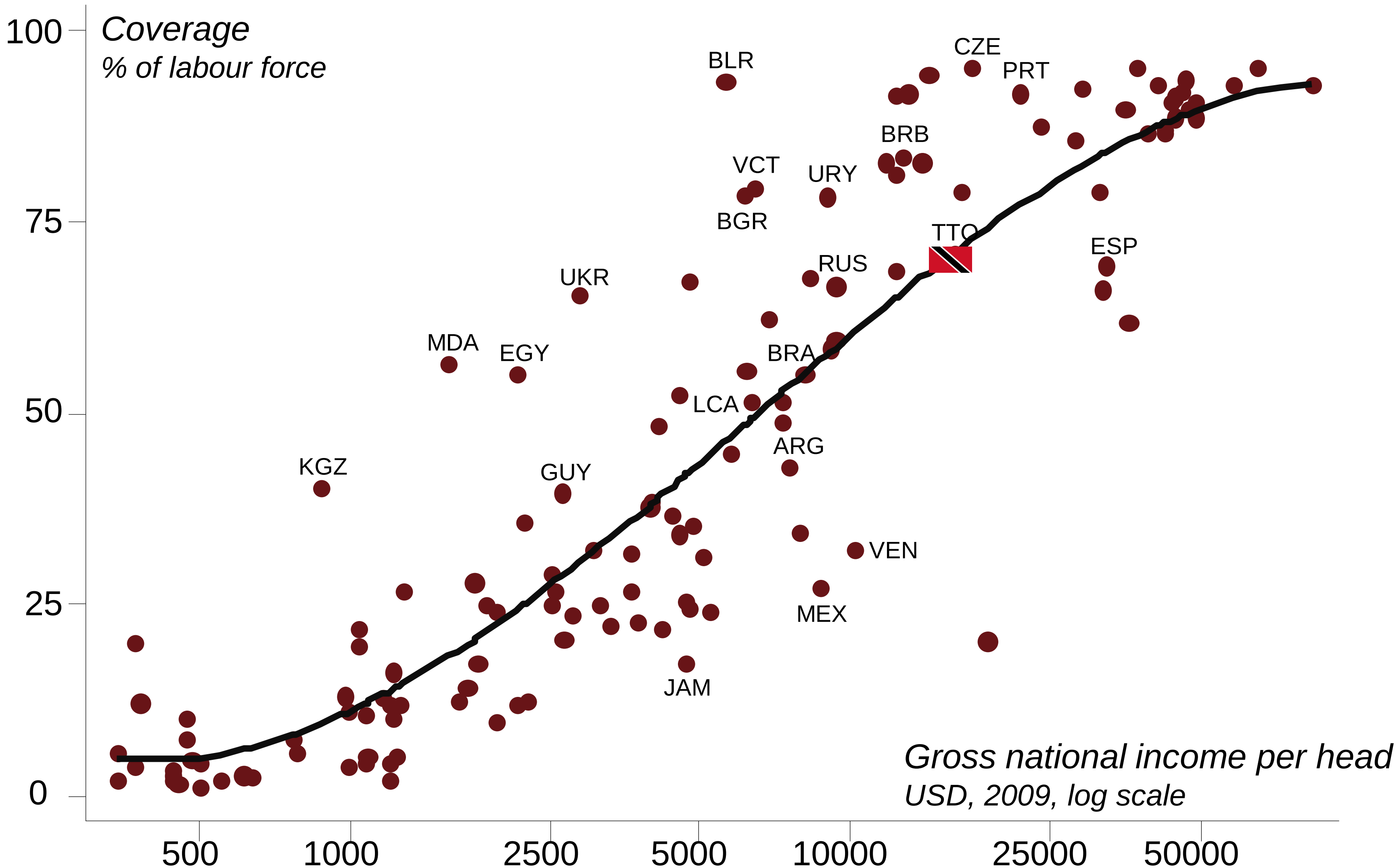
Each element of the pension system has different elements – the key is to ensure the overall arrangements add up to a harmonized system

Pillar	Main purpose and some key issues from cross county experience
Zero	Non-contributory social assistance financed by the state, fiscal conditions permitting. It deals with poverty alleviation by providing all of the elderly with a minimum level of protection. Particularly helpful to lifetime poor and those in informal sector. The costs can be limited by taxing it for wealthier pensioners and tapering off eligibility above a given level of income.
First	Mandatory with contributions linked to earnings and an objective of replacing some portion of pre-retirement income. Typically financed on a 'Pay As You Go' basis so subject to demographic and political risk. Civil service pensions are often of this form - so are formally in the first pillar – but for reform options is can be instructive to compare their schemes with comparable employer sponsored schemes in either the second or third pillar.
Second	Mandatory defined contribution plan with independent investment management. Some have investment guarantees – which can be costly. Wide range of industry structures, with decentralized systems typically costly compared to those with a strong agency acting on demand side on behalf of members.
Third	Voluntary – Defined Benefit or Defined Contribution and either employer sponsored (or facilitated) or individually arranged. Very wide range of formats – and of certainty that pensions will be paid. Wide range of contribution arrangements and effective costs.
Fourth	Informal support (such as family), other formal social programs (such as health care or housing) and other individual assets (such as home ownership and reverse mortgages).

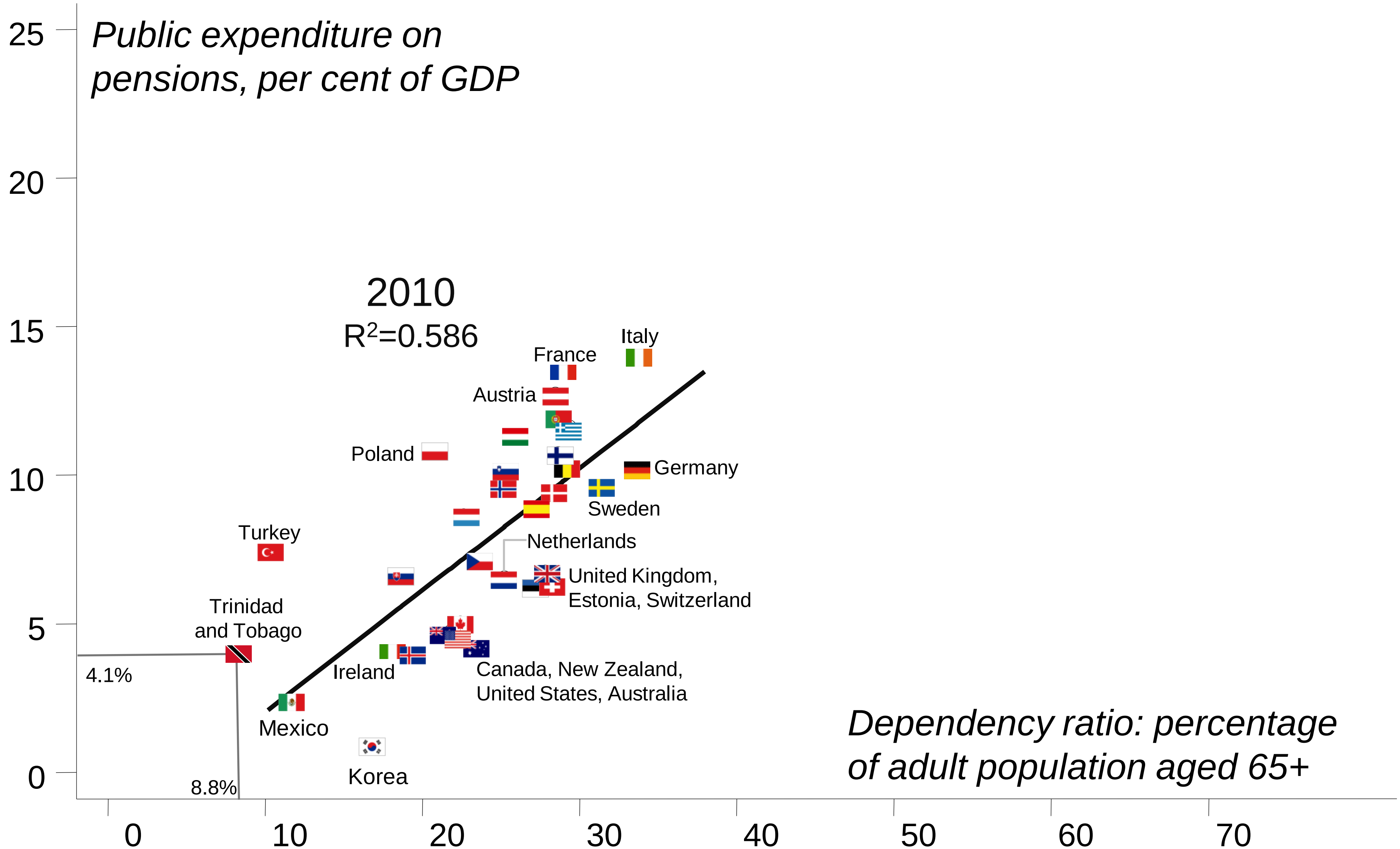
A core set of criteria can then be used to review the impact of a pension system

- **Coverage** of the pension system, by both mandatory and voluntary (occupational and personal) schemes
- **Adequacy** of retirement benefits
- **Financial sustainability** and affordability in the short and long term
- Delivering the right **incentives**: encouraging people to work, contribute to the system and save through voluntary pension plans
- Effective **administration** that provides a good service at reasonable cost and prevents fraud and abuse
- **Security** of pension benefits in the face of risks and uncertainties, such as inflation and individual longevity

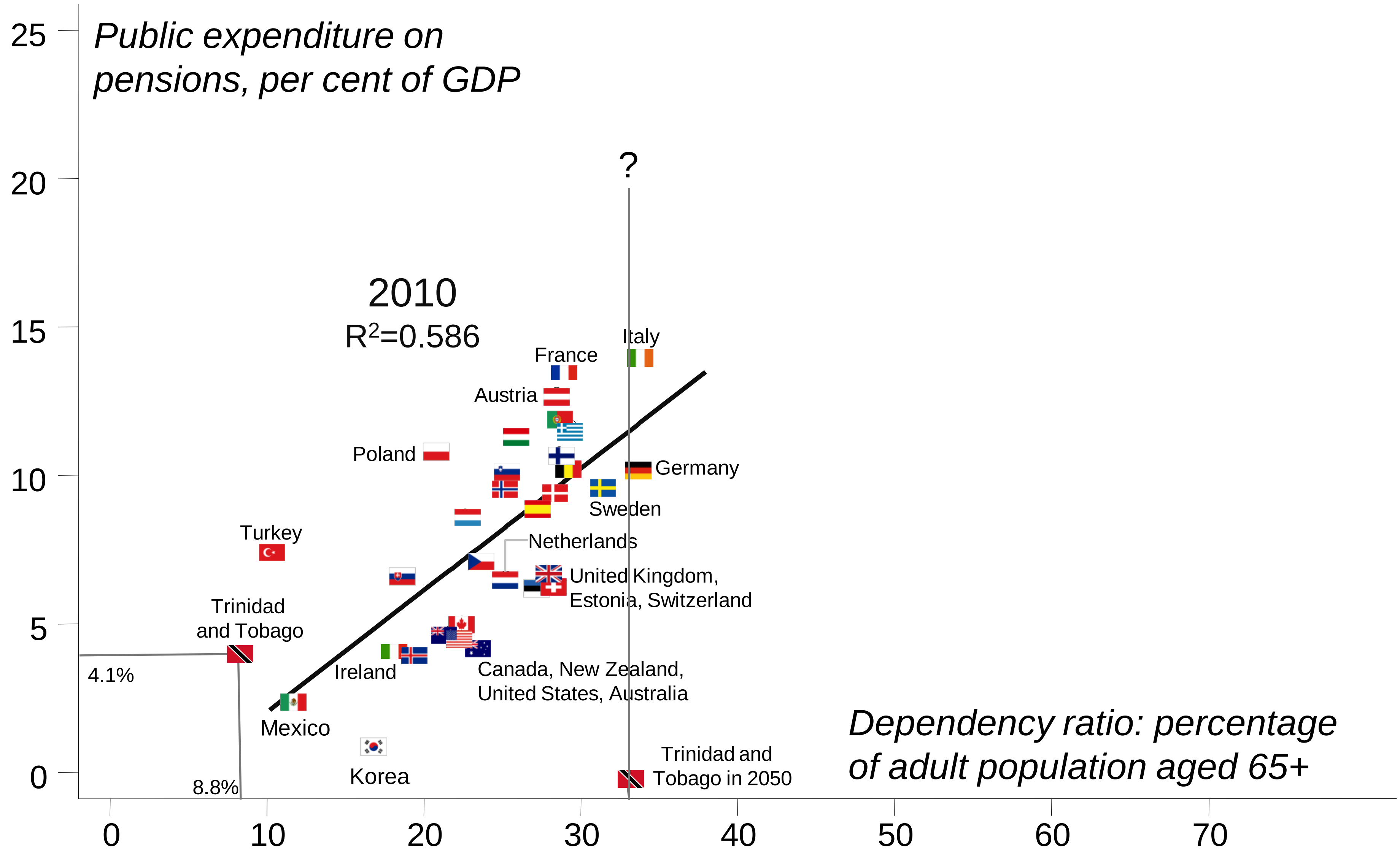
Coverage is a critical measure of success – particularly to understand if pensions are reaching the poorest



The central challenge for countries is to ensure decent pensions that are robust to profound demographic pressures



Trinidad, like many countries, is set to see significant increases in its dependency ratio – with the question of how much of its national resources will be used to deliver pensions



Recent challenges for private pensions were the focus of a recent World Bank conference

- ‘Second pillar’ pensions (mandatory funded pensions) are under attack in some countries - but they remain necessary not only to ensure fiscal sustainability but also to deliver affordable and sustainable pensions for future retirees.

- 2nd pillars will continue to be an important part of the design of pension systems – but only if the essential preconditions are there in terms of government and market capacity. Do not rush into reform to introduce funded private schemes if the pre-conditions are not there.

- The crisis must not distract our attention from the huge demographic challenges – which are too big for any one part of the pension system to deal with on its own. Some attacks on funded pension schemes may be ‘political’ but there are legitimate concerns about performance – either through high fees or low investment returns.

- You cannot hide fiscal or investment risk. If countries dismantle privately funded pillars that will mean greater costs for governments or worse pensions for members.

- Delivering better outcomes means tax financing the transition - at least in large part – rather than relying on debt.

- Politics and building consensus matters to support truly durable pension reforms.

In addition to issues on political consensus, tax financing and the scale of the demographic challenges there were key discussions related to improving risk based supervision and default options

•Volatile economic conditions make it challenging to deliver and sustain any kind of major pension reform.

•There is a need for a more commonly agreed approach to measure and publicize explicit and implicit debt these combined liabilities.

•There is a a strong degree of cross over between pension reforms and domestic capital market reforms. There needs to be complementary work on the capital market when private pensions are reformed to ensure maximum benefits.

•Risk based supervision is a potentially powerful tool to help supervisors focus on the risks to their objectives but those objectives had to clearly focus on achieving the best outcomes for members. And supervisors needed both the ability and the willingness to act – as many did during the recent financial crisis with a full range of tools.

•Default options for accumulation and decumulation were hugely important. Governments, regulators or groups of wise people needed to find ways to set sensible defaults – real or as benchmarks - to protect members of pension schemes.

The final set of current issues focused on improving default funds, being clearer on the cost of guarantees, tackling costs and fees in new ways and finally ensuring enough focus on coverage

•Default funds can better help to build longer term horizons for investment managers and for focusing attention on achieving better outcomes for members than many of the types of investment regulation currently being used around the world.

•Guarantees on capital or investment returns have costs – and if introduced there needs to be clarity on who was going to pay.

•In the pay-out phase - retirees should be offered a restricted menu of options initially – with greater liberalization as pensioners have other sources of income.

•Costs and fees:

- Examine the supply side and remove costs created by unnecessary processes that don't help members.
- Examine the 'industrial organization' to see if the real problem is collusion among suppliers or problems in the distribution from customer to supplier; and
- Focus on the demand side where there have to be large, powerful operators on the demand side acting in members' interests if we are going to ensure that lower costs actually lead to lower fees for member.

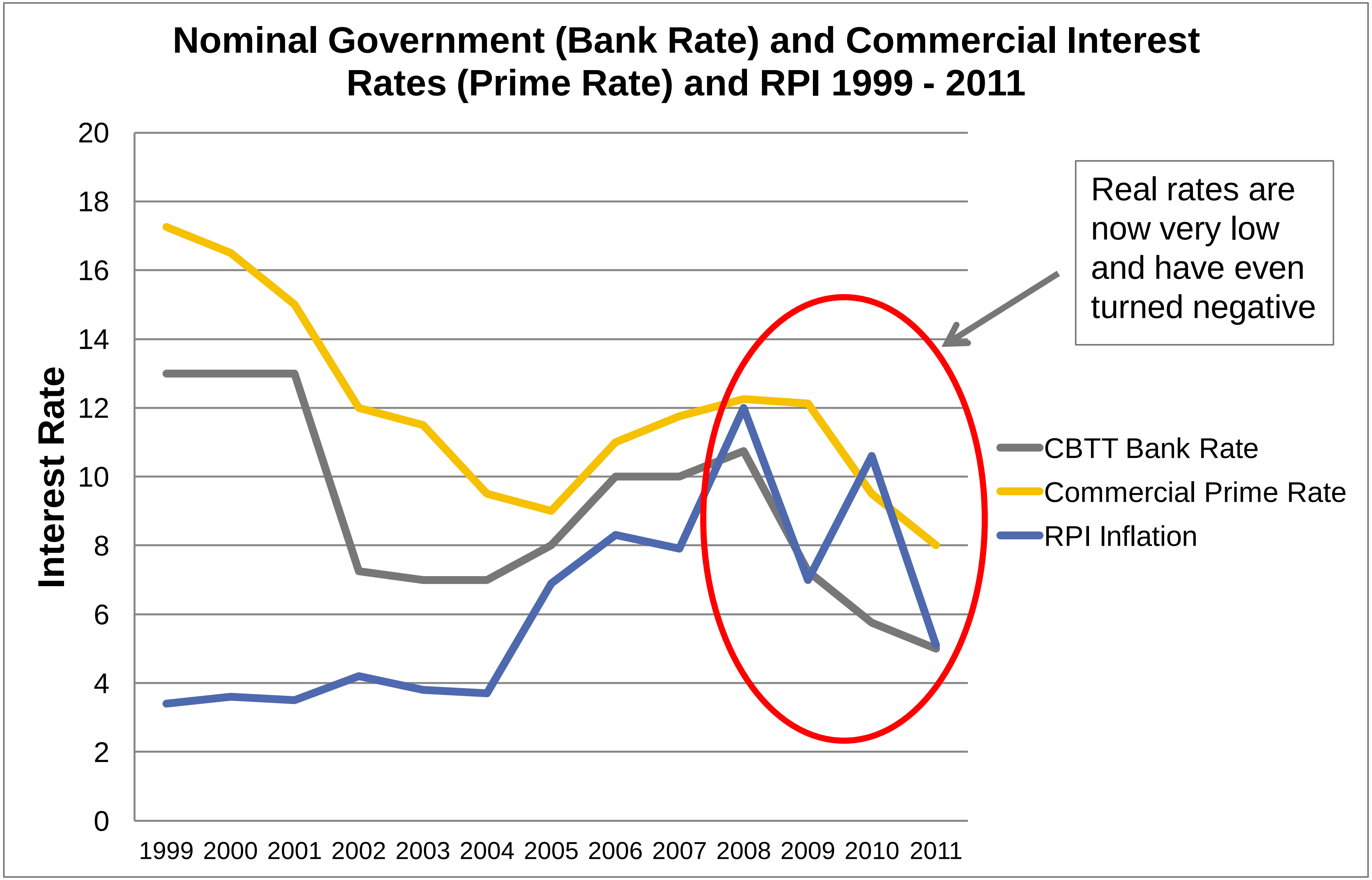
•Coverage – Never forget that most people in the world are not in pension systems. If we really are going to achieve a world free from poverty we must improve coverage.

Defined Benefit funds are impacted by volatility on both the asset and liability side that has to be managed sensibly – 2008 say very significant falls in funding ratios in the UK and other countries

Source: The Pension Protection Fund

A picture of health can rapidly deteriorate when bond yields and asset values fall together – which is why in many countries employers have moved from DB to DC – except in Trinidad

The correct discount rate to use for liabilities is a key issue given the large falls over the past 10 years in both nominal and real government and commercial interest rates in many countries – including Trinidad



International Comparisons of private Defined Benefit are complex – and approaches vary – so comparisons need to review all the factors that impact on safety and security of member benefits

•Different systems place different weights on the following factors – some are better than others but you can not tell without reviewing:

- Solvency Ratios
- Use of ‘contingent’ assets
- Strength of the discount rates used
- Strength of mortality assumptions
- Benefits guaranteed in real or nominal terms
- Existence of an insurance fund in case of sponsor bankruptcy
- Who has legal liability for the liabilities – the fund or the employer
- What role does collective bargaining play in overall security

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