PRECONDITIONS OF FUNDED REFORMS

WORLD BANK PENSION CORE COURSE, 2016

Csaba Feher

Disclaimer: The views expressed herein are those of the author, and should not be attributed to the IMF, its Executive Board, or its management

What are Funded Reforms?

- Partially or fully **replacing** mandatory, contributory, earnings related public schemes with some sort of fully funded – typically DC – arrangement;
- **Augmentin**g existing scheme(s) with voluntary funded (again, mostly DC) schemes;
- Funded reforms are **structural reforms:**
  - Objectives and their relative importance remains unchanged;
  - Parameters of pre-existing schemes may or may not change
  - **What changes**:
  - **Division of responsibilities across state, market, household**
  - **Assumption of underwriting/underfunding risk**
  - **Extent and nature of state involvement**

Critical Features of Funded Schemes

- DC or DB (today's focus: DC)
- Mandatory vs supplementary (voluntary)
- If mandatory: universal vs fragmented
- If fragmented: homogeneous vs heterogeneous rules
- Public vs private management
- Longevity risk
  - Pure DC: individual/household
  - Mandatory annuitization (full or partial): underwriter

Stated Objectives of Funded Reforms

- **Reducing unfunded public pension liabilities**
- **Change risk profile faced by scheme members**
- **Reduce politically-induced fiscal risks**
- **Improve compliance**
- **Contribute to financial sector development:**
  - Supply of securitized assets
  - Competitive intermediation
  - Deepening domestic markets
  - Demand-driven expansion of yield curve
  - Improved regulations and supervision
- **Impose fiscal discipline (transition deficit)**
- **Higher benefits (or lower cost) over time**
- **Greater horizontal equity, improved inter-generational equity**

Reality Check: Actual Outcomes

- Fiscal impact in NPV terms is ambiguous and depends on
  - the treatment of explicit vs implicit liabilities/debt by market
  - state guarantees supporting DC plans
  - manner of financing the transition deficit
  - Remaining (DB) social security schemes
- Improved compliance did not emerge
- Financial sector development impact is suspect
- Political risk manifest in a different manner
- Fiscal discipline did not improve (debt financing)
- Higher benefits are unlikely, given returns and costs
- Greater horizontal equity within DC calls for increased vertical equity elsewhere (poverty alleviation in old age)

Funded Reforms: What's in it, then?

- Under proper **macroeconomic, administrative and financial sector circumstances**, in the presence of forward-looking, **transparent and accountable governance**, as well as **efficiently sized risk and asset pools**, funded reforms can
  - Reduce long-term pension public liabilities
  - Diversify
    - single issuer risks
    - home bias
    - principal-agent issues
  - Accelerate (but not generate) the development of financial market

Conceptualizing DC Schemes

DC scheme = **legal construct** linking numerous administrative and financial sector services;

Quality (performance and transparency) of DC schemes is as strong as the weakest link in the product chain

DC schemes are **not organizations** and rely on pre-existing services

>> no need for entirely new types of entities

>> no need to create new types of products

The Players: the State

Government

- **Fiscal policy**
  - Fiscal space for transition
  - Monetary and exchange rate policy
  - Tax policy and administration, incl. contribution collection
  - Financing and debt issuance strategy
- **Regulations**
  - Accounting
  - Domestic and overseas investments
  - Asset valuation
  - Trading and settlement
  - Licensing, monitoring, enforcement

The Players… (cont'd)

Government

- **Availability of investment assets**
  - Deep, liquid and transparently priced public debt market
  - Promoting non-bank corporate financing
  - Transparent and easy access to foreign issue
- **Administration, IT**
  - Citizen registries (birth, death, residence)
  - Taxpayer registries
  - Asset, debt, property and collateral registries
  - Mortality tables
- **Public information**
- **Risks (potentially) not covered by DC schemes**
  - Disability and work accident
  - Survivors (depending on payout design and permissible annuities)
  - Longevity (depending on payout design)

A Little Detour

Schemes = legal construct

Fund = pool of assets and

Scheme ≠ Fund

Implication:

Scheme liabilities = Fund's asset value only in plain vanilla DC

Scheme administration ≠ Fund management

AN ENTITY SHOULD ONLY BE PERMITTED TO GENERATE RISK IF IT CAN REASONABLY BE EXPECTED TO COMPENSATE FOR RESULTING DAMAGES *AND* MITIGATE THE PROBABILITY OF RISK EVENTS.

Implication:

Fund manager ***can be*** administrator;

Scheme administrator ***should not*** manage assets (unless separately licensed).

The Players: Private Sector

Scheme administrators

(individual accounts, monitoring, reporting)

Collection agencies

(contributions)

Banks

(account management, settlement, custodianship)

Exchange and settlement infrastructure

(platforms for transparent trading and pricing)

Asset managers, traders, brokers

(forming investment strategies and executing investment decisions)

Life insurers

(providing payout products, underwriting longevity risk)

Stewards and Fiduciaries (Boards, Auditors, Advisors)

(protecting members' interest)

Regulators, supervisors

The Players: Households

Individuals (households) must

- Have an understanding of the importance of pension savings as well as the gains and risks involved
- Receive relevant, readily accessible information about other players' actions and performance
- Have the legal and operational opportunities to protect their own interests by making informed decisions

…and the Stage

Factors beyond the direct influence of government

- **LASTING COMMIITMENT TO THE CHOSEN REFORM PATH ACROSS THE POLITICAL SPECTRUM**
- Efficient market size
- Per capita monetized income
- Faith in financial intermediaries
- Commitment to the chosen reform path by current and future political elites
- Interest by experienced “vehicles of experience” to become active in local markets
- Level of transparency, rule of law, enforceability of contracts
- Extent of corruption, nepotism

Social Policy Preconditions

- **Public pension policy = subset of social policy**
- **Mandatory funded schemes:**

- Strictly earnings-related
- No ex-ante redistribution in accumulation phase
- Redistribution in payout phase is limited longevity risk-pooling
- Certain risks are difficult to cover

↓

- Risk of old-age poverty must be addressed by different scheme(s)
- Vertical equity concerns >> before contributions are credited
- State may need to substitute missing annuity providers
- Disability and loss of breadwinner risks need special treatment, possibly outside 2nd pillar

Fiscal and Macroeconomic Preconditions

- **Optimal financing strategy for the transition deficit in view of other sectors' needs, debt levels, tax policy and tax competitiveness**
  - Expenditure cuts
  - Increasing current taxes
  - Increasing future taxes (debt)
- **Analytical tools to project and monitor the reform's fiscal impact**
  - Preferably: both fiscal and welfare impact
  - Choice: off-the-shelf or specifically developed
- **Sustainable pre-reform public debt**
  - Cost of financing reflects debt sustainability but not the reduced implicit liabilities

Financial Sector Preconditions - I

Payment Systems:

- A core number of solvent banks providing infrastructure for large value and retail payments at competitive prices
- IT system able to process and conciliate the flows of funds and the flows of information – preferably through automated clearing mechanisms
- Arrangements for medium and large companies to pay contributions electronically

Securities Settlement Systems and Trading Platforms:

- Delivery versus Payment (DvP) to mitigate counterparty risk
- Reliable settlement system for processing trades, that is cost effective and convenient for its participants
- secure platforms that guarantee market prices in all secondary market transactions

Financial Sector Preconditions - II

Custodial and Depository Services/Institutions

- Independent depository institutions executing book entry transfer of financial instruments
- Custodian conducting global monitoring of compliance with investment regulations and policies

Accounting, Auditing, Valuation Standards

- Independent external auditors
- Pension fund portfolio valuation on a mark-to-market basis in a context of accurate, transparent and enforceable systems of accounting and financial reporting
- At least one independent provider of data on asset prices to avoid manipulations of price data
- Convergence of local accounting standards to International Financial Reporting Standards (IFRS)

Transparently Priced Annuities

Financial Sector Preconditions - III

Availability of Securitized Assets

- Developed public debt markets
- Regulatory framework for mortgage- and asset-backed securities
- Deep and liquid corporate equity and bond markets and corporate law and securities law protecting stakeholders
- Available simple foreign exchange instruments and derivatives
- Capitalization and trading volumes large enough in each market segment to avoid pension funds becoming captive sellers or buyers
- Regulated access to overseas markets

Regulatory framework

- Supervisor, properly staffed and enjoying a reasonable degree of legal and operational independence in place
- Adequate collaboration – including data exchange platforms- across regulatory agencies

Conclusions

- **Preconditions** for successful 2nd pillars **are rare** outside OECD
- **Permissive approach** (slow build-up of assets allows time to create proper conditions on the go) **is wrong: early-stage problems jeopardize commitment and trust**
- A reversed reform is **more costly** – in every sense – than a reform delayed
- **Supplementary, voluntary scheme** need to come first
- Funded reforms change the **nature of state involvement**, requiring more sophistication, flexibility, and genuine belief in regulated markets.

Thank you!

cfeher@imf.org

Disclaimer: The views expressed herein are those of the author, and should not be attributed to the IMF, its Executive Board, or its management