

# **Old-Age Income Support in the 21st Century: The World Bank's Perspective on Pension Systems and Reform**

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# Background

- Since early 90s, the Bank's involvement in well over 80 pension reforms world-wide, o/w some 60 countries with loans and technical assistance – applying and moving beyond “Averting the Old-Age Crisis”
- 12 countries in LAC and 10 countries in ECA have reformed and introduced some type of funded pillar as part of a comprehensive overhaul of their pension system
- Sustained Bank' efforts to analytically, empirically and politically review pension reforms world-wide: Pension Primers, Savings Conference, recent NDC conference, core courses, Harvard and Oxford, BBS, etc.
- Chief economists request for more clarity on the Bank's position of Pension Reform – what is the Bank standing for and for what reasons?

# Structure of Presentation

- Conceptual Underpinnings of World Bank View on Pension Systems and Reforms
- Design and Implementation Issues: Selected Areas of Firm Positions and Open Questions
  - Taxation of pension schemes
  - Costs and fees of funded and privately managed pillar
  - Regulation and supervision of private pillars
  - Retirement Products: Can the private sector deliver?

# Need for Reform – Beyond Demographic Crisis (1/2)

- **Fiscal Pressure**
  - Short-term pressure and consequences of un-sustainability: macro instability and crowding-out of other social expenditure
  - Long-term pressure and aging of population: the challenge for developing countries
  - The opportunities and challenges of migration
- **Delivering on Promises**
  - The unfairness, over-promise and low coverage of formal schemes
  - Poverty alleviation among the elderly

# **Need for Reform – Beyond Demographic Crisis (2/2)**

- **Aligning systems with Socioeconomic Changes**
  - Increase in life-expectancy and old-age pension
  - Increase in life-expectancy and disability pension
  - Female labor force participation, divorces and widow's pensions
- **Challenges and Opportunities in Globalization**
  - Reacting to shocks – the need of flexibility
  - Mobility across professions and countries
  - Financial Sector development – a crucial element to absorb shocks and to diversify risks

# Extension of Original Concept

1. A better understanding of reform needs, limits to formal and mandated schemes, and importance and limitations of some pre-funding
2. Moving from three to multi-pillar to deal with multiple objectives, target groups and constraints
3. There will be considerable variations in the way each pillar is formulated, and not all pillars will and need to be present
4. Conditions in a country matter (reform pressure, inherited system, and enabling environment): the path dependency of scope and pace of a viable reform
5. Strong interest in and support of country innovations – such as Non-financial Defined Contribution (NDC) systems, clearinghouse concepts to reduce costs and fees, and new approaches of public pre-funding to review

**Table 1. Multi-Pillar Pension Taxonomy**

<i>Pillar</i>	<i>Target groups</i>			<i>Main criteria</i>			
	<i>Lifetime poor</i>	<i>Informal sector</i>	<i>Formal sector</i>	<b>I.</b>	<b>Characteristics</b>	<i>Participation</i>	<i>Funding/collateral</i>
<b>0</b>	<b>X</b>	x	x		“Social pension,” at least social assistance, universal or means-tested	Residual	Budget/general revenues
<b>1</b>			<b>X</b>		Public pension plan, publicly managed, defined-benefit or notional defined-contribution	Mandated	Contributions, perhaps with financial reserves
<b>2</b>			<b>X</b>		Occupational or personal pension plans, funded defined-benefit or funded, defined-contribution	Mandated	Financial assets
<b>3</b>	X	<b>X</b>	<b>X</b>		Occupational or personal pension plans, funded defined-benefit or funded, defined-contribution	Voluntary	Financial assets
<b>4</b>	X	<b>X</b>	<b>X</b>		Homeownership, family support and so forth	Voluntary	Financial assets

*Note:* The size of x or **X** characterizes the importance of each pillar for each target group.

# Restatement of Key Principles

- Each country should, in principle, have a zero or basic pillar to address poverty among the elderly – issue of who is most vulnerable, fiscal capacity, eligibility criteria and delivery mechanism
- If conditions are right, some pre-funding makes sense for economic and political reasons and can happen in any pillar – issue of balancing benefits and costs, best organization and management
- A mandated and fully funded pillar provides a useful benchmark – but not blueprint – against which the proposed design of a reform should be evaluated

# Goals of a Pension System and Reform

- **Primary goals: To provide adequate, affordable, sustainable and robust old-age income**
  - Adequate refers to both the absolute and relative level (i.e. poverty alleviation and income replacement)
  - Affordable refers to the financing capacity of individuals and the society
  - Sustainable refers to the financial soundness of the scheme, now and in the future
  - Robust refers to the capacity to withstand major shocks, including those coming from economic, demographic and political risks
- **Secondary goals: To create developmental effects by**
  - minimizing negative impacts (e.g. labor market)
  - leveraging on positive impacts (e.g. financial market development)

# Criteria for Evaluation of Reform Proposal

- **Four primary content criteria**
  - Does the reform make sufficient progress toward the goals of a pension system, and meet distributive concerns?
  - Is the macro and fiscal framework capable of supporting the reform?
  - Can the administrative structure operate the new (multi-pillar) pension system?
  - Have steps been prepared to establish regulatory and supervisory arrangements and institutions to operate a funded pillar?
- **Three primary process criteria**
  - Is there a credible commitment by government
  - Is there local buy-in and leadership
  - Does it include sufficient capacity building for implementation

# WB Financial Support for Reforms

- 1984-2004: Bank has made 204 loans involving 68 countries with some type of pension component
- These loans total 16% of Bank lending
- Most of the World Bank's pension related lending goes toward funding multi-pillar projects
- Major share of World Bank loans to multi-pillar schemes were post-reform implementation loans
- World Bank lending to reforms with dominant second pillar is a small share of the total pension related lending

**Table 1.3. World Bank Pension-Related Lending Funds Projects Classified**

Type of pension project	Number of countries	Total Bank lending with pension component (US\$ m)	Pension component (US\$ million)	Percentage of pension component	Number of loans	Share of World Bank's pension-related lending (%)
<b>Loans associated with single pillar</b>	<b>60</b>	<b>18,694.8</b>	<b>2,373.9</b>	<b>12.7</b>	<b>119</b>	<b>43.4</b>
First pillar	53	13,356.4	2,078.2	15.6	91	38.0
Second pillar	8	322.6	125.5	38.9	10	2.3
Third pillar	15	5,015.8	170.2	3.4	18	3.1
<b>Loans associated with more than one pillar</b>	<b>43</b>	<b>13,844.8</b>	<b>3,095.3</b>	<b>22.4</b>	<b>81</b>	<b>56.6</b>
First and second	19	4,125.8	1,433.4	34.7	25	26.2
First and third	20	5,634.9	1,170.3	20.8	22	21.4
Second and third	2	167.0	12.1	7.3	2	0.2
All three	24	3,917.1	479.4	12.2	32	8.8
Loans not associated with any pillar	3	1,660.0	0.0	0.0	4	0.0
<b>Total</b>	<b>68</b>	<b>34,199.8</b>	<b>5,469.3</b>	<b>16.0</b>	<b>204</b>	<b>100.0</b>

**According to the Three Reform Pillars**

# Selected Areas of Firm Positions and Open Questions

- Taxation of pension schemes
- Costs and fees of funded and privately managed pillar
- Regulation and supervision of private pillars
- Retirement Products: Can the private sector deliver?
  
- [How best to reform the unfunded pillar – the Bank’s love affair with NDCs]
- [How to improve the performance of centralized pension funds – guidelines for governance]
- [How to assess poverty among the elderly and introduce social pensions]

# How to tax Pension Schemes

- Pensions should not be tax free (as this is the case in many client countries ....)
- A consumption-type taxation is favored over a comprehensive income-type taxation
- A back-loaded approach (EET) is favored over a front-loader approach (TEE)
- Voluntary and supplementary schemes may be tax favored, but within limits

# Costs and fees: How to contain?

- Comparison of fee levels requires a life-cycle type approach in which all types of fees are considered
- Savings on administrative expenses through use of central clearing house (such as in Sweden)
- Limiting of marketing costs through blind accounts or switching constraints
- Limiting of asset management fees by restrictions on individual choice and, passively managed accounts, employers choice in provider, or competitive bidding of restricted number of asset managers

# How to regulate and supervise private and funded pillars?

- Experience in LAC and ECA in addition OECD indicates less and more controversial regulation
- Basic and largely uncontested regulation to be applied from the beginning, such as
  - Appropriate licensing and capital requirements
  - Full segregation of pensions assets from other activities
  - Use of external custodian and transparent asset valuation rules
- More controversial rules include
  - Market structure and portfolio choice
  - Minimum funding standards for DBs
  - Minimum rate of return guarantees

# Regulation and supervision - II

- Non-controversial rules of supervision, e.g.
  - Need of independent, proactive, well-financed and professional staff in supervisory body
  - Vetting of application for licensing
- More controversial rules and questions, e.g.
  - Single purpose (pioneered in Chile) or integrated supervisory agency
  - Decision about range of institutions permitted to offer retirement products

# How to provide retirement products?

- Focus so far on accumulation phase gives way to investigating the capacity of private sector to deliver appropriate retirement products (phased withdrawal, annuities, ?)
- Joint work program of Financial Sector and Social Protection to review conceptual issues and experience
- Is there a demand-side problem to explain annuity puzzle such as
  - Underestimating (remaining) life expectancy
  - Strong bequest motive
  - Incomplete insurance markets for other risks increase the marginal value of traditional (non-insurance) assets

# Retirement Products - II

- Is there a supply side problem due to investment or longevity risk as appropriate assets to hedge these risks do not exist?
- Can private sector fully insure investment and longevity risks at reasonable/competitive prices?
- Is there a need to share the risk between individual and provider?
- Does the government need to assume both main risks and be the final provider of annuities?
  
- What type of providers should be allowed to offer annuities?
- What kind of products should be allowed?
- When must the private annuity market be ready?
- Should there be price indexation of annuities?

# Summing-up

- Pension reform issues at the Bank – fully multi-sectorial affair which covers from safety-net type via social insurance to financial sector provisions
- Major progress and adjustments in the Bank's understanding in pension issues. Result of constant re-evaluation, re-thinking and internal discussions
- Many conceptual and operational challenges are remaining, such as provision of social pension and private sector annuities