

New Policies for Mandatory Defined Contribution Pensions

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Agenda

- Increasing policy concerns
- Addressing Firms' Market Power
- Managing Investment Risk
- Conclusions

Increasing policy concerns

- Mandatory DC pensions cover more than 100 million
- **Loud critics questioning performance**
- High prices  excessive marketing, supernormal profits
- Redistribution from consumers to firms
- High volatility, negative returns during global crisis
- **Do participants bear excessive risk?**

Increasing policy concerns

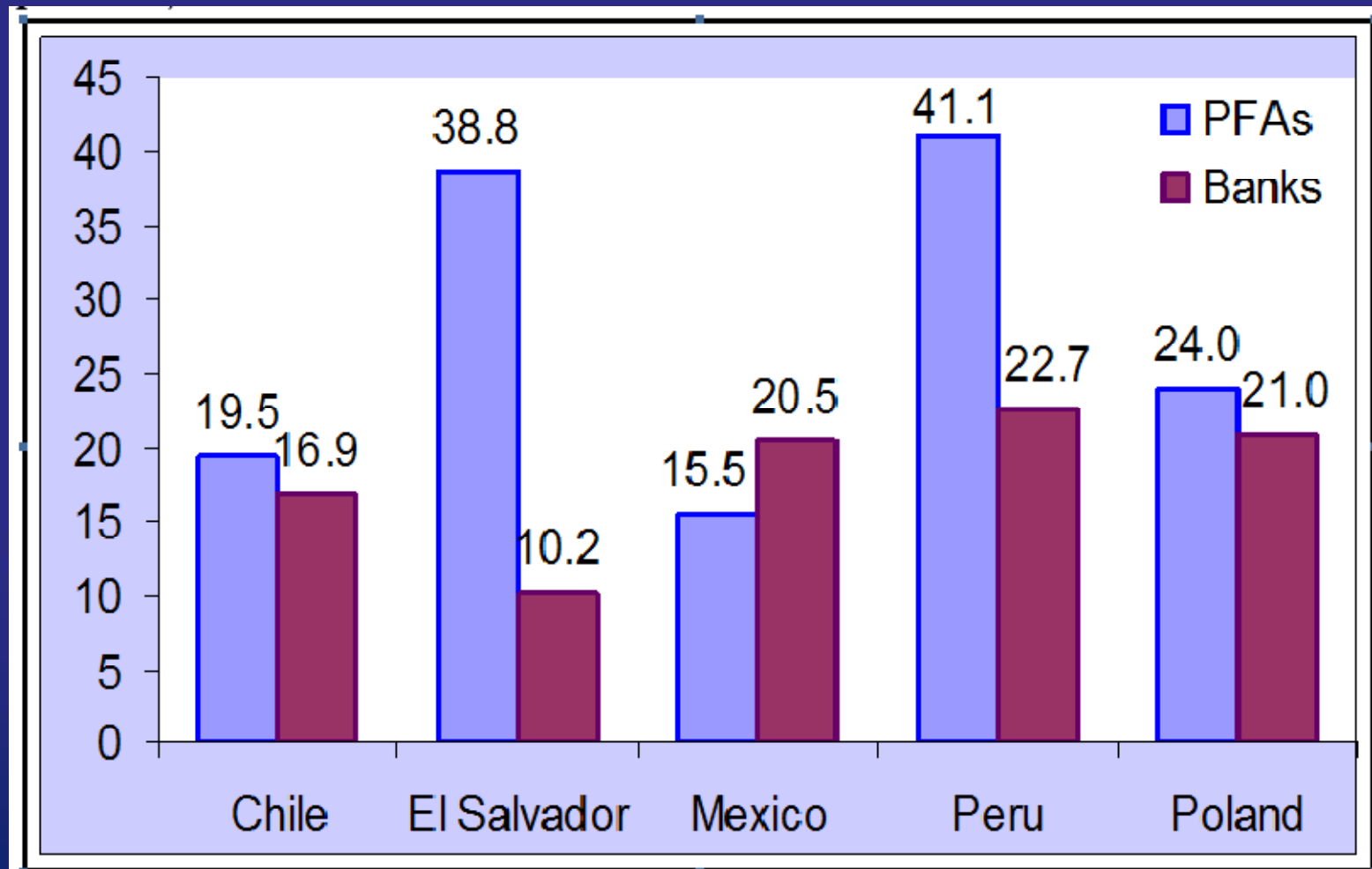
- The two policy concerns are interrelated
- Market affected by captive and inert ***demand***
- Inelasticity to prices (rates of return and fees)
- High participant inertia explained by:
 - Irrational consumer behavior
 - High switching costs
 - Information problems

Increasing policy concerns

- **Supply** constraints (barriers to entry) also affect the market
 - Economies of scale aggravated by bundling of services
 - Specialized entities
- Inertia (demand) and barriers to entry (supply) lead to market power (fees above average costs)
- Pension firms have recorded supernormal profits

Market power leads to supernormal profits

Returns on equity of pension firms and banks, 2006



Source: AIOS, Bankscope, Fitch Ratings.

2. Addressing Firms' Market Power

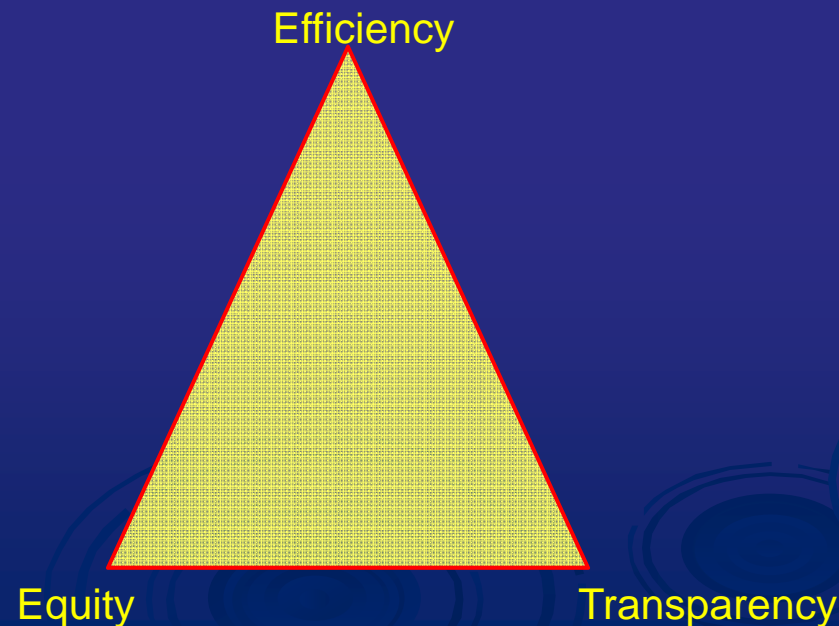


Addressing Firms' Market Power

- Inaction is not a policy option
- Policy interventions to reduce high fees are common
- Narrow focus without addressing the cause of the distortion
- Often generate other distortions

The regulator's trilemma

- Measures that aim at increasing equity, efficiency, or transparency undermine one of the other two policy goals (and vice versa).
- The magnitude of such trade-offs proportional to the inertia of consumers.



Addressing Firms' Market Power

Lighter regulatory interventions

1. Uniform rates

- Pros: More transparent and equitable
- Cons: Increase supply inefficiencies
- Firms cannot cover the marginal cost of each service consumed
- Encourage firms to invest in marketing
- Examples: all countries with DC systems

Addressing Firms' Market Power

2. Simpler fee structures and bundling

- Pros: Need to compare less prices
- Cons: Supply inefficiencies and intergenerational inequities

3. Switching restrictions

- Pros: Discourages marketing
- Cons: Barriers to entry and market power increases

Addressing Firms' Market Power

4. *Price ceilings—more draconian*

- Pros: Reduce administrative fees
- Cons:
 - ✓ Starves asset management/regulatory forbearance
 - ✓ Discriminatory
 - ✓ Become obsolete
 - ✓ Regulatory capture and political risk
- Better price regulation:
 - ✓ Cost-based tariffs linked to a model firm: difficult to estimate and need regular updating

How to promote lower fees with fewer policy trade offs?

1. *Alternative industrial organization models*

Pure procurement

- ✓ Pros: Deals with consumer inertia
- ✓ Establishes competition for the market rather than in the market reducing barriers to entry and rent extraction activities
- ✓ Cons: Pure procurement could reduce investment in innovation and financial technology
- ✓ No benchmark for measuring performance
- ✓ Examples: Singapore, TSP (USA), Bolivia.

How to promote lower fees with fewer policy trade offs?

2. *Alternative industrial organization models*

Hybrid model

- ✓ Involves procurement and the market
- ✓ Pros: Deals with consumer inertia and provides a benchmark for measuring performance
- ✓ Challenges: Is the flow or the stock model better?
- ✓ Flow: New entrants to the system
- ✓ Stock: Full set of inert participant
- ✓ Examples: Bulgaria, Chile, México, Hungary, NZ.

3. **Unbundling of pension services**

- ✓ Reduces cost of entry

How to promote lower fees with fewer policy trade offs?

4. *When possible, complement hybrids and unbundling with flat fees with subsidies for lower income:*

- ✓ Discourage marketing because all participants provide the same rent
- ✓ More efficient to redistribute across the whole population than the clients of a firm
- ✓ Increase the stability of the hybrid model

3. Managing Investment Risk



Managing Investment Risk

- Regulator and pension firm carry a reputational risk
- Individual bears full investment risk
- Global crisis exposed the severity of market risk

Real Rate of Return (end 2008)

Chile	-20.0
Colombia	-2.7
Mexico	-6.5
Peru	-26.2
Bulgaria	-26.8
Estonia	-41.7
Hungary	-6.1

Source: Author's calculations

Note: Last 12 months. Average of all mandatory DC pension funds

Managing Investment Risk

- Regulator and pension firm carry a reputational risk
- Individual bears full investment risk
- Global crisis exposed the severity of market risk
- Inertia and inadequate skills can lead to suboptimal portfolios even during stable times
- What have been the recent policy trends?

Managing Investment Risk

- A gradual move towards some investment choice--multifunds
- Life cycle fund as default option
- Maximize risk-adjusted returns over lifetime
- Young investors with long horizons should have higher equity
- How have they performed?

Real Rate of Return

	End-2008	Mid-2009
<u>Chile</u>		
Conservative	-0.9	4.5
Aggressive	-40.3	-22.2
<u>Mexico</u>		
Conservative	-0.1	4.5
Aggressive	-9.3	-0.6
<u>Peru</u>		
Conservative	-10.2	3.1
Aggressive	-41.7	-24.0

Source: Author's calculations/Note: Last 12 months

Managing Investment Risk

- Life cycle funds can protect those close to retirement from price shocks
- Need for improvements
 - ✓ Increase the universe of investment options (better geographical risk diversification)
 - ✓ Require use of deferred annuities and long duration bonds toward retirement
 - ✓ Increase the number of default options
 - ✓ Allow individuals to allocate cash balances to more than one fund

Managing Investment Risk

Target annuitization funds

- Better link the incentives of fund managers to the long-term retirement objectives
- DC products with a target maturity (the retirement date)
- Investment portfolio is driven by a long-term financial target (e.g., replacement rate)
- Asset allocation is derived from stochastic programming techniques

Managing Investment Risk

Target annuitization funds

- Target is only probabilistic, no liability for the asset manager
- Policymakers can better track the performance of pension funds
- **Challenges:**
 - Stochastic programming techniques are complex and can be implemented only in markets with a minimum degree of development

4. Conclusions



Main Messages

- Addressing these challenges is crucial for the *political economy* of pension reform
- Financial literacy necessary, not sufficient
- Institutional design and default investment options are critical
- More use of hybrid organizational models and unbundling of services to encourage competition
- Flat fees with subsidies where fiscally feasible

Main Messages

- All jurisdictions should consider introducing lifecycle default options
- Great potential for improvements over current design
- Introduce investments products that reconnect the accumulation and retirement phases—where feasible

MUCHAS GRACIAS!

