

# **SOME THOUGHTS ON THE FUTURE EVOLUTION OF PENSION SYSTEMS**

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# NO PREDICTIONS

- Pension systems are highly complex and reflect complex interaction of social, political, economic, financial and medical factors.
- Impossible to make solid predictions.
- Focus on likely trends and pressures.

# IMPOSSIBILITY OF TIME CONSISTENCY

- Pension contracts are inter-generational with long time span, 60 years or more.
- Underlying conditions are bound to change over such a long time.
- Pension systems that make sense today become unworkable or inefficient 20 or 50 years later.
- Need for periodic flexible adaptation.
- Marginal, incremental change is better than radical, path-breaking change.
- Respect for past promises and legitimate acquired rights.

# TIME CONSISTENT WISDOM

- **TA PANTA REI**

- Irakleitos

- **PAN METR(I)ON ARISTON**

- Aristotelis

# MAIN OBJECTIVES OF PENSION SYSTEMS

## PRIMARY OBJECTIVE:

- Provide adequate, affordable and sustainable pensions to all workers.

## SECONDARY OBJECTIVES:

- Minimize economic distortions.
- Promote long-term savings, labor force participation, financial sector development, and economic growth.

# TIME INCONSISTENCY: EMPLOYER DB PLANS

- Group contracts, low operating costs, professional asset management, avoidance of selection issues.
- Early functioning on unfunded basis and “tontine” principles.
- Favoring long stayers and high fliers against early leavers and slow plodders
- Increasingly demanding rules on funding, vesting and portability.
- Heavy regulation essential, but ineffective.
- Assumption of investment, annuitization and longevity risks by employers, but critical dependence on integrity and solvency of sponsors.
- Huge potential conflicts of interest. No primacy of pension provision objective. Use as personnel and treasury management tool.
- Fatal impact of contribution holidays, move toward DC plans.

# NEED FOR BALANCED MIXED STRUCTURES

- **Role and Structure of Unfunded Public Pillar**
  - Basic universal coverage and social protection.
  - Benefits independent of financial market volatility.
  - Need for low payroll taxes to discourage evasion.
  - Strong link between contributions and benefits.
- **Role and Structure of Funded Private Pillar**
  - Mandatory or voluntary with tax incentives.
  - Fully funded with diversified asset portfolios.
  - Effective prudential regulation and supervision
  - High transparency and low operating costs.

# LARGE VARIETY OF PENSION SYSTEM STRUCTURES

- Universal budget-financed benefits in Australia, Denmark, Hong Kong, New Zealand, South Africa.
- Payroll tax financed, modest, well functioning, DB, social security systems in Netherlands, Switzerland, USA.
- NDC schemes in Sweden and a few other countries. Small funded component in Sweden.
- Large dominant unsustainable social security systems in several European countries.
- Mandatory national provident funds in some Asian/Pacific countries.
- Mandatory occupational pension plans in Australia, Finland, Hong Kong, Switzerland.
- Quasi-mandatory in Denmark, Netherlands, Sweden.
- Voluntary company plans in Canada, Ireland, New Zealand, South Africa, UK, USA and several developing countries (Brazil, Caribbean countries, Mauritius, Namibia).
- Mandatory personal plans in several ECA and LAC countries.

# **GROWING BUT TRANSITORY DEMOGRAPHIC PRESSURES**

- **Growing demographic pressures on both unfunded and funded schemes, public or private.**
- **Demographic transition will weaken after completion of baby boom impact.**
- **Uncertain prospects of future longevity. Medical technology might prolong it, bad eating habits might shorten it.**
- **Demographic disequilibrium likely to decline in the long run, mitigating pressures.**

# FURTHER DOWNSIZING OF PUBLIC UNFUNDED PILLARS

- Major parametric reforms in lagging countries (mainly Continental Europe).
- Removal of design faults.
- Possible expansion of NDC pillar, although potential benefits are overstated.
- Adoption of flexible “endogenous” retirement.
- Attractiveness of modest “means-tested” universal benefit for countries with large informal sectors.

# **GROWING CONVERGENCE OF OCCUPATIONAL AND PERSONAL PENSION PLANS**

- **Continuing move to DC plans. Demise of DB plans.**
- **Allowance of group contracts and group discounts in personal pension plans.**
- **Centralization of administration, decentralization of asset management.**
- **Attractiveness of combination of Swedish PPM and American TSP.**
- **Mutation from Swiss Chilanpore to Swedish TSP.**

# Significant Lowering of Operating Costs and Fees

- **Benefits of centralized administration and decentralization of asset management.**
- **Offer of a small number of index tracking funds**
- **Offer of lifecycle funds that operate as “funds-of-funds”.**
- **Rate-of-return regulation on central administrator.**
- **Competitive bidding for asset management mandates.**

# CONSTRAINED CHOICE

- **Constrained choice in selecting among a small number of fund managers (similar to TSP).**
- **Role of fund managers to organize competitive bidding for asset management, select successful bidders, and monitor performance.**
- **Need to resolve agency issues in selecting and appointing fund managers.**
- **Need to ensure good governance and protect the rights of members.**
- **Offer of housing loan option, subject to clear limits.**

# DEVELOPMENT OF ANNUITY MARKET

- Major challenge.
- Need for product innovation (escalating real annuities, extendible annuities, variable annuities, reverse mortgages).
- Need for more effective regulation, including asset/liability management.
- Competitive bidding and greater transparency.
- Combination of TSP approach with greater product innovation.

# RELEVANCE FOR CHILE I

- **Coverage**
  - Linked to size of informal labor market.
  - Consider offering 15% universal pension.
  - Adopt proportionality rule for minimum pension guarantee, e.g., 0.5% for each year of contribution.
  - Exclude high income pensioners to contain fiscal cost.
- **Leave more room for voluntary savings**
  - To contain market power of AFPs narrow range of “eligible earnings” to between 40% and 200% of average wage. Stipulate range each year.
  - Additional voluntary contributions for earnings below or above this range should be permitted, but they could also be directed at other institutions.

# RELEVANCE FOR CHILE II

- **Operating costs and fees**
  - Operating costs: 0.43% of assets in 2004 or 7.1% of contributions. Reasonable but higher than the 7 bp of TSP in the US and ATP in Denmark or the 20 bp charged for index funds by Vanguard and Fidelity.
  - Operating fees amounted to 0.79 percent of assets. Over 1% with hidden fees of international mutual funds.
  - Margins are very high: 84% of costs (46% of revenues). Over 130% with hidden fees (56% of costs).
  - High margins could be partly explained by need to recoup start-up costs and to recover future costs but they reflect market power and ineffective competition.
- **Return on Equity (ROE)**
  - Reported ROE was 21% in 2004. But AFPs operate with unusually high 75% equity ratios. Using 80% subordinated debt would raise reported ROE for 2004 to 65%.
  - Operating fees need to be substantially reduced. Rate-of-return regulation or radical move to centralized administration, decentralized asset management.

# RELEVANCE FOR CHILE III

- **Group contracts**
  - Permit group contracts to be arranged by employers or associations to lower operating costs and obtain group discounts.
  - Monitor terms and conditions to prevent conflict-of-interest situations.
  - Allow group members to change group or join individually.
- **Use of balances for housing and other purposes**
  - Major social and economic benefits from investment in owner-occupied housing.
  - Permit with limit of lower of 100% of outstanding balances or 30% of projected retirement balances.
  - Also permit for education and healthcare.
  - Withdrawals rather than loans but with obligation to replenish over time.

# RELEVANCE FOR CHILE IV

- **Investment policies and returns**
  - Positive past experience due to high but declining real interest rates.
  - Need to expand international diversification and allow investment in other emerging markets.
  - Need to offer constrained choice with lifecycle funds.
- **Expansion of annuity market**
  - Semi-voluntary annuity market, well developed by international standards.
  - Need to ensure better matching of assets and liabilities.
  - Strengthen competition to lower commission rates.
  - Consider offer of variable annuities, escalating real annuities, and extendible annuities.