

The World Bank's Perspective on Pension Systems Reform

"Pension Reforms in Russia and all over the World

—
Implementation Challenges"



Moscow

June 14, 2005

Hermann von Gersdorff
World Bank

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

Conceptual Underpinnings (selection)

Evolution of Bank's perspective of pension system and reforms reflect

@ extensive reform experience in client countries

@ ongoing dialogue with academics and partner organizations (such as OECD, ISSA and ILO)

@ extensive internal discussion and evaluation of pension reforms worldwide

Need for reform – beyond demographic crisis

Extension of Original Concept

Pre-funding still important, but context specific

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

- **Fiscal Pressure**

- Short-term pressure and consequences of unsustainability: macro instability and crowding-out of other social expenditure
- Long-term pressure and aging of population: the challenge for developing countries

- **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. Initial conditions in a country matter – 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>	I.	Characteristics	<i>Participation</i>	<i>Funding/collateral</i>
0	X	x	x		“Social pension,” at least social assistance, universal or means-tested	Residual	Budget/general revenues
1			X		Public pension plan, publicly managed, defined-benefit or notional defined-contribution	Mandated	Contributions, perhaps with financial reserves
2			X		Occupational or personal pension plans, funded defined-benefit or funded, defined-contribution	Mandated	Financial assets
3	X	X	X		Occupational or personal pension plans, funded defined-benefit or funded, defined-contribution	Voluntary	Financial assets
4	X	X	X		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 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, 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 to regulatory and supervisory arrangements and institutions to operate a funded pillar?

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 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
- 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

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