financial & private sector development

2nd Pillars under Attack: Lessons from the Financial Crisis

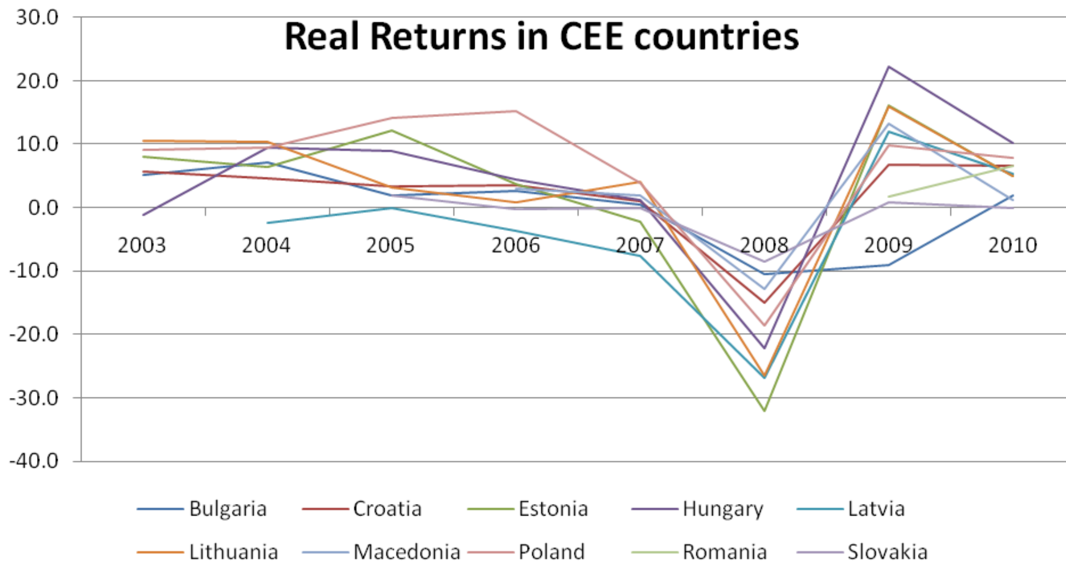
Heinz P. Rudolph, World Bank

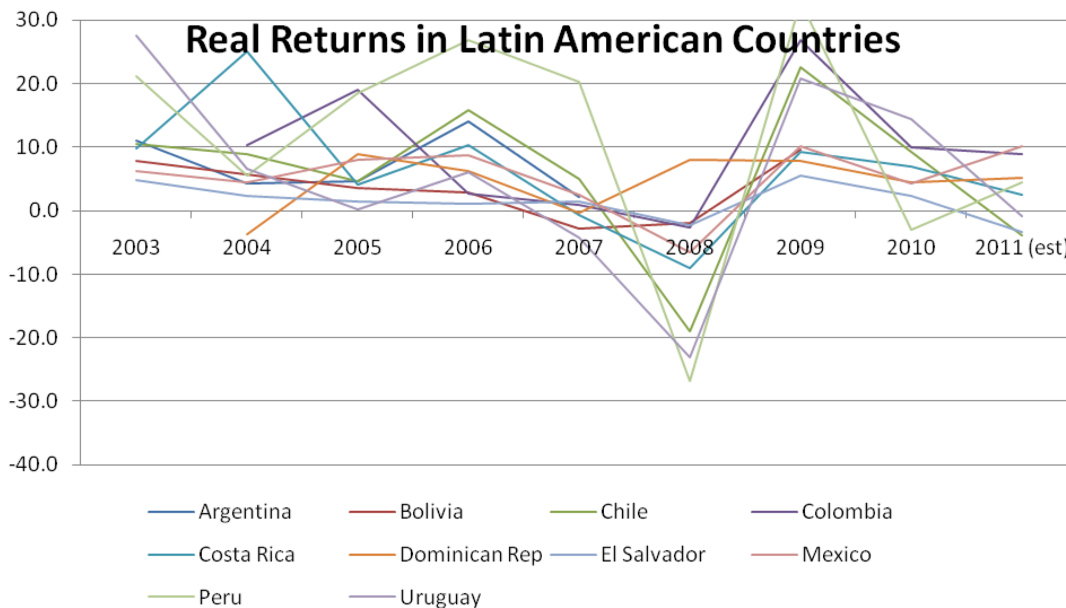
V Contractual Savings Conference

Washington DC,

January 9- 11, 2012

Real rates of return of pension funds

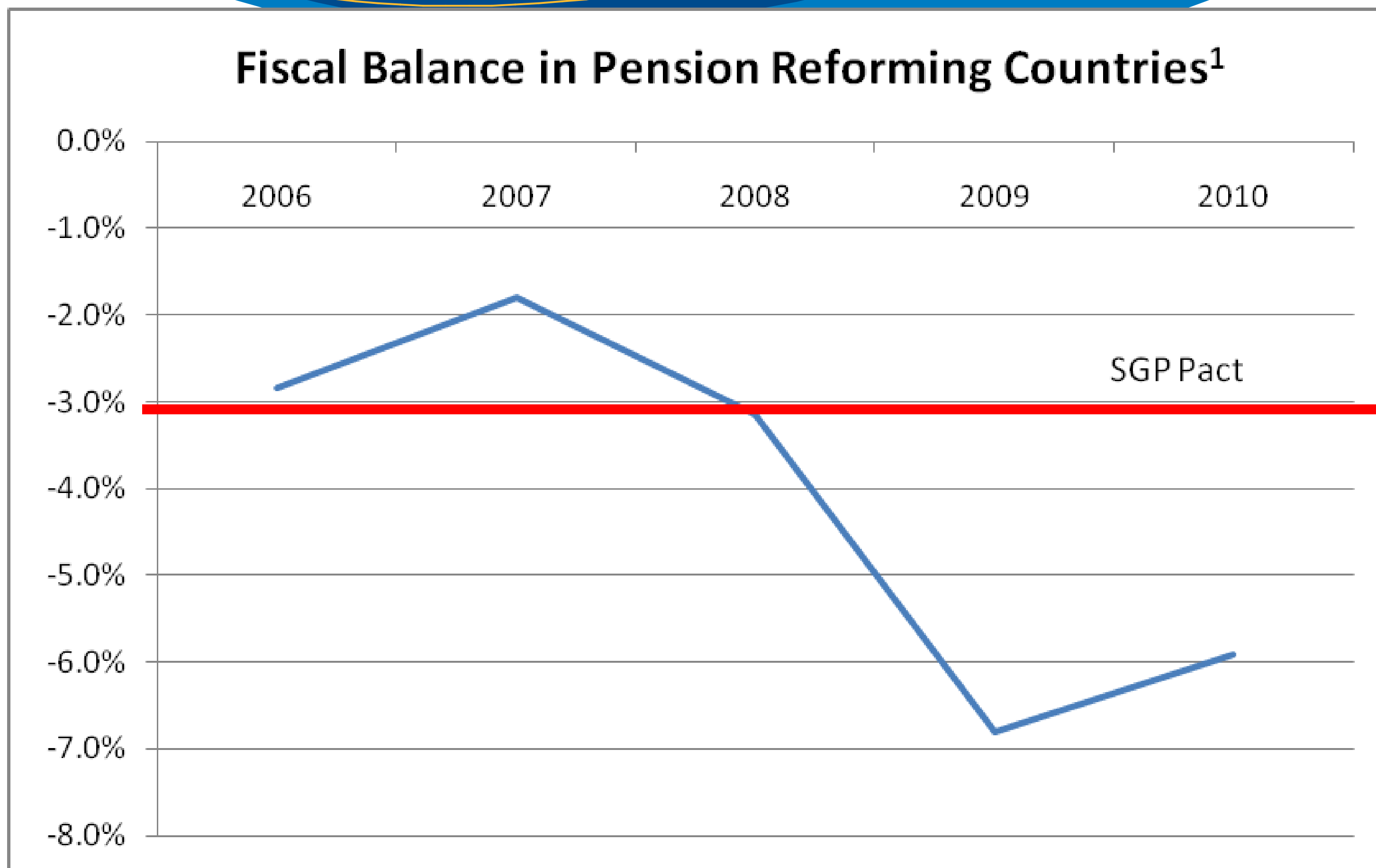




Average Annual Rate of Return		
	Real rate of return since inception or 2002	
	to 2007	to 2010
Bulgaria	4.4	0.8
Croatia	4.8	2.8
Estonia	5.5	1.0
Hungary	4.1	3.2
Latvia	-3.5	-4.0
Lithuania	5.7	2.1
Macedonia	2.5	0.9
Poland	10.7	6.6
Slovakia	0.6	-1.1
Average CEE	3.9	1.4
Chile	7.9	6.1
Colombia	8.0	8.9
Costa Rica	9.0	6.6
Dominican Rep	2.6	4.0
El Salvador	2.2	2.1
Mexico	5.7	4.6
Peru	17.0	10.4
Uruguay	11.7	8.4
Average LAC	8.0	6.4
Source World Bank		

THE WORLD BANK

Fiscal balance in CEE countries[1]



Source: IMF

[1] It includes Latvia, Lithuania, Hungary Poland, Romania, Slovakia, Croatia, and Macedonia

While the crisis has been severe, it does not seem to justify the policy reactions…

Permanent Measures

- Hungary: nationalization of the second pillar
- Poland: Shifting of 5 percentage points (pp) of the contribution rate from the second to the first pillar, and gradual increase of 1.3 percentage points until 2017

Transitory Measures

- Estonia: shifting of 4 pp of the contribution rate from the second to the first pillar, followed by a gradual increase until 2014

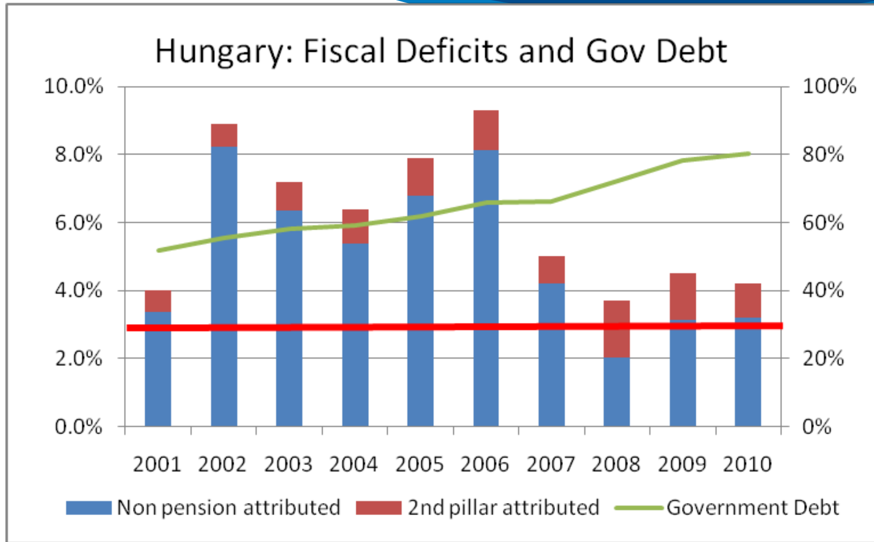
Maybe Transitory, Maybe Permanent

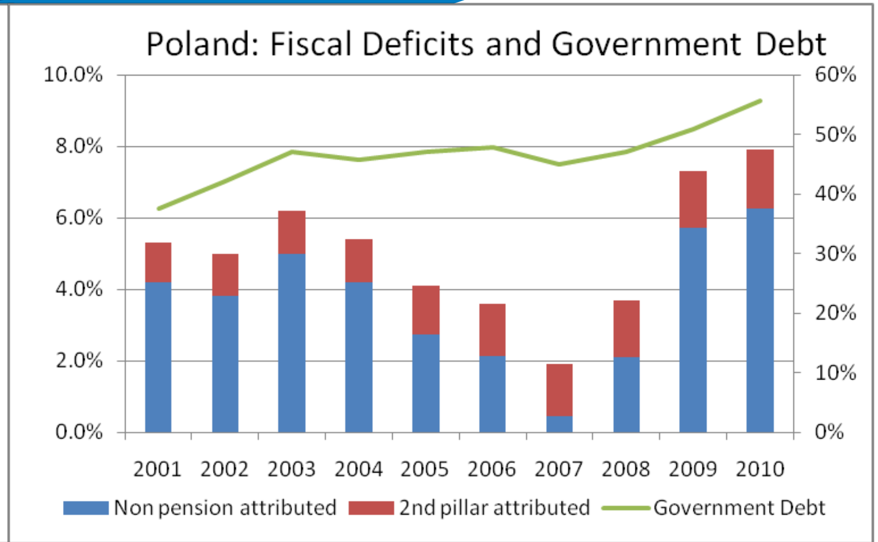
- Latvia: Shifting of 6 pp of the contribution rate from the second to the first pillar
- Lithuania: Shifting of 3.5 pp of the contribution rate from the second to the first pillar
- Romania: Reduction in the growth path of the contribution rate

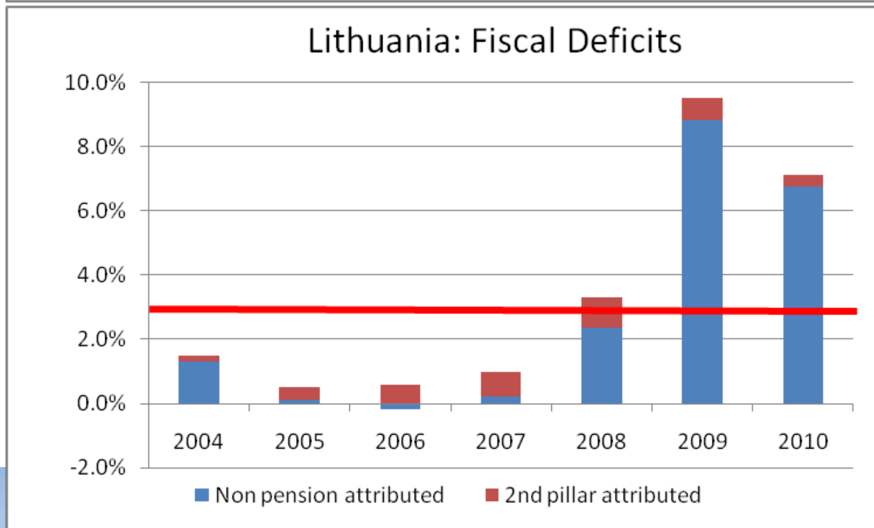
What's behind these reactions?

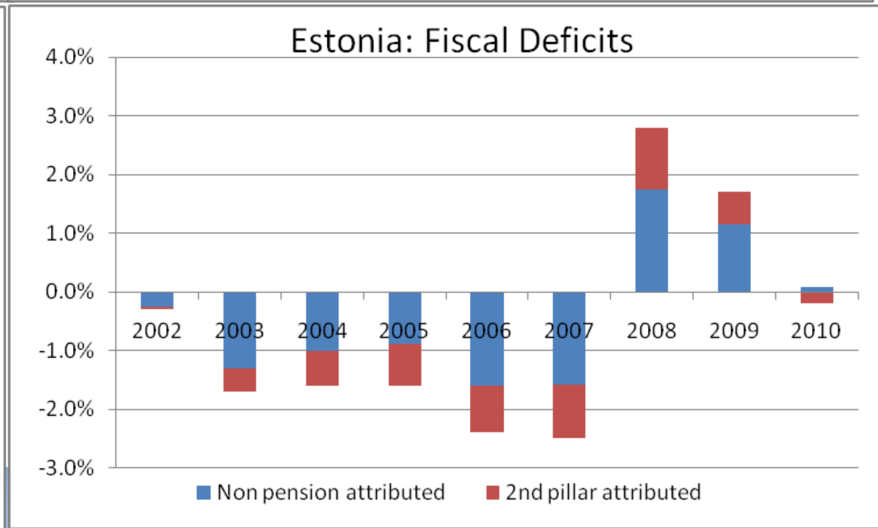
- Unsustainable fiscal policies
- Incomplete reforms
- High fees, undiversified portfolios

Direct correlation between the magnitude of the reaction and the fiscal performance









Source: IMF

THE WORLD BANK IFC

Short- versus- medium-term challenges (1)

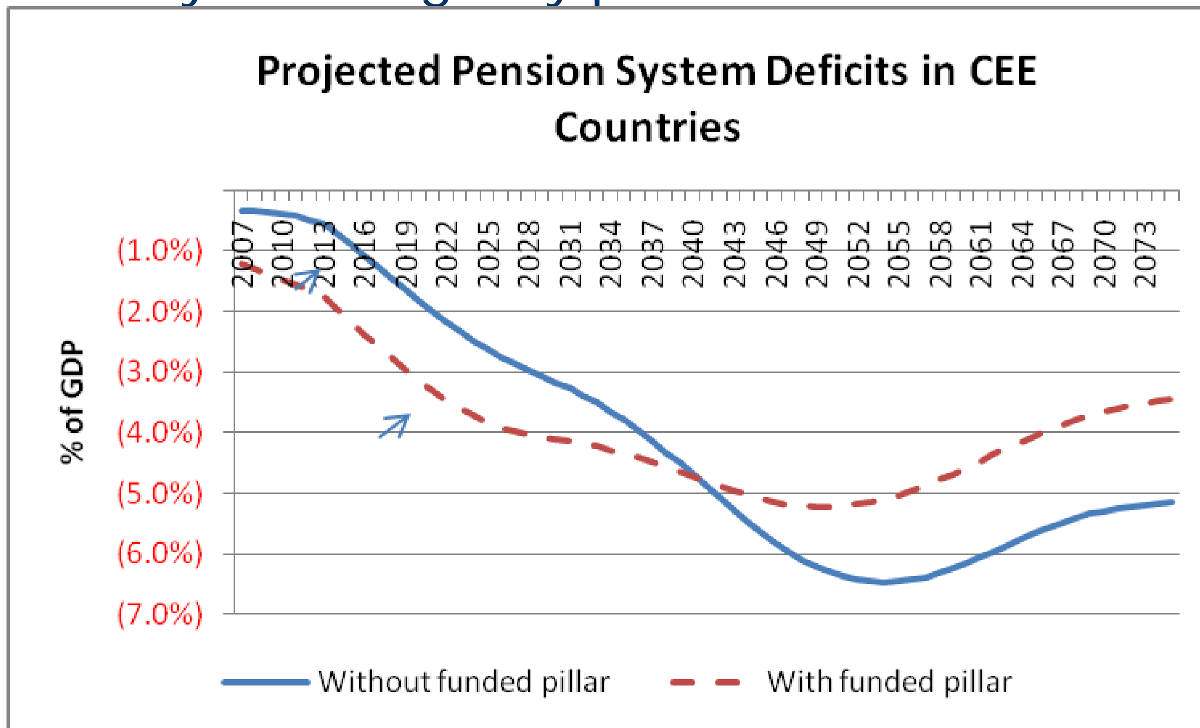
- Countries like Poland and Hungary have relied heavily on debt financing…but pension reform explains a relatively small part of the fiscal deficits
  - By increasing the relative size of the 1st pillar, future pensions will depend more on fiscal risk, as the opposite of capital market risk
- Using the 2nd pillar contribution rate as the adjustment variable for fiscal deficit (Latvia, Lithuania, Romania) creates serious long term consequences in terms of reputation and expectations
  - This is the right time for building broad political consensus about the need for sustainable 2nd pillars
- Estonia's transitory adjustment seems to be a case of a country pursuing a superior objective (Eurozone access) to stabilize the country

Short- versus- medium-term challenges (2)

- By downsizing the 2nd pillar
  - Governments are also reducing their capacity to finance their deficits
  - Government will lose the possibility of a stable source of long term funding (buy-and-hold)
  - Governments will have to rely more on foreign banks, which are openly trying to reduce their exposure to emerging Europe
  - Banks will be unable to download their portfolios, low capital market development
- In the medium term, some of these countries probably will have to either increase taxes, cut benefits to pensioners or a combination of both

Would a shift of contributions from 2nd to 1st pillar solve the problem?

- Fertility and longevity problems are still there



Source: Schwarz(2011)

CEE countries still need funded systems

Would the nationalization of the 2nd pillar solve the problem?

- Nationalization of pension funds create two effects:
  - 1. Liquidity relief for financing short term fiscal deficits
  - 2. Swap of explicit for implicit liabilities
- However,
  - 1. Most of the fiscal deficit has nothing to do with the pension reform
  - 2. By creating an implicit liability, governments still have an obligation…do they?
- Different treatment of defaults on implicit and explicit debt
  - Governments avoid defaulting on explicit debt
  - Governments have less problems by defaulting on implicit debt, for example through parametric reforms
- If countries switched explicit for implicit debt to avoid a future default on explicit debt, they might well default on the implicit one in the future

Implicit versus explicit debt

- While a differentiation between implicit and explicit liabilities persists, countries will have incentives to maintain unfunded systems
- Europe's Stability and Growth Pact (SGP) is a good example. Since only explicit debt is taken into consideration.
  - Countries with large funded systems enter with a disadvantage compared with countries with only pay as you go system
  - Strong incentives to downsize the 2nd pillars in emerging Europe
  - Wrong timing for discussing waivers to the SGP?
- More transparency on the implicit pension debt, and a common methodology for its measurement is needed
  - While risk tolerance of implicit bond holders (contributors) remains different from the one of explicit bond holders (institutional investors), challenges will remain

The bulk of the transitional deficit should be tax financed

- Tax financing is the only way of ensuring that funded system will be sustainable over time
  - Third pillars are tax financed
  - Economies subject to shocks
  - A broad political consensus
- Countries are not double taxing current workers when transition is tax financed
  - Worsening demographics are the main cause of the future pension deficits
    - Decreases in fertility rates are endogenous to the current generation (and are under the control of the workers in most countries)…
    - Current working generation is benefitting from increases in longevity
  - Then, taxing the current generation is socially optimal
    - Why should future generations pay (debt financing) for our decision to have less children?

What's behind these reactions?

- Unsustainable fiscal policies
- Incomplete reforms
- High fees, undiversified portfolios

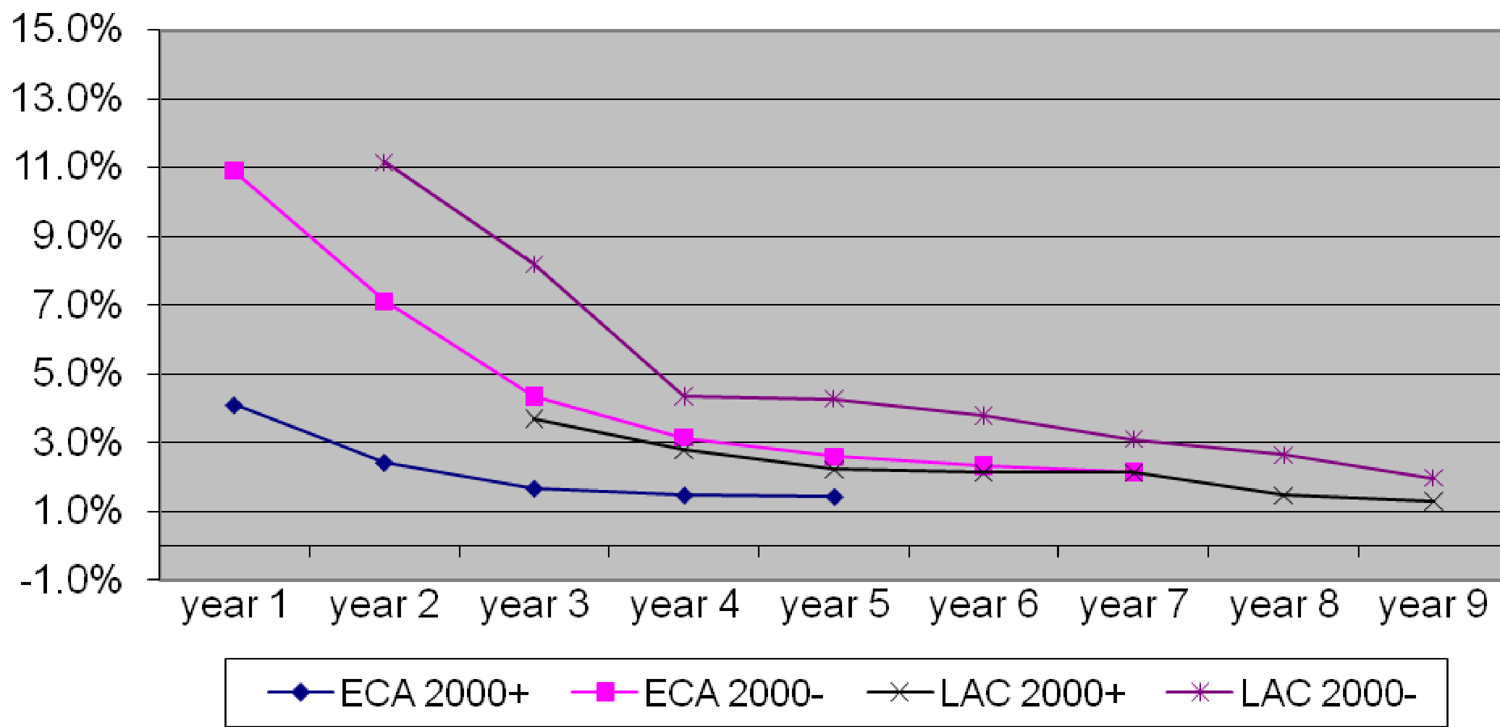
Pensions reforms as an option for development

- Some of these reforms have been implemented in countries that did not have in place the enabling conditions for pension reform
  - Government commitment
  - Fiscal sustainability
  - Financial infrastructure
  - Regulatory and supervisory framework
- Broken promises have been used as a justification for policy reversals
  - *Portfolios highly invested in government securities*, but government bond market crowds out the market due to debt financing of the transition, and restrictive investment regulation
  - *Low impact on the development of the domestic capital market*, but low standards of protection to minority shareholders
  - *Low coverage of the funded system*, but no tax enforcement capabilities and high proportion of rural population
- Pension reform are an option for development (not a guarantee). Successful reforms have been accompanied by sound fiscal, capital market and labor market policies.

What's behind these reactions?

- Unsustainable fiscal policies
- Incomplete reforms
- High fees, undiversified portfolios

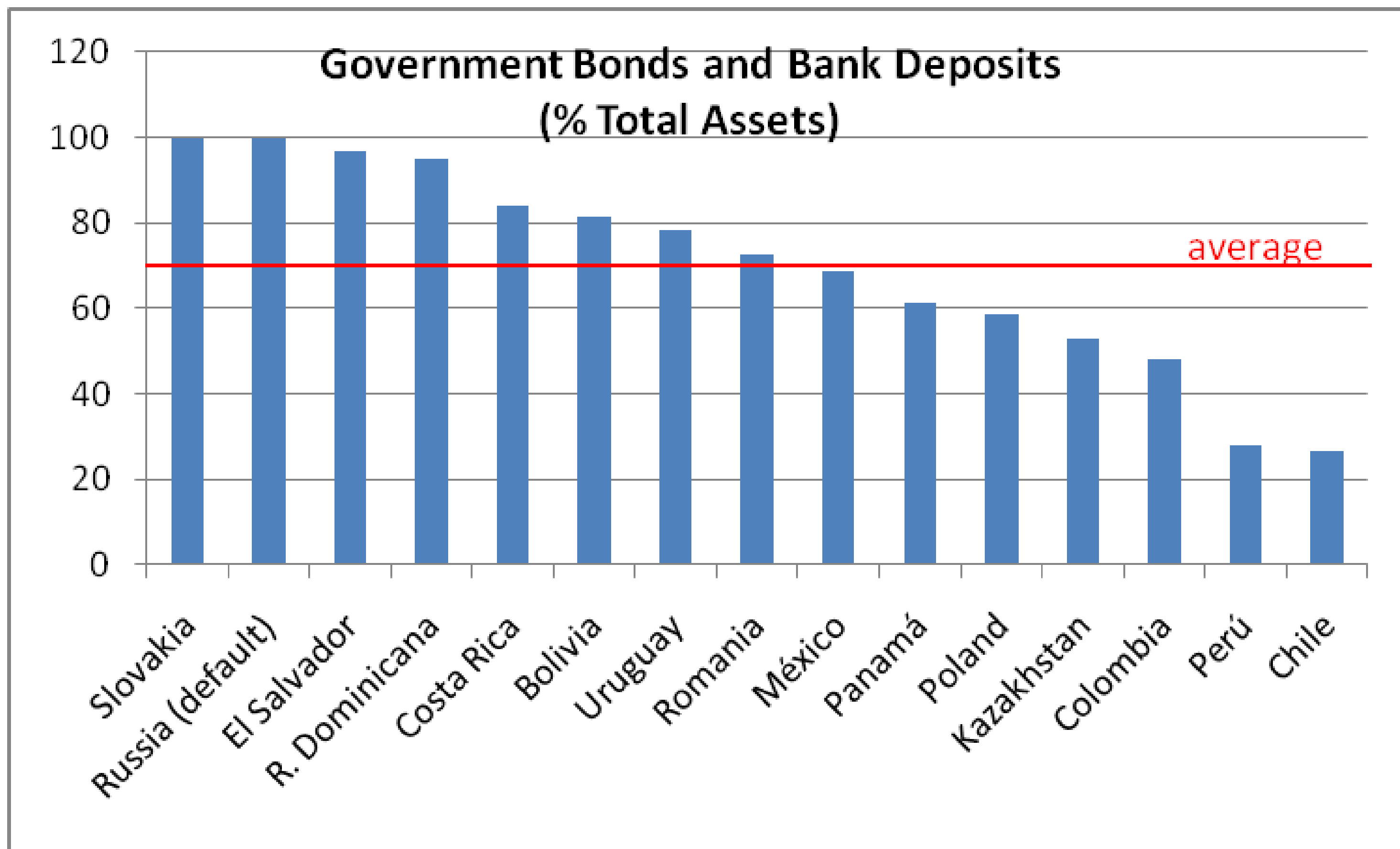
Some issues have not been properly addressed…(1)



High fees are a response to the industrial organization of the pension fund management companies (PFMCs)

- Excessive emphasis on individual selection, in the presence of bounded rationality
  - Excessive expenditures in marketing
  - Supply driven selections of PFMCs
- Inefficient design of the pension management company
  - PFMCs are a hybrid of portfolio and account management
  - While we want competition in portfolio management, we want to take advantage of scale economies in account management
- Pension regulation should move to
  - Unbundling the system (portfolio and account management), and
  - Establishing blind accounts for portfolio managers
- This will result into low costs and efficient IO

Some issues have not been properly addressed…(2)



A better balance between the relative role of the public and private sector

- Competition around the average return of the industry will not bring portfolios into their optimal levels
  - The market is clueless about the portfolio that maximizes the replacement rate
  - We cannot leave to the market a decision that it is not able to solve properly
  - Bounded rationality
- Lifecycle portfolios are those that best address future pensions risk (Campbell and Viceira (2002))
  - Strategic asset allocation explains the bulk of the long term performance of pension funds
  - Market timing and portfolio selection explain less than 10 percent of long term returns
- Pension funds should compete against exogenously defined lifecycle benchmark
  - Lifecycle benchmark is derived from a process of optimization
  - Default option is the lifecycle allocation, but individuals are free to choose

Policy conclusions

- Multipillar pension systems are still needed to reduce pension risk
- Sustainable 2nd pillars require:
  - Broad political consensus
  - Large tax financing component in the initial stages of the reform
  - Active policies to develop the domestic capital markets
- High fees are not endemic to 2nd pillars
- Need to move to optimal portfolios with lifecycle benchmark strategies

The Fifth Contractual Savings Conference

Reshaping the Future of Funded Pension Systems

January 9–11, 2012
Preston Auditorium, World Bank Group
1818 H Street, N.W.
Washington, D.C.

THE WORLD BANK

IFC International Finance Corporation World Bank Group

http://go.worldbank.org/RGPDC72D60

financial & private sector development

Thanks!

hrudolph@worldbank.org

V World Bank Contractual Savings Conference

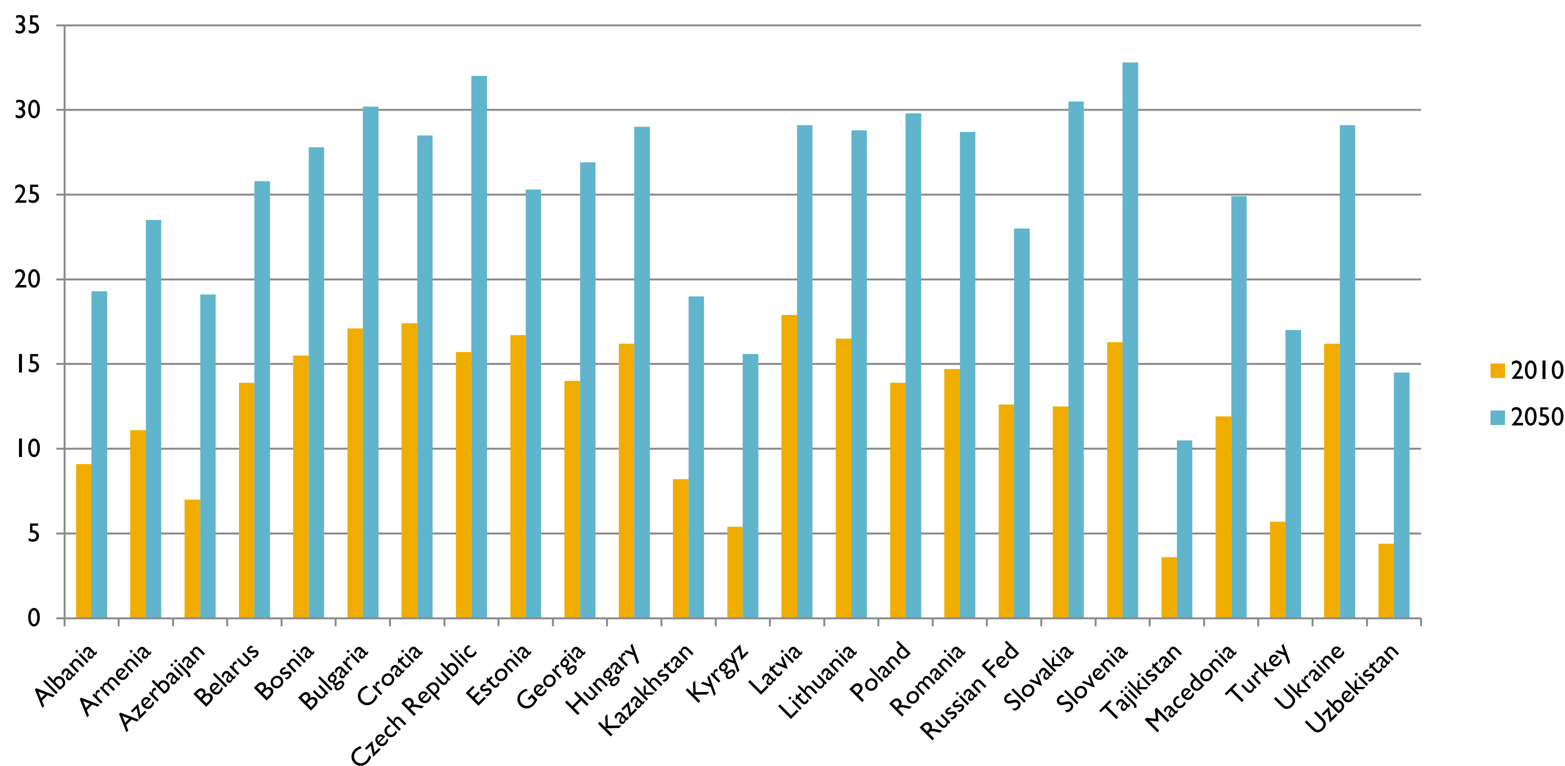
January 9- 11, 2012 Washington DC

Impact of Financial Crisis on Pension Systems – Europe and Central Asia

Anita M. Schwarz
Lead Economist, Human Development Department
Europe and Central Asia Region
World Bank

Europe and Central Asia – Oldest Region covered by World Bank

- Percentage of the population over 65



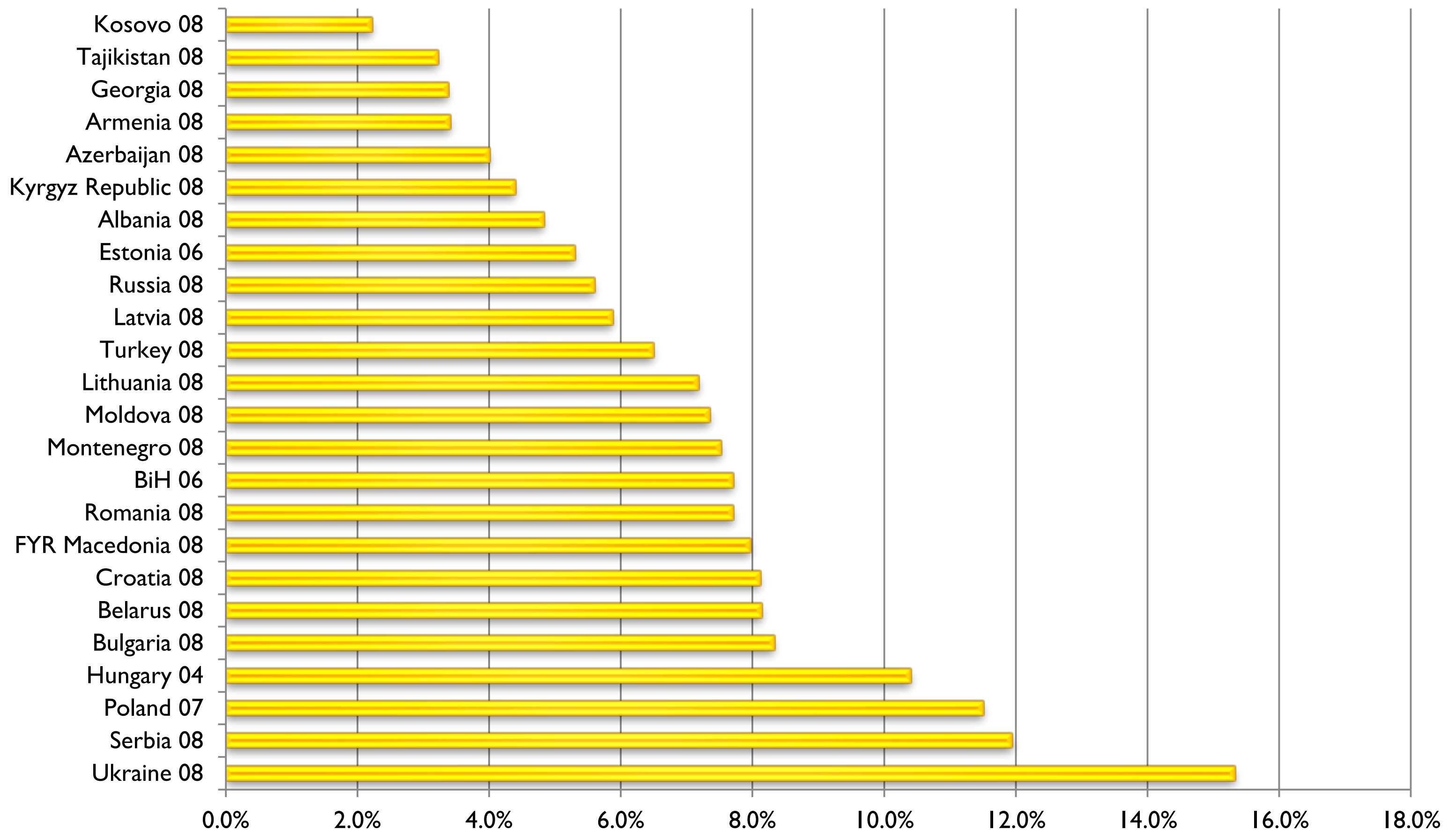
Most Dynamic Region in Pension Reform

- Fiscal pressures from aging and from transition
- Open to reforms – developing new institutions and policies appropriate for a market economy
- Countries have adopted a variety of systems
  - Notional accounts
    - Poland, Latvia, Kyrgyz Republic, Azerbaijan, Russian Federation
  - Point systems
    - Slovak Republic, Croatia, Serbia, Montenegro, Romania, Republika Srpska of Bosnia-Herzegovina
  - Flat universal
    - Kazakhstan, Georgia, Kosovo
- Countries added funded pillars
  - Poland, Hungary, Slovak Republic, Lithuania, Latvia, Estonia, Bulgaria, Romania, Croatia, FYR of Macedonia, Kosovo, Russian Federation, Kyrgyz Republic, Kazakhstan, Armenia, Ukraine

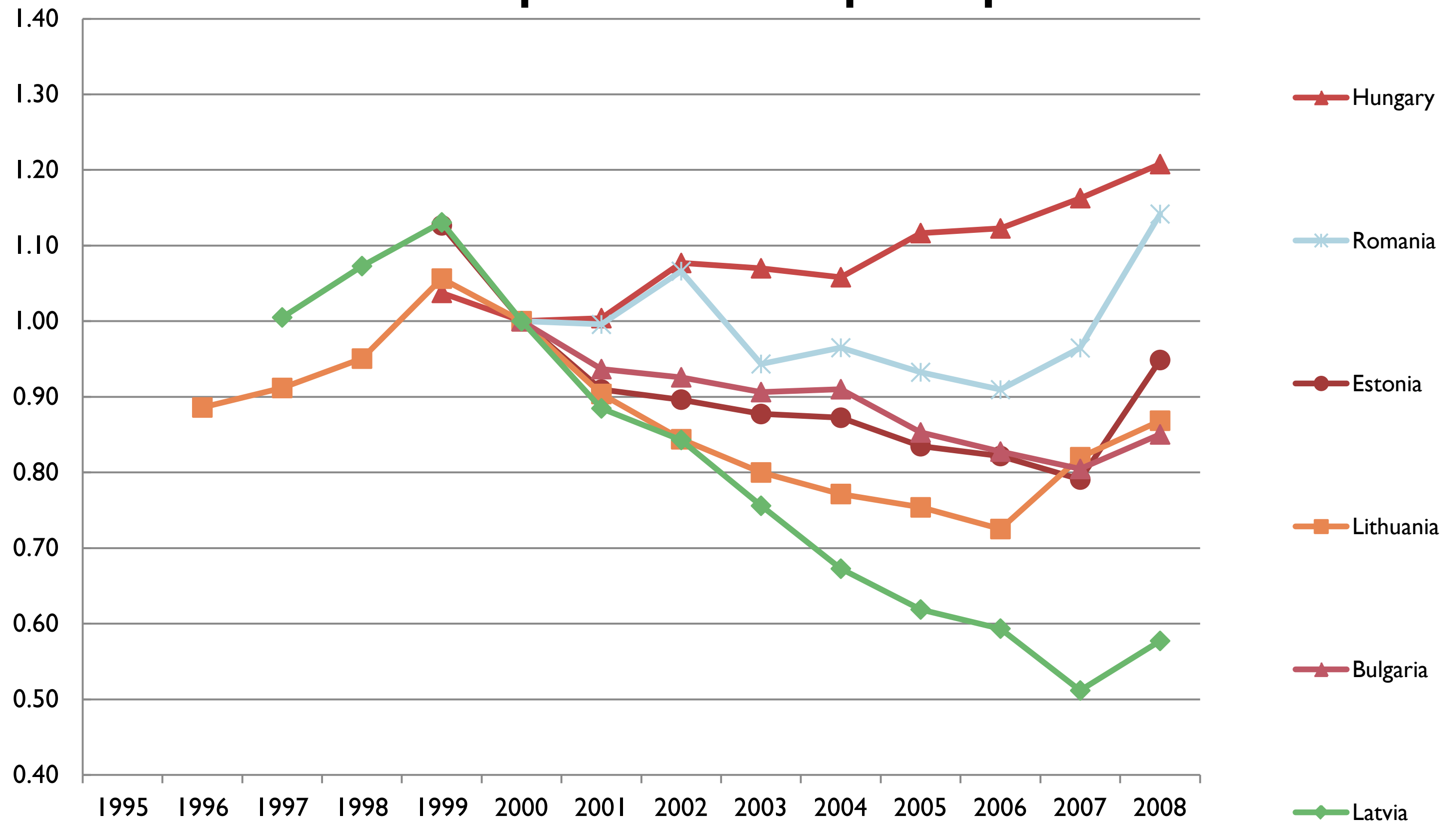
Reforms have included:

- Raising retirement ages
- Reducing replacement rates
- Tightening disability eligibility
- Reducing indexation
- Tying contributions to benefits

Despite reforms, pension spending remained high pre-crisis



Pension Spending Increased in Some Countries Prior to the Financial Crisis



Impact of Financial Crisis

- Contribution revenue fell
  - Increased unemployment
  - Falling or stagnating wages
- Expenditures rose
  - People opted for early retirement and disability
- General revenue which could be used to offset pension deficits also fell as economy slowed and all forms of tax revenue fell

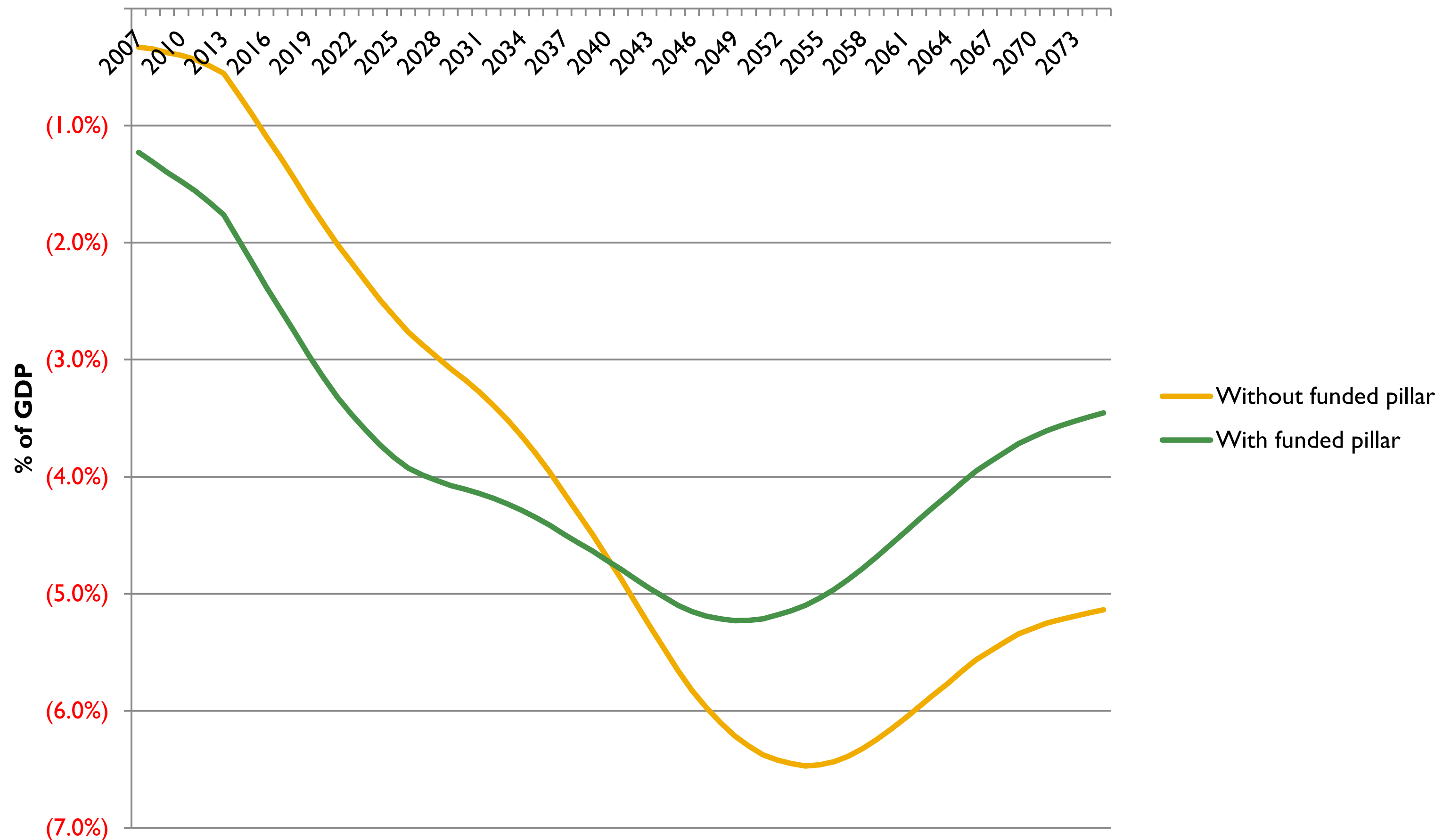
Adjustments in First Pillar

- Pensions were frozen and efforts made to cut them
- Contribution rates were raised
- Some of generosities removed
  - 13th pension
  - Supplements

Adjustments in Second Pillar

- Governments strapped for revenue looked to use second pillar contributions to support first pillar pensions
- 5 out of 15 countries enacted changes
  - **Hungary** - nationalized private system
  - **Latvia** – reduced second pillar contributions from 8% to 2% temporarily, but still in place
  - **Lithuania** – reduced second pillar contributions from 5.5% to 2% temporarily and now proposing additional contributions from individuals
  - **Estonia** – redirected state contributions from second pillar to first in 2009 and 2010, but returned to 2% state second pillar contribution in 2011 and to the original 4% in 2012, with a catch-up period of 6% state contributions scheduled for 2014-17
  - **Romania** – postponed planned increase in second pillar contribution in 2010, but reintroduced increases beginning in 2011
  - **Poland** – reduced second pillar contribution from 7.3% to 2.3%, with a possible increase to 3.5% in 2017 and beyond

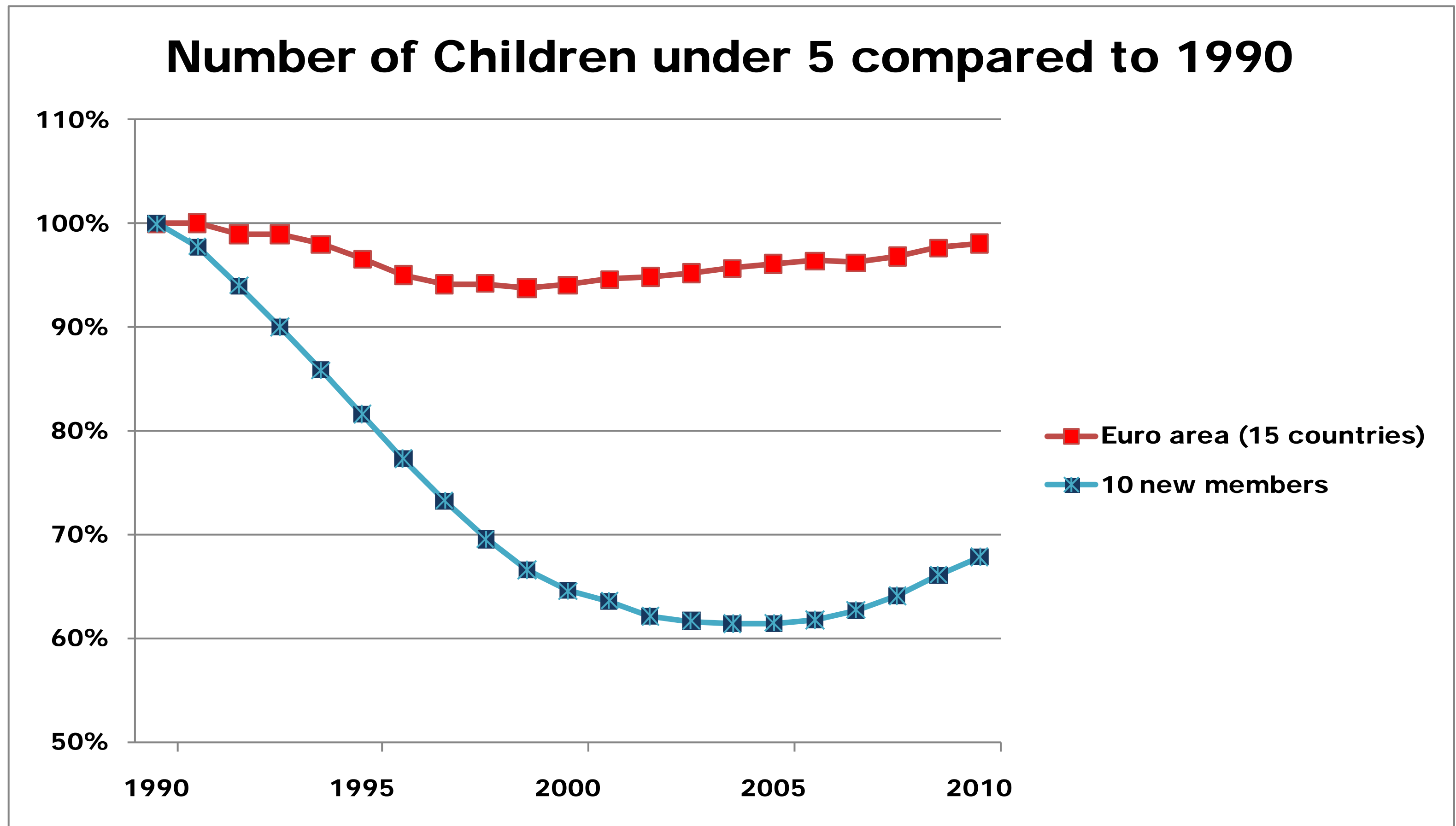
What is the Impact of These Changes in the Second Pillar?



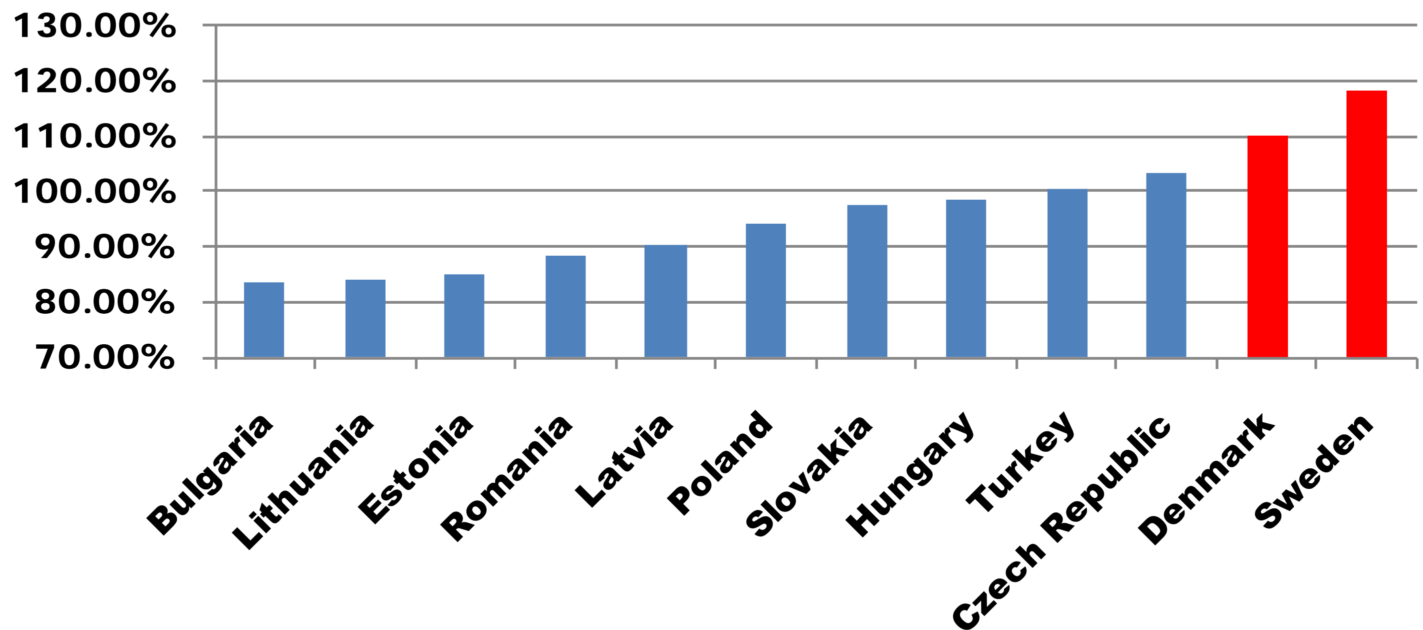
New realities faced by these countries moving forward

- Tighter enforcement of the Stability and Growth Pact
- New fiscal challenges arising from slower growth and lower consumption following the financial crisis
- Starker demographics
  - Sharper decline in fertility
  - Prolonged emigration
  - Persistent informality

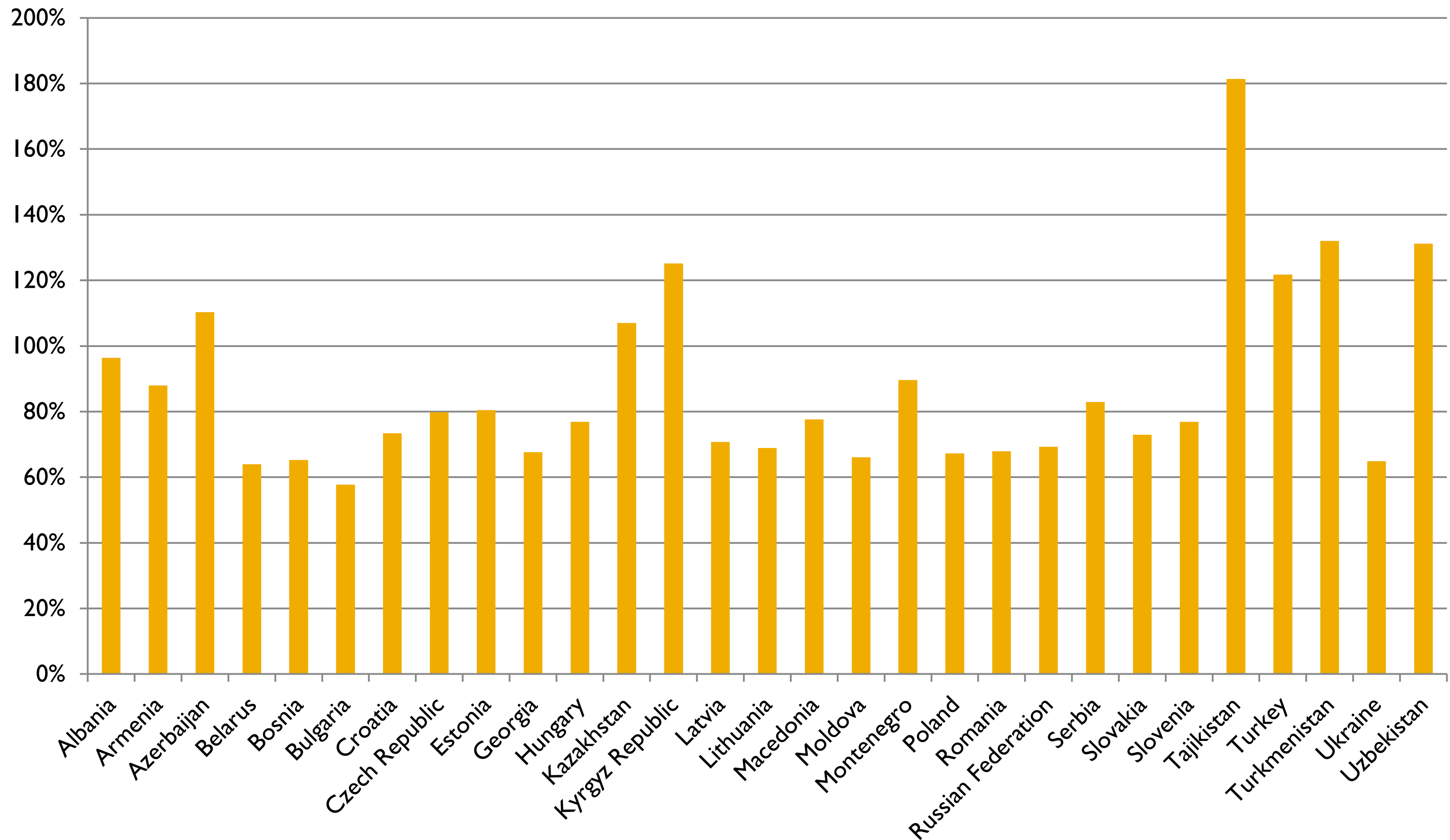
Fertility Rates Have Dropped by a Third Between 1990 and 2010



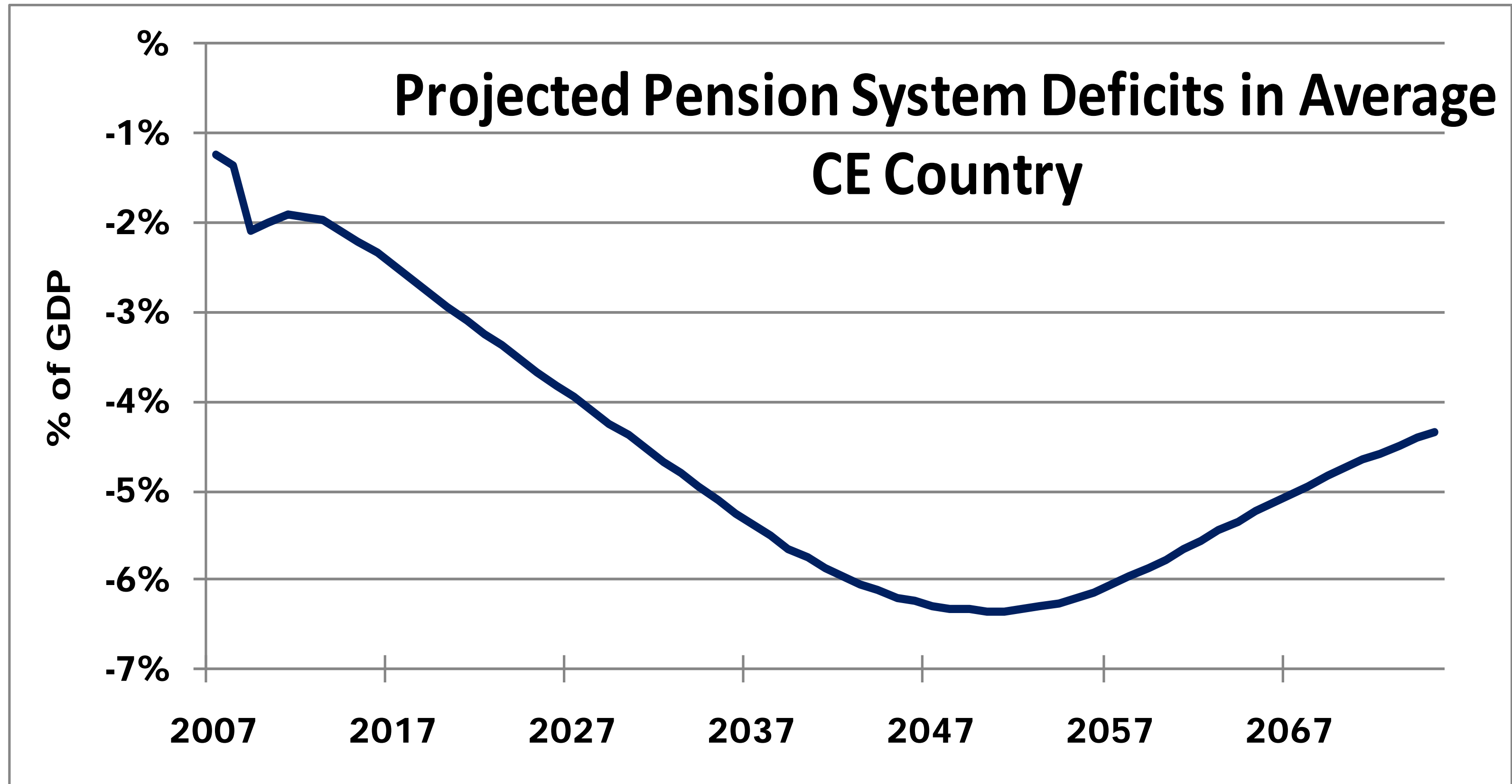
Working Age Population is Shrinking Due to Emigration



Resulting Decline In Working Age Population



Impact of reversals on long-term fiscal sustainability



Before dismantling the second pillar, useful to have social dialogue on other options

- Second pillars are one way of dealing with the long-run demographic challenge
- Alternatives:
  - Rule out raising contribution rates
  - Raise retirement ages further
    - Limits on how high retirement age can go, particularly for some occupations like miners
    - May need to consider modifications more applicable to an aging workforce like part-time work, adjustments to pay scales, etc.
    - May need to finance lifelong learning and retraining opportunities
  - Lower benefits further
    - Limits to how low benefits can go and still prevent old age poverty
    - May need to focus public benefits on basic pensions and maintaining the pensioner's absolute consumption basket in retirement
    - Additional benefits will have to be financed on a voluntary basis
  - Increase selectivity in benefits to be financed by payroll taxes
  - Narrow eligibility criteria for benefits
    - Provide some benefits only to low and middle income
    - Redefine disability to those unable to do any kind of work
  - Actively seek immigration from areas with unemployed youth

Social Dialogue is Critically Important To Avoid Abrupt Policy Changes

- Want to avoid instability and loss of credibility in policy making
  - Do not want to turn "social security" into "social insecurity"
  - Equally applicable to countries which are considering second pillars – need to think hard about whether they meet appropriate pre-conditions
- Also has implications with respect to the credibility of overall fiscal policy
- Impacts signals to private investment community

Reversal of the pension reform in Poland

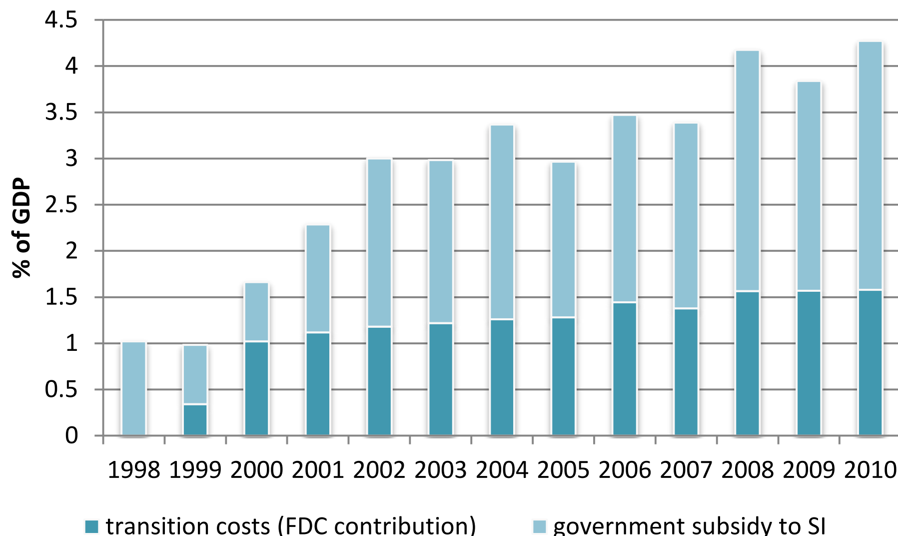
Agnieszka Chłoń-Domińczak, Ph. D.
Institute for Statistics and Demography
Warsaw School of Economics

5th Contractual Savings Conference,
Reshaping the Future of Funded Pension Systems
Washington DC, January 9th 2012

The new pension system in Poland: implementation experience

Initial plan:

- NDC + FDC operating from 1999
- Indexation of pensions close to CPI
- Diversification of FDC investment strategies from 2004
- Early retirement removed from 2007
- Transition costs financed partcially through removal of early retirement



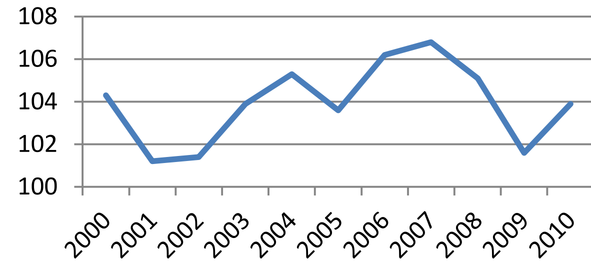
Reality:

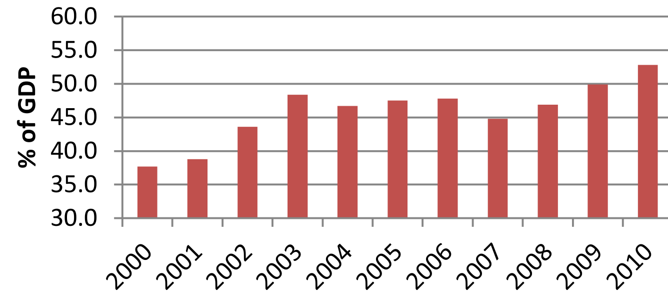
- Initial plans implemented, but some elements remained not solved (annuities, multi-funds)
- Indexation close to wage growth until 2004
- No diversification of FDC investment strategies
- Early retirement prolonged by two years, additonal early retirement rights for men granted in 2008
- Increased social insurance deficit due to reduction of disability contribution from 2008

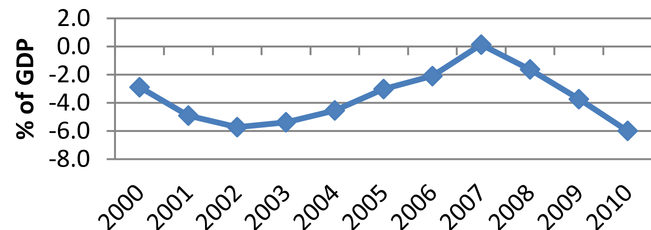
Macroeconomic situation

- Economic growth slowdown after 2007
- Slower employment and wage growth
- Rising state budget deficit and public debt close to the thresholds set in the public finance law and the Constitution (55% of GDP)

- Losses on the financial market affecting perfomance of pension funds
- Upcoming parliamentary elections in 2011





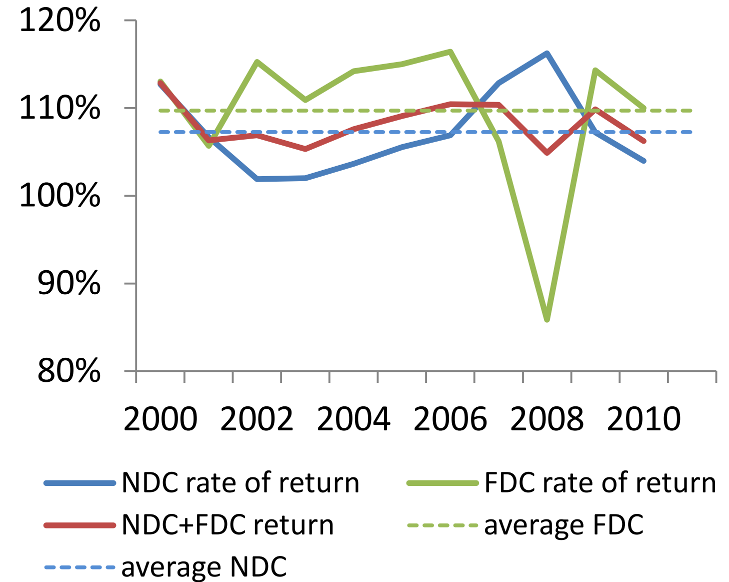


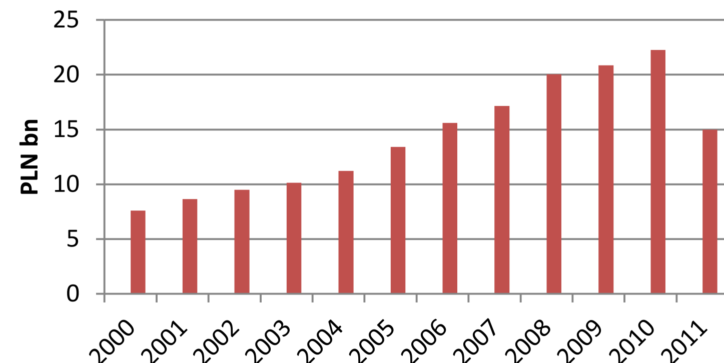
Pension discussion and changes in 2010

- Announced systemic changes:
  - Improved efficiency of pension funds:
    - life-cycle investments
    - External benchmark
    - New incentive / penalty structure to improve performance
- But at the end of the day:
  - decision to reduce FDC contribution :
    - From 7.3% of wage to 2.3% of wage in 2011 (rising to 3.5% in 2017
    - Reduced part transferred to a separate account at Social Insurance Institution (quasi – NDC), with inheritance rights maintained
    - New voluntary pension account with tax exemption introduced, that can be managed by Pension Funds managing companies

Conseqences of the reversal

- **Sustainability of public finance**
  - In short run: public finance debt remaining below 55% of GDP
  - In long run: increased implicit pension debt and higher pension expenditure in the future, when demographic dependency rates worsen sigificantly
- **Adequacy of pensions**
  - Increased risk level (due to changed proportions of FDC and NDC)
  - Potentially lower returns (historically higher average returns in FDC and less investment in equity)
- **Reduced role of pension funds as domestic institutional investors**:
  - Potential impact on the volatility of the Warsaw Stock Exchange
  - Smaller involvment of pension funds on the primary market
  - Problem of relative guarantee (herding, risk aversion)





State of the pension system in 2012

- **NDC holds, its construction allows to maintain long-term balance**
- **In FDC: necessary steps still not completed**:
  - Annuity legislation (first pensions should be paid in 2014)
  - Changes in pension funds regulations:
    - Lifecycle investments
    - External benchmark
- **Lost credibility and transparency of pension system:**
  - Government can take away pension saving
  - Multiple pension accounts: NDC, quasiNDC, FDC, 2 types of individual retirement accounts with different tax treatment, Employee Pension Plans (still underdeveloped)
- **Further changes announced:**
  - Raising retirement age to 67 for men and women
  - Pension indexation (lump-sum in 2012, CPI from 2013)

The Demise of the Hungarian Second Pillar

Peter Holtzer

5th World Bank Contractual Savings Conference
January 9, 2012, Washington, DC

A difficult reform from start

- The 1995 Bokros austerity package paved the way for a World Bank assisted second pillar pension reform in 1997, the first in CEE.
- Consensus was missing among political parties (and pension experts) whether this sort of reform was optimal.
- The government was also divided and in time-pressure before elections had to make compromises on institutional structure (no real ownership of funds) which led to low transparency. Financial providers, asset managers do not own the fund and do not have to put up real capital.
- The next (the first Orbán) government in 1998 immediately changed basic elements, such as opening up switch-back options and freezing contribution rates, which delayed initial plans regarding contributions by 4 years.

Financing does matter

- Transitional deficit was designed to be at 1-1.5% of GDP p.a.
- At the start of the reform, parametric changes in first pillar seemed to allow such a burden.
- The reform plan was based on tax financing.
- The transitional deficit in fact was being debt financed all along.
- Overall governmental mismanagement of the economy made the transition more difficult than expected.
- Overgenerous irresponsible state pensions exacerbated the issue.

Implementation is everything

- The badly designed institutional structure led to low accountability of financial providers.
- Fund managers broke even after appr. 4 years.
- Charges remained high for 10 years.
- Supervisors were ticking boxes.
- The market went for a low-risk home-biased herding strategy for a long time.
- Regulatory changes (fee caps, introduction of life-cycle investments) came only late, with unlucky timing.
- Legal changes regarding ownership of funds and of pay-out design could not be enacted in 2010.
- The overall result is an average net real return of about 1% in 1998-2010.

A second wave paradigmatic reform initiative unused

- The government, in crisis mode, realised in 2007 that changes may be necessary.
- Fine-tuning of second pillar started.
- Parametric changes in state pensions introduced (retirement age, indexation, abolishing 13th month pensions).
- A committee of non-partisan experts (the Pension Round Table) was commissioned to investigate further systemic options, such as basic pensions, point system or NDC in first pillar, size and role of second pillar and voluntary savings.
- In 2010, the incoming new government fully ignored the Report of the Round Table.
- Instead, the government quasi-nationalised second pillar (assets 12% of GDP; ¾ of active population).
- The assets have been spent for cutting state debt, funding current PAYG pensions and other current budgetary purposes.

Is second pillar dead? Here to stay? To be reintroduced?

- Second pillar pension funds do not solve the problems of PAYG alone.
- The funded system covers mostly the same groups (formally employed), while has limited effect on informal economy and the poor.
- Provides better investment diversification than pure PAYG but the effect of aging on asset prices is still relevant.
- Boosting of voluntary savings limited, capital markets development effects mixed.
- Focused, proactive and risk-oriented regulations and supervision are necessary for sufficient gross *and* net performance.
- Smaller and more transparent mandatory pillars, a bigger role for voluntary savings, and a basic pillar may be necessary ingredients of future pension sytems.

Thank you

Peter Holtzer
Partner, Oriens IM, Budapest
+36309718561
peter.holtzer@oriensim.com

Revising second pillar reforms in Latin America: The case of Argentina

Rafael Rofman

Lead Social Protection Specialist

Latin America and Caribbean Region

The World Bank

World Bank Contractual Savings Conference

Washington, January 2012

Outline

- Background: The pension systems in Argentina in the 1990s
- Performance and challenges
- The political context
- The reforms
- Conclusions

Background

- Argentina reformed its pension systems in the 1990s:
  - New privately managed second pillar, with individual accounts (but choice to stay in a PAYG second pillar scheme)
  - Stricter rules and lower benefits, to ensure sustainability
  - Multipilar, with basic contributory benefit

Challenges and performance

- Fiscal: Transition costs
- Financial: Portfolio structure and returns volatility in funded scheme
- Social: Coverage trends

Fiscal Issues: Transition Costs

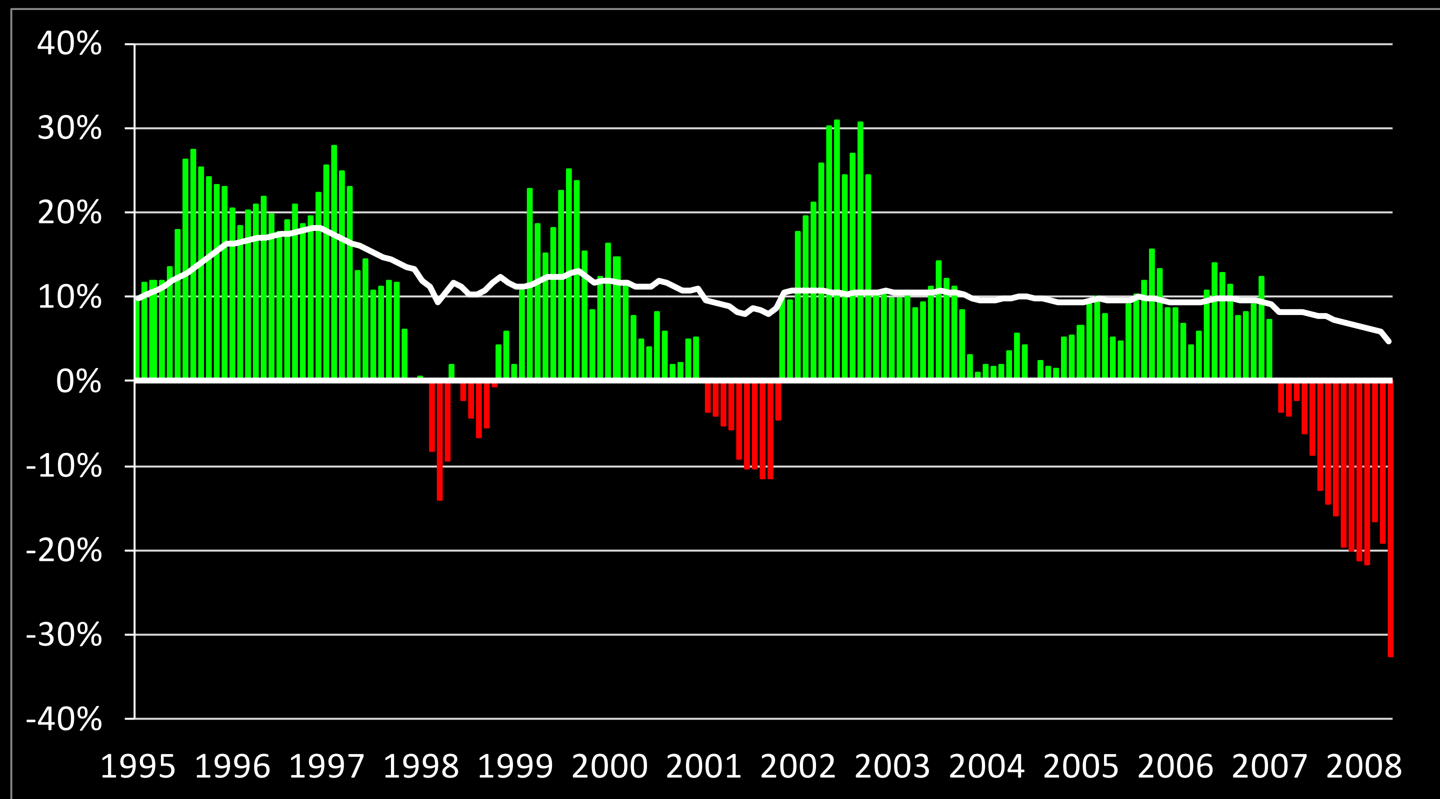
- Partial conversion to FF made transition easier, and parametric reforms helped finance it

Percentage of GDP

Year	Transition cost		
	Contrib. to Funded Scheme	Savings in Benefits	"Pure" Cost
1994	0.3%	0.1%	0.2%
1996	0.9%	0.4%	0.5%
1998	1.4%	0.6%	0.8%
2000	1.5%	0.9%	0.6%
2002	1.2%	1.1%	0.1%

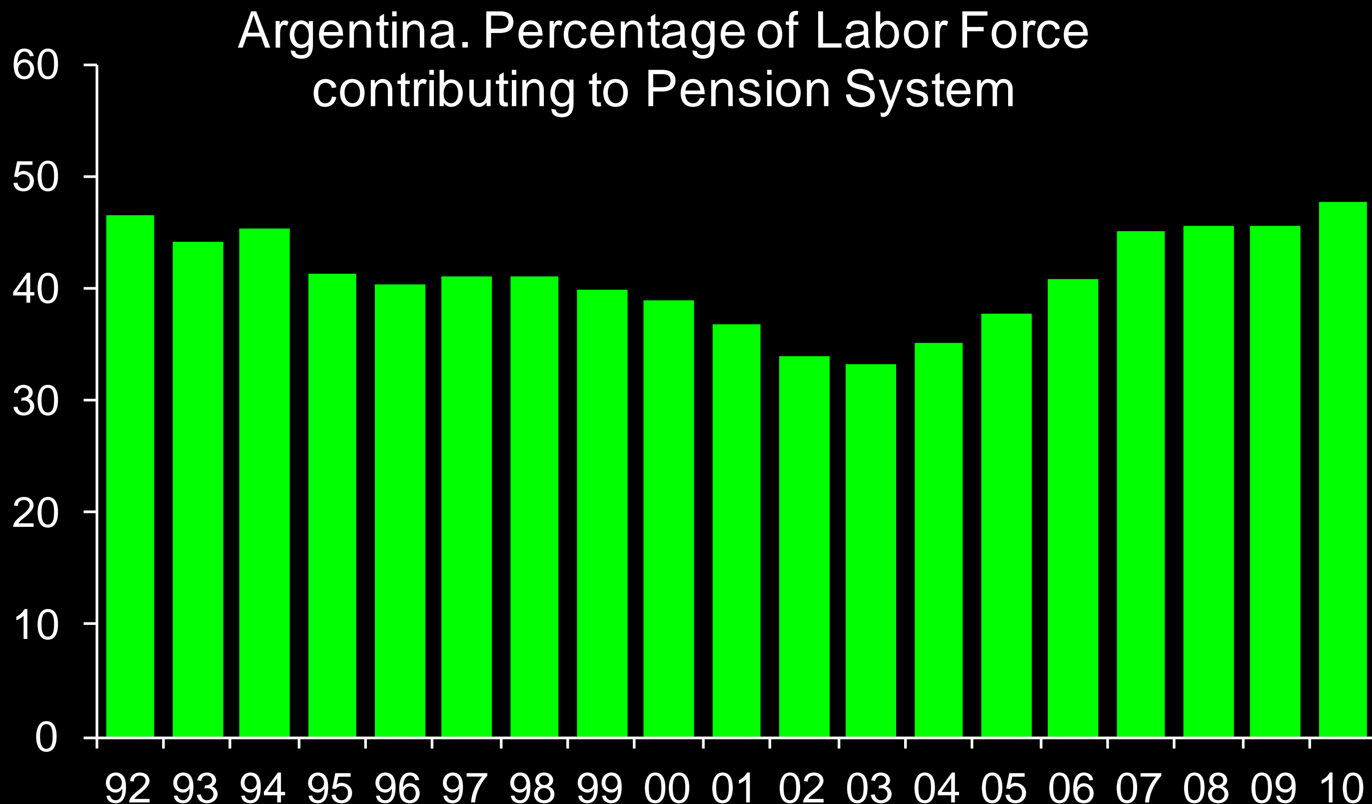
Financial Issues

- High exposure to local public debt, by design
- Heavy impact of 2008 financial crisis on short term returns, but accumulated returns still reasonable:



Coverage trends

- Proportion of labor force protected did not improve after the reform, but started to grow with the economy in the 2000s



The Political Context

- Beyond performance issues, relevant political issues:
  - the 2001-02 crisis resulted in strong negative perception of financial sector in general
  - Difficult year (2008) for Government, needed to score a clear political victory

The Reforms: Argentina

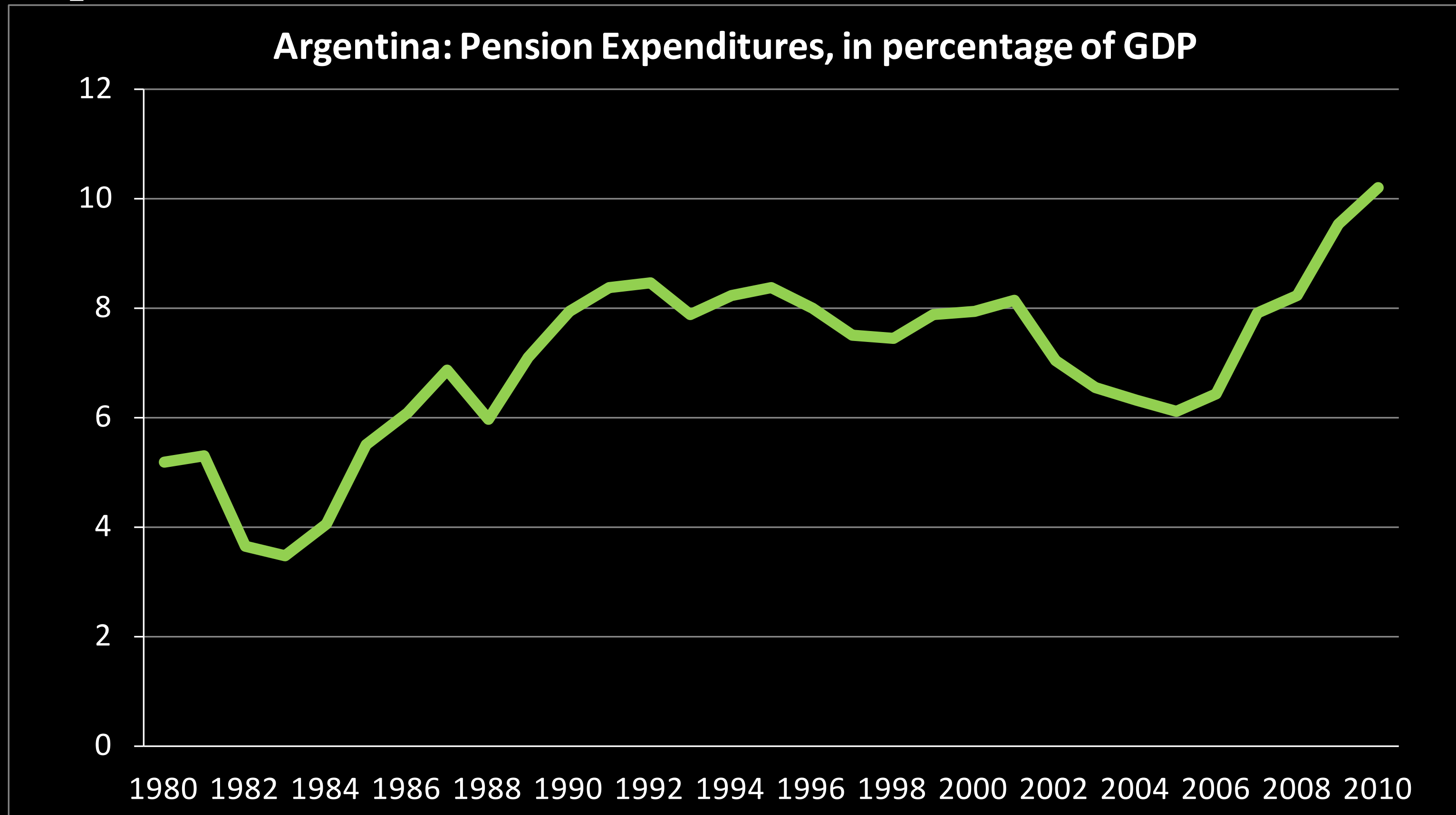
- Multi-stage reform:
- Early 2007: New law affecting second pillar:
  - All new workers enrolled by default in PAYG scheme
  - Workers near retirement with low balance transferred to PAYG
  - Maximum fees for pension managers
- Late 2008: Additional Law, closing second pillar:
  - All workers contributing to funded scheme transferred to PAYG
  - Accumulated funds to be managed by public agency
  - FF beneficiaries (except those receiving annuities) also transferred
  - Tax incentive scheme for voluntary pillar eliminated

Challenges ahead

- Two main challenges: social and fiscal
- Government needed to expand coverage to provide adequate social protection to all
  - Action so far have been on non contributory system. Increased revenue from nationalization help financing this in Argentina, but is a short term solution.
  - Formal employment has improved but is far from desired levels

Challenges ahead

- Fiscal: Expanded coverage and higher benefits must be paid for, now and in the future



Conclusions

- Argentina reversed part of the 1990s reform
- Motivation was on performance, but also political
- Extra funds and good fiscal performance allowed to focus on higher coverage among the elderly in recent years
- But sustainability is not clear, especially if formality does not grow faster
- Main risk is to go back to the pre-1990s reform: weak labor markets, growing fiscal pressures and lack of adjustment mechanisms