The Private Pension Team Strategy: Non-Bank Financial Institutions

The Development Context

The current share of the global population over 65 is 10%. By 2050 this will have doubled to 20%. And in 2050, 80% of the world's over 65's will be in developing countries. Even today, one out of five of the population living under $1.25 a day is aged over 60. Looking forward 80% the elderly- nearly 1.3 billion - will be living in low income countries that do not provide any income for them. The demographic challenges that have placed such significant strains on high-income OECD countries are being seen throughout the world. In part these trends are a problem of success. Greater economic wealth and security lead to longer lives and smaller families. But a failure to deal with income in old age for this and future generations will mean rising poverty or unsustainable burdens on public finances.

Some of the drivers are irreversible. Shrinking family sizes, the fragmentation of family units, and rising urbanization in low income countries translates into less income support for the aged from the next generation. The consequence of inaction is massive old age poverty or people literally working until they die – never to have enjoyed any years of retirement. The common challenge is to build pension systems that prevent poverty in old age and improve labor and capital markets through a diversified mix of public and private provision.

Countries across the world provide positive and negative lessons for how to ensure that coverage of adequate pensions is high, but that those pensions are delivered in an efficient, sustainable and secure manner. These range from countries where: (i) excessive state pensions have created unsustainable fiscal burdens – from Greece to Tanzania; (ii) to those where systems are sustainable but coverage is far too low – from Mexico to Guyana; (iii) to systems where a lack of focus on costs and investments have reduced returns and led to lower pensions in the long run – from Turkey to Peru; and (iv) systems where failures in government policy, regulation and supervision led to the risk of some people losing out on their private savings – from some occupational plans in Ireland to Argentina - where the state took assets from private funds and transferred them to unfunded Pay As You Go state provision.

In addition to preventing poverty in old age and ensuring for sustainable government budgets, private pension reform can also have a positive impact on investment. For example, the build-up and investment of pension assets in Chile reduced the cost of capital, increased total savings and has contributed to economic growth. Pension funds have also been found to contribute to the development of capital markets – when the enabling conditions are right. Huge potential remains. For example, the infrastructure investment gap is recognized as a major barrier to growth in developing economies. Developing countries have $2.5 trillion in pension assets under management. On current trends could be $15-$20 trillion by 2050. So pension funds in economies could be important sources of long term local currency financing for infrastructure. But pension funds must have the expertise to ensure projects are productive, economically rewarding and in the best interests of pension fund members.

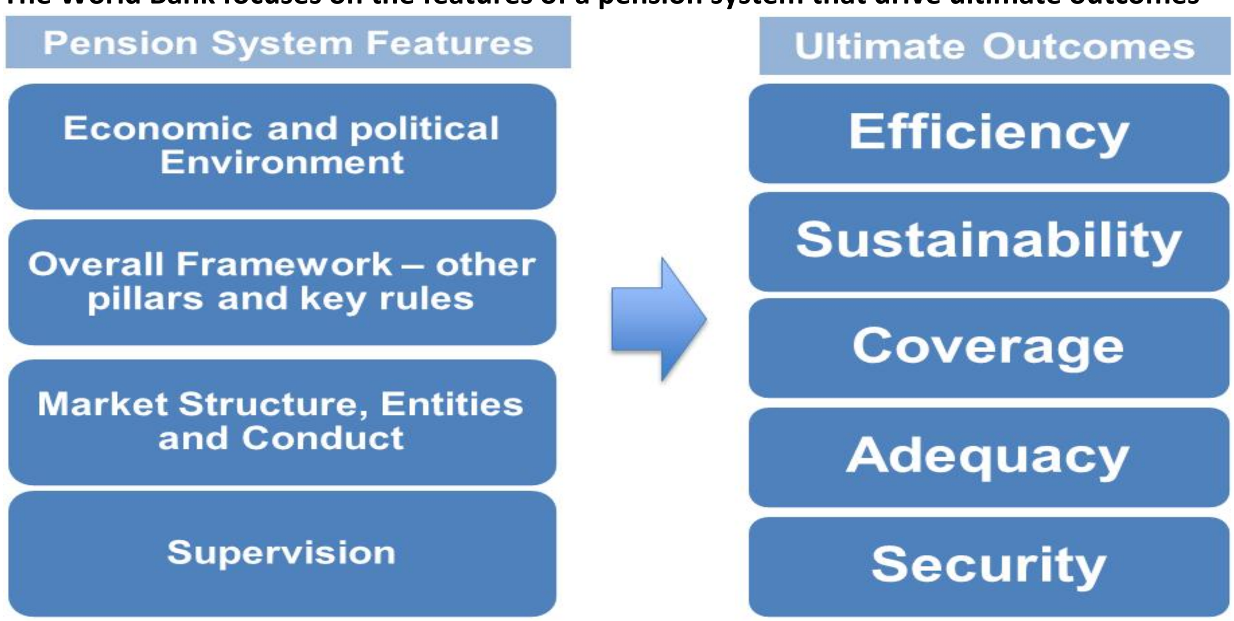
Our Response

The World Bank focuses on working directly with client countries to deliver pension reforms and globally to develop better data, new solutions and to disseminate knowledge of what works. The work focuses on how best to increase the ultimate outcomes of a pension system – the combination of efficiency, sustainability, security, coverage (inclusion) and adequacy that mark out a robust pension system.

For example we are working with African governments to improve the administrative efficiency of social security and pension funds. In the Caucasus region, the Bank supports governments to ensure that new pension systems are established with a low cost -high investment quality - industry structure. Here a 0.5% (50 basis point) reduction in costs can increase final pension income by 10%. In countries where investments are mainly in government bonds (as in much of Eastern Europe) implementing better investment strategies that raise real returns by 1% would increase pension income by 20%. Likewise advising on extending coverage targeting programs on the informal sector can increase coverage as seen in Brazil. Promoting the UK's experience of auto-enrolment (with lessons from New Zealand and Italy) can show how to increase coverage by up to 40%. Advising on improved regulation and supervision as in projects in Guyana and Trinidad & Tobago can ensure occupational plans have sufficient assets to pay all members – avoiding crises seen in the US and UK and most recently Ireland where pre-retirement members of one plan lost 82% of their pension.

Our experience with clients highlights four main drivers of these ultimate outcomes on which we focus: i) the economic and political environment – including the capital and labor market, ii) the overall legal and policy framework including the contributions and investments, iii) the market structure and conduct of the pension industry (who is providing pensions and annuities and how); and iv) the work of the pension supervisor to ensure assets are secure and the system is robust to shocks. We combine a mix of economic, strategy, legal, investment, modeling and supervisory expertise to develop proposals that lead to changes in law, regulation, supervision, financing and operations in client countries. Moreover, we work closely with IFC colleagues as part of a joint practice, for example on developing the equity and bond markets necessary to channel new pension contributions to productive investments.

The World Bank focuses on the features of a pension system that drive ultimate outcomes



Our strategy is to have a mix of country-specific engagements. Building on our experience of client demand these are split between country projects with broad-ranging strategic reforms affecting all aspects of a pension system – both public and private - and all outcomes; projects on the accumulation phase of private pensions, projects on the ‘payout’ phase e.g. working with countries that have large pension assets but not a way to transform them into a stable retirement income; and projects that target a specific aspect of a pension system, such as the coverage, or efficiency.

One of our MENA clients is an example of strategic reform (category 1 above). In addition to in-depth modeling work supporting reform of the civil service pension plan, we are supporting a new pension supervisory authority and are working with the government on its medium-term roadmap to make the overall pension system more efficient via the merging of funds and the extension of pension coverage.

Advice in Malaysia on the payout phase (category 3 above) aimed to tackle a problem where very significant pension accumulation (Malaysia’s main ‘2nd pillar’ pension fund is in the global top 10) was followed by a very under-developed payout phase – where 70% of people had used all their assets within 10 years of retirement.

Linking country specific projects with developing global data, solutions and dissemination

The country projects are then used to develop global “best practice” – for example in our books on key policies to improve pensions – such as on annuity markets and other payout options or how to improve investment strategy and allocation; in case studies and lessons learned from policy reforms and implementation and in developing guides and toolkits to improve the ability of countries to deliver and reforms. In addition we work to develop the availability and understanding of the facts on pensions and work globally on disseminating lessons and leveraging partnerships with other academic, private sector and international organizations – including the OECD and International Organization of Pension Supervisors. A critical gap is the very poor state of data on most countries. This includes information on costs and real investment returns. Even data on developed countries is often poor, inaccurate or incomplete yet such data is central to having a clear understanding of current and future outcomes.

Our work has a country, regional and global focus that is mutually reinforcing

Regional and country teams, and global and regional partners, are central to achieving maximum impact

The regional and country teams help develop the knowledge and relationships that will influence a desire to act.
Global and regional partners (OECD, IMF, IOPS, IAIS) help create solutions we can implement and in turn influence countries to understand and address issues.

Monitoring and Evaluation Framework

The Monitoring and Evaluation Framework flows from the focus on the outcomes. This is shown by the Monitoring and Evaluation loop in our published strategy. The targets are dependent on the country and the project scope. But for example a strategic reform, or reforms focused on improved efficiency could target a 0.5% (50 basis point) reduction in costs. This equates to an average increase in retirement income of 10%. Increasing investment returns for a given level of risk by 0.5% in the countries with investment portfolios heavily focused on domestic government bonds translates to a 10% increase in retirement income. Increased coverage targets again depend on country and program but recent UK experience suggests an improvement of 30% points could be achieved even in mature markets through auto-enrolment – if labor markets are relatively formal. In the countries that have a significant public sector pension and a small or non-existent funded private pension system one can target a % point reduction in the ratio of implicit pension debt to GDP. Finally, for the security of pension systems one can target an improvement in compliance with international standards, with no areas 'not met' and an average of 5 areas moved to the next level between 'partly met' and 'fully met'.

Examples of global best practice and outcomes from which the country specific indicators are drawn

Efficiency	•World leading pensions cost under 0.5% or 50bps of assets under management a year, second tier 0.5% to 1%, third tier 1% to 2% and the most expensive systems cost over 2%. •Returns on average in the worst funds can be negative or zero, while the best give 4% real pa •By 2050 a 0.5% point difference in annual growth achieved through good policy would be worth $85bn a year.
Sustain ability	• Achieving sustainable public finances and politics requires tackling the challenges from longevity and low interest rates and returns. Target would be to reduce the combined total of explicit and implicit debt (unfunded pension obligations on government balance sheet. As a reference implicit debt in key EU countries ranges from 163% to 293% of GDP.
Coverage	•Increasing coverage from 20% to even 50% globally would cover hundreds of millions of workers. Specific target for increase in coverage would be country specific and linked to the type of intervention – for example if only a voluntary private pension introduced coverage target would have to be modest – around an extra 10% point. Mandatory/auto-enrolment reforms can target much higher percentages – depending on degree of labor market informality – from 30% to 80%.
Adequacy	• Core adequacy – increase in % of people with income above the poverty line. • Broad adequacy – increase in incomes of bottom 40% of population (to align with new World Bank global targets on eradicating poverty and boosting shared prosperity. • In both cases target broken down by gender (and other relevant groups e.g. region) to focus on improving equity.
Security	•Annuities and other retirement products can protect against falling back into poverty – so outcome would be increased % of individuals with secure retirement income •Automatic adjustments to risks can be built into the system – with retirement ages rising with longevity and investment allocations changing with age to reduce the impact of instability and encourage long-term investment players in the capital market.