Why Consider a Funded Pension System?

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Topics to Be Covered

- I. Advantages and Disadvantages of Funding
- II. Structure of Funded Systems
- III. Moving from PAYG to Funded
Essential Difference Between Funded and Unfunded Systems

- **Unfunded**
  - Use contributions from current workers to pay benefits to current retirees, giving current workers “promises” in return for contributions
  - “Promises” have different legal weights in different countries
    - In some constitutional rights; in others, just a changeable promise

- **Funded**
  - Use contributions from current workers to accumulate assets; these assets are used in part or in full to pay benefits in the future

- Can be partially funded
Potential Advantages of Funded Systems

- Better able to deal with aging of the population
- Better rates of return on pension contributions
- Limited fiscal liabilities
- Removes some labor market distortions
- Increases capital market development and even possibly savings
- Reduces the politicization of the pension system
Demographic Change in OECD countries

2000:
- 0-14: 18%
- 15-59: 63%
- 60+: 19%

2040:
- 0-14: 17%
- 15-59: 51%
- 60+: 32%
Aging and Unfunded Systems

◆ Aging
  – Reduced fertility rate (temporary problem)
  – Increased life expectancy (permanent)

◆ Impact on unfunded PAYG systems
  – Number of retirees increase relative to contributors
  – Raise contribution rates, raise retirement ages, cut benefits to maintain fiscal sustainability

◆ At some point, systems no longer protecting workers
US Example

Real Rates of Return for Different Cohorts

Year of Retirement

Male
Female
Couple
Aging and Funded Systems

- Different cohorts may experience different rates of return
- Not systematically related to aging
  - Option of foreign investment if returns are higher elsewhere
Better Rates of Return in Funded System on Average

◆ Rate of Return on PAYG – growth of labor force + wage growth
  – When growth of labor force becomes negative, left with wage growth

◆ Rate of Return on funded – rate of return on capital
  – Historically rate of return on capital higher than wage growth

◆ Given contribution rate will translate into higher pensions with funded in long run
Limited Fiscal Liabilities in Funded System

- Unfunded system – government responsible for covering deficit
- No fiscal liabilities for new entrants in pure funded system
  - Individual’s benefits are based on what he/she has saved
  - However, most countries include a minimum pension guarantee, particularly if this is the only pension system
  - Liabilities for those who have rights in the former system
Funded System Reduces Labor Market Distortions

- **Unfunded systems** – often poorly designed
  - Lack of portability
  - Incentives to retire early
  - Often backloaded formulas
    - Pensions depend on last salary – incentive to underreport earnings except for last year

- **Funded systems**
  - Tie benefits to contributions throughout career
Funded System Increases Capital Market Development and Savings

- Risk rating processes established
- Greater variety of financial market instruments offered
- Savings intermediated through financial markets – increased growth impact
- Potential positive impact on savings
- Positive impact on growth
- Unfunded has mixed impact on capital markets
Reduces politicization of the pension system

- Under unfunded, costless now to promise higher benefits to workers or to special groups of workers
  - Costs in the future when politicians are out of office

- Under funded, increased benefits only possible if someone pays increased contributions
  - Forces governments to acknowledge costs
Potential Disadvantages of Funded Systems

◆ Impose investment risks on workers
  – Although workers face political risk of nonpayment and changes to the system in unfunded systems

◆ Potential costs to the government of providing minimum benefits
  – Explicit or implicit
  – Can be reduced via adequate regulation

◆ Poverty in old age
Investment Risks for Workers

- Workers will face investment risks
  - Long term accumulation risks exist, but not that huge since rates of return reasonably stable over the long run
  - Short term risks – on the day you want to retire, financial markets could tank

- Political risks from unfunded
  - Changes in rules
  - Governments unable to make payments
Possible Remedies for Financial Market Crisis

- Government guarantee of value of funds
- Requirement to change portfolio composition automatically with age
Costs of Minimum Benefits

- Actual costs of providing minimum benefits
- Implicit costs to government even if not explicit
- Can lead to possibilities of gaming of the system
Poverty in Old Age

- **Funded System**
  - Lifetime poor
  - Those with incomplete work histories
  - Those with incapacity to work

- **Unfunded Systems**
  - Can run arrears
  - Can reduce benefits substantially
Structure of Overall Pension System with Funded Pillar

◆ Only funded system with minimum pension guarantees
  – Mexico, Chile, Kazakhstan, Kosovo (with basic pension), El Salvador, Hong Kong

◆ Choice of system
  – Colombia, Lithuania, UK

◆ Mixed system
  – Uruguay, Costa Rica, Slovak Republic, Poland, Hungary, Latvia, Lithuania, Estonia, Croatia, Bulgaria, Macedonia, Australia, UK, Switzerland, Sweden, Netherlands
Pension Fund Structure

- Single public agency – Kosovo
- Single pension fund, but private – Bolivia
- A few private pension funds - Uruguay
- Many private pension funds – Chile, Poland, Hungary
- Public and private pension funds – Mexico, Russia
- Who chooses the pension fund
  - Employer, employee, industry/social partners, government regulator
Pension Fund Portfolios

- Single portfolio per pension fund
- Multiple portfolios per pension fund
- Restrictions on who can own what type of portfolio
Industry Structure

- 3 parts to the business
  - Collection and record-keeping
  - Investment
  - Payout

- 4 principles:
  - Economies of scale
  - Competition
  - Incentives
  - Default options
Pension Administration – Collection and Record-keeping

- **Centralized**
  - Particularly in mixed system countries
  - Could be through tax authorities, through public pension agency, through specialized social insurance agency
  - Private centralized agency

- **Decentralized**
  - Individual funds
  - Web based
Investment of Funds

- Typically decentralized
- Who chooses the asset manager?
- What are the incentives of the asset manager?
How Are Pensions Paid?

- **Annuity**
  - Pension balance transferred to insurance company which provides an indexed annuity, typically joint annuity

- **Programmed withdrawal**
  - Balance divided by life expectancy determines pension in any given year; remainder continues to earn interest

- **Lump sum**

- **Combination of the above**

- **Payout provider can be chosen by:**
  - Employer, employee, industry/social partners, government regulator
Moving from Unfunded to Funded – Transition Costs

- If current workers move all or part of their contributions to their own accounts, how will current pensioners be paid?
  - Government liability

- All workers, particularly those close to retirement, have rights in the old system
  - If funded system starts when a person is 40 years old, only has 25 years to accumulate pension funds, but has contributions in old system
    - Needs compensation from government for first 20 years
  - Even in mixed system, whole contribution went to public system for first 20 years and only part will go for the next 25 years

- Will last for at least 25 years, more likely 40 years, depending on design of transition
**Acquired Rights**

- **Existing pensioners**
  - Pensions to existing pensioners always continue to be paid

- **Existing contributors**
  - Recognition bonds
    - Some measure of present value of future pension, prorated by years of service in old system
    - Earn a rate of interest and cashable upon reaching retirement age
  - Prorated pension from public system
  - Different implications for financing needs
Design Issues

◆ Can affect transition costs by design of system
  – Indexation of pensions
  – What is recognized?
    ◆ Retirement age
    ◆ Accrual rates
    ◆ Minimum pensions
    ◆ Interest rate assumptions

◆ Who is allowed to switch?
  – Optional switch with different degree of recognition of accrued rights and future rights for those who switch

◆ Gradual increase in contribution rates to funded system
Design Issues - 2

- Can you increase contribution rates?
  - Add on vs. carve-out

- Ceilings on existing systems
  - Contribution rate might not be low, but effective contribution rate is, so can add on
Readiness in Financial Markets/Macro Stability

- Is there sufficient macro stability to provide moderately safe financial instruments?
- Are there sufficient financial instruments available?
- Option of foreign investment
  - Exchange rate issues
  - Political economy
Readiness in Supervision

- Need for financial market regulation well recognized
- Even stronger need in pension market
  - Government is mandating savings in these institutions, unlike normal financial market instruments
  - Longer term instruments – too much uncertainty without strong government supervision
Readiness in Administrative Capacity

- Many unfunded systems do not keep contributor records; documentation provided only at retirement age.

- Records need to be kept and updated each salary period.
  - Valuation of pension fund also depends on daily returns.