Why Consider a Funded Pension System?

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

Topics to Be Covered

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

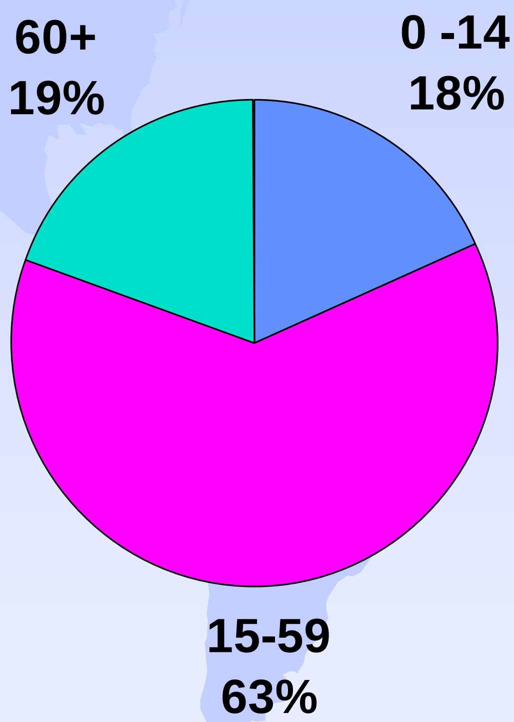
Essential Difference Between Funded and Unfunded Systems

- 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

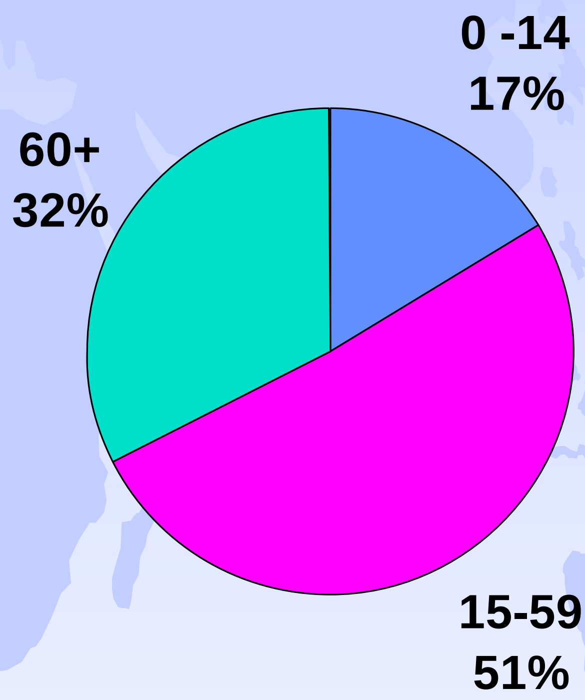
Potential Advantages of Funded Systems

- 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

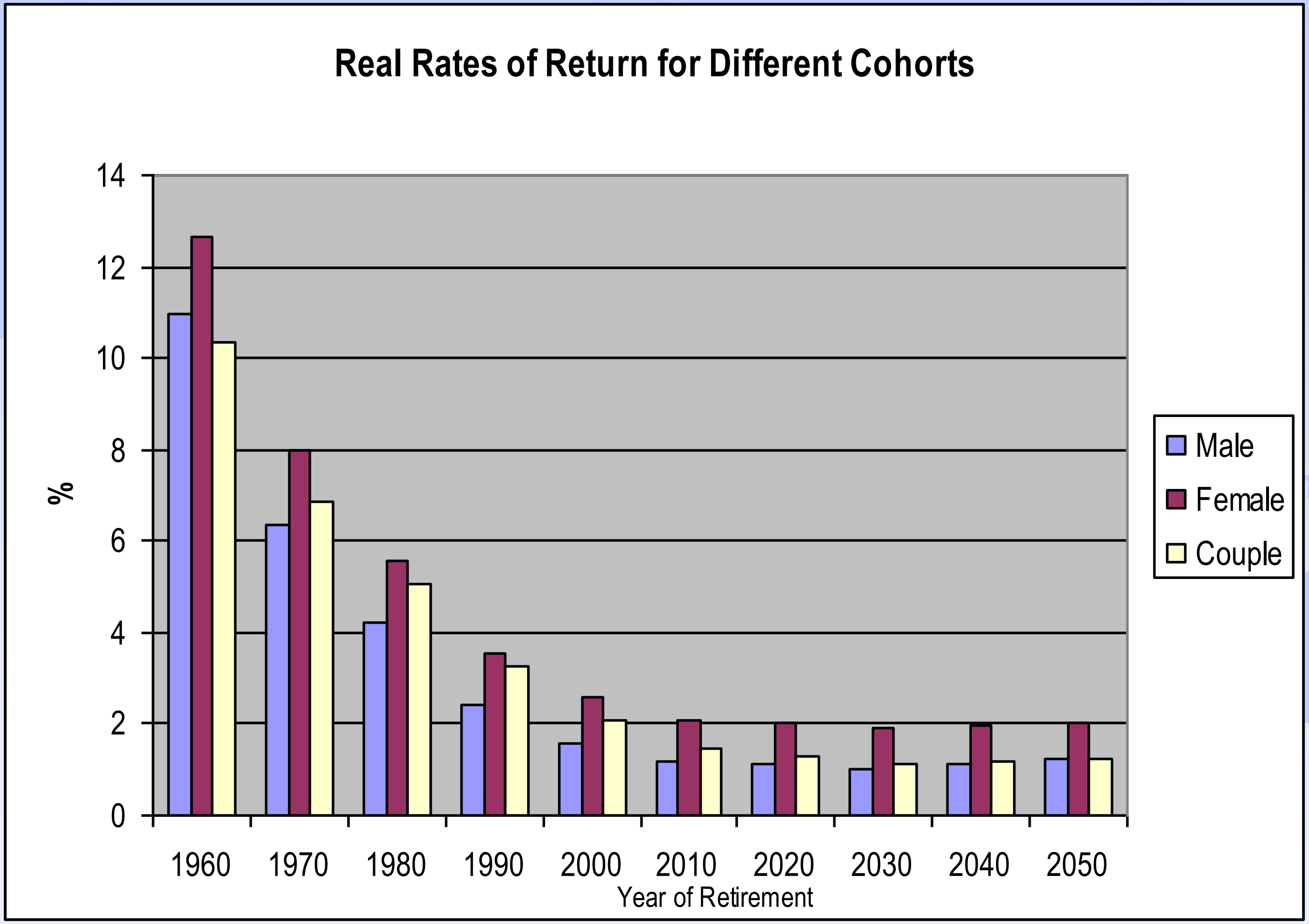


2040

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
14
12
10
8
6
4
2
0
%
1960
1970
1980
1990
2000
2010
2020
2030
2040
2050
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, Kazakstan, 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