Meeting The Challenges of Pension Supervision in a Global Economy

Richard Hinz

The World Bank

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Questions That Should Guide Our Thinking About the Future

- Why are privately managed and occupational pensions now more important than ever?
- What forces will dictate how supervision of these funds is conducted?
- What will supervision need to do to address these challenges?

Several Closely Related Forces That Will Define the Future

- Worldwide Population Aging
- Changes in the Way We Live and Work
- Information Technology & Innovation in Financial Markets and Products
- “Globalization” and The Integrated Global Economy

Population Aging

- Life expectancy was relatively constant for thousands of years until the middle of the 19^{th} century
- In the developed countries it has increased by a constant ¼ of a year per year for more than a century
- We have added 50% to average life expectancy (from 50 to 75 years) in the last 100.
- A century ago we would not be having this discussion – because most of us would already be dead
- The developing world is rapidly catching up and will, through the transfer of medical technology, improvements in nutrition and other factors is expected to experience a much faster rate of change

Family Structure and Patterns of Work

- Industrialization and rural to urban migration has lead to disintegration of multi-generation families and community based forms of support in old age
- Increased need for education and delayed child bearing results in the so called “sandwich” generations – Workers responsible for the care of both parents and children
- Larger number of women entering formal employment with expectations or legal requirement for earnings equality
- Divorce and single parent households have become more common
- Less stable formal employment patterns and increase in number of lifetime jobs

Technology and Financial Innovation

- Markets operate at far higher speeds with increased volatility – Speed and consequences of failures are accelerated
- Product life cycle and production are compressed – new industries are created overnight – Old firms adapt or die
- New products alter characteristics of traditional investment categories – Legal definitions of property rights become less important than their financial characteristics
- Risks are far more diverse than in the past but also are managed very differently
- New products and methods (in part enabled by technology) make sophisticated financial engineering and risk management possible

The Global Economy of the 21st Century – What is it?

- World economy is increasingly integrated in both products and financing – Competition for markets and capital is no longer at the national level
- Global trade, legal and monetary integrations -Trade barriers, currency and capital restrictions are rapidly disappearing worldwide
- Capital moves with few restrictions – transparency and efficiency are rewarded – Risk and restrictions are costly
- Information and transparency are enhanced and communication occurs at an accelerating pace
- Firms are multi-national in operations, financing and ownership

The Global Economy- What Does It Mean?

- Competition is much faster and happens across national lines
- The gains from marginal efficiencies in production and financing are increased in a world market – this leads to a "Winner Takes All" economy
- Advances in technology allows for competition across more sectors – not just goods but now services
- The rate of change and product innovation happens at a faster pace to respond to these competitive pressures – This raises the stakes for everyone - Decisions need to be made faster and the consequences of bad choices are magnified
- Competition is now as much among countries to provide an environment that is most competitive to attract capital and create jobs as it is between firms in their product markets
- Availability of information enables workers to become more aware of conditions and opportunities in other places and for investors to move capital nearly instantly

Multi pillar pension framework

- Zero Pillar – Non contributory social assistance for lifetime poor (either as universal benefit or means-tested) usually funded by general revenue
- 1st Pillar - Publicly financed and managed PAYGO system to provide basic income protection funded by contributions; benefits are generally linked to earnings and are likely to be redistributive
- 2nd Pillar - Mandatory funded individual account system creating direct linkage between contributions and benefits
- 3rd Pillar - Voluntary retirement savings, individual or occupational
- 4th Pillar – Family and inter-generational support for the elderly, access to housing and medical care

Multi Pillar Pension Taxonomy

	Target Group			Main Criteria		
Pillar	Lifetime poor	Informal sector	Formal sector	Characteristics	Participation	Funding/ Collateral
0	☎	✉	✉	Social pension, at least social assistance, universal or means tested	Residual	Budget General revenues
1			☎	Public pension plan,publicly managed, DB or NDC	Mandated	Contributions, maybe with financial reserves
2			☎	Occupational or personal pension plans, funded DB or funded DC	Mandated	Financial assets
3	✆	☎	☎	Occupational or personal pension plans, funded DB or funded DC	Voluntary	Financial assets
4	✆	☎	☎	Home ownership, medical care, family support, etc.	Voluntary	Financial assets

Note: Importance of each pillar for each target group:

☎ Great ✆ Moderate ✉ Little

Why Are Private Pension Systems More Important Than Ever?

- Workers can now be expected to spend as much as one third of their adult lives in education, skills development or retirement and will need to finance this through reliable savings instruments
- Lifetime employment is becoming a distant memory – Workers in the most competitive economies have 5 – 8 jobs and perhaps several professions over a lifetime - retraining is essential to survival
- Coverage must be expanded to meet new household structures
- Aging populations require pension system that provide incentives for longer periods of work
- The capacity of public systems to expand to meet these needs is constrained by market forces that limit the ability to raise taxes or finance benefits through public debt and rigidities in design
- Competing in world markets requires efficient and transparent domestic capital markets – institutional investors and professional managers are a key element in developing these
- Diversification of retirement savings instruments is required to lower risk and potentially provides greater benefit levels

Why Do Pension Systems Matter When Countries Compete in the Global Economy?

- Fiscal and Monetary stability becomes more important when capital can move instantly – Public pension debt is one of the key elements of long term fiscal stability -In the new economy investors place their bets on countries as well as firms (eg Brady Bonds)
- Pension Funds are the largest source investment capital in many countries – More than 100% of GDP in some developed nations
- This capital can have very positive effects on development by providing depth and liquidity to financial markets and fostering the development of institutional investors
- Pension funds and other institutional investors can exercise positive effects on corporate governance that will help countries attract and retain investment capital
- The presence of reliable retirement savings vehicles, risk management devices and other types of social protection can have very positive effects on behavior that supports development – they lengthen planning horizons and reduce incentive for corruption and other counter productive behavior

What Does This Mean For Pension Systems?

- **In this transition we can expect a greater divergence of outcomes in the labor market as high skill jobs are more valued and lower skilled labor becomes a commodity on the world market**
- **This imposes pressures on public systems to address basic poverty alleviation objectives (ie Social Pensions) limiting their ability to replace income broadly – Higher taxes or debt financing is less feasible when competition is global and between countries**
- **Public and occupational defined benefit systems are rapidly disappearing – They are not manageable fiscally and pose too high financial risks for firms to sponsor**
- **Individual capital accounts play a larger role**
- **Greater demands are placed on private systems to support needs of emerging middle class – Political economy of pension becomes greater when a report card on economic management is available daily over the internet in the form of an account balance**
- **Efficiencies and support for broader development become paramount in system design and operation**

The Fundamental Challenge : Balancing Efficiency and Security

- **There have been two basic supervision paradigms:**
  - Transactional: Focus on agency risks and procedural standards, trust based using prudent person principles
  - Structural: Commercial entities, quantitative limits, directed to systemic and portfolio risks
- **Each establishes a level of security (risks) as the objective without defining acceptable cost and efficiency parameters**
- **Both can impose potentially high opportunity costs and regulatory burdens**
  - Transactional approaches limit investment opportunities based on relationships- consider primarily legal and procedural issues
  - Quantitative approaches presume historic relationship between categories of investments and risk
- **The pressures of a more competitive environment is now requiring more consideration of greater flexibility and more explicit consideration of the trade-offs between efficiency and security**
  - Interaction of rules and compliance interventions require consideration
  - Efficiency, coverage and developmental effects become more important

A New Supervision Paradigm – Risk Management

- Risk management and outcome orientation rather than a focus on structure and compliance - Target becomes the “efficient frontier”
- Whole portfolio approach to risk management rather than segmented evaluation of individual instruments – Stress tests and value at risk standards
- Movement from normative models to reliance on market pricing and dynamics – Flexibility and responsiveness to market development
- Substitution of variable risk based capital rules for quantitative restrictions
- Evaluation of risks through scoring systems that combine quantitative and qualitative standards to establish “supervisory ladders” and “traffic light” approaches
- Selective interventions based on evaluation of the quality of the management of funds and changes in risks rather than routine inspections

A New Paradigm- Regulatory Structure

- Use of regulatory structures that incorporate incentives – rewarding risk management and reduction with lower supervisory burden
- Cost/benefit analysis and consultative/negotiated process in regulatory development
- Integration of financial services supervision to prevent conflicts and avoid regulatory arbitrage
- Reliance on transparency and disclosure – Audits, exception reporting and disclosure
- Information technology to reduce monitoring costs

A New Paradigm – Organization and Mission

- Increased policy coordination with other pillars of retirement income system
- Integration and coordination with financial services regulation – banks, insurance, capital markets.
- Enhancement of new skills areas, information technology, financial analysis, risk management and market monitoring
- Development of matrix organizations and centers of expertise
- Operations through flexible multi-disciplinary teams to deploy staff effectively
- Effective strategic planning and outcomes measurement
- Outreach and education of industry participants

What Will Be Needed To Make The Transition?

- Definition of risk measurement models and acceptable tradeoffs
- Qualitative standards for management and risk control capacity
- Careful consideration of the role and consequences of guarantees
- Procedures and standards for evaluating costs and benefits of alternative regulatory frameworks
- Reliable process for open consultation without attempts to "game the process" by industry
- Development of centers of high level financial and technical expertise within supervisory authority and effective deployment of this across operating units – Capacity to pay competitive wages
- Insulation from short term political interventions
- Relevant outcome measures and performance standards for supervisors
- A change in "culture" and "mentality" of supervisors

Other Important Challenges

- **Accommodating diversity and individual choice**
  - Multiple portfolios are required to address increasingly varying needs and circumstances
  - Simple model is to provide individual choice
  - This creates need for education and advices – raises significant problems of conflicts of interest for financial services industry
- **Transition from investment in public debt**
  - Many system maintain large investments in public debt
  - Standards for managing risk to transition to private investment require difficult tradeoffs
  - This will need to be done for economies to remain competitive
- **Enhancing corporate governance**
  - Pension funds will become major owner of equities and often only large shareholders
  - How they exercise ownership rights will have a major impact on quality of corporate governance
  - Regulatory standards and oversight by supervisor will have significant effect on overall quality of corporate governance

More Challenges

- **Expanding coverage of informal sector and portability**
  - Making unskilled labor an internationally traded commodity makes it even more difficult to involve lower wage or informal sector workers in pension systems
  - To avoid major social disruptions in the future or untenable fiscal costs, supervisors will either have to enforce mandates or support new designs that can enroll these workers
  - New research on behavior is essential
- **Developing and supervising the pay out phase**
  - Competitive and fiscal pressures have made Defined Benefit pensions rare
  - Reliable annuity markets, scheduled withdrawals (most likely both) are required to make individual account systems into pension systems
  - Supervisors will need to control product design and transactions to make this feasible
  - Long term fixed income instruments and financial engineering are essential elements
- **Adapting to new financial products and transactions**
  - Technology offer efficiency gains but makes supervision more difficult
  - Off market trades, complex derivatives, electronic venues require new rules and technical skills from supervisors

Some Concluding Thoughts

- **The global economy is now a reality**
- **It has many dark sides, the transition is difficult but there are benefits as well**
- **For better or worse nearly every country has decided that the benefits of participation exceed the costs of opting out – We are on this journey together more than ever before**
- **This has raised the stakes for pension supervisors who now need to concern themselves with national competitiveness, efficiency and market development as well as the security of members**
- **Political scrutiny of their actions can only increase when workers judge politicians economic management skills through their pension account balances – This makes the job more difficult**
- **Supervisory models will need to adjust to this reality – risk management, efficiency, incentives and a focus on outcomes are now key considerations**
- **New methods and skills are required to address the demands of changes in financial markets – Traditional public administration models will have to adapt to this reality**
- **Which 19th century thinker will prevail? Charles Darwin would recognize the process. Did Marx and Malthus predict the result?**