

Comments - Session2

Towards Sustainable Second Pillar Pension Systems

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Towards 2nd pillar pension system

Three urgent aspects to take into account:

- **Coverage** (more participation and better replacement rates)
- **Asset allocation and financial returns**
- **Competition** (fees)

Coverage

- Some countries have low per capita income and very high informal economies (especially in LAC). Difficult to count on exclusively on mandatory DC scheme to extend participation in the second pillar.
- The other face of coverage lies on workers, who actively participating in a DC scheme, face the risk of not having enough savings (replacement rates) for the old age stage.
- Difficulties to extend participation imply a real challenge for policy makers. Reduce structural problems (sustainable/inclusive growth and informal economy's reduction) is the long term exit. In the short term, it is necessary to strengthen solidarity pillars although trying to build incentives to save at the same time based on this structure (Levy 2008; Bachelet's reform in Chile 2008; experiences with MDC schemes in New Zealand-Kiwi Savers).
- To increase pension sufficiency: more contributions; to extend working years (labor market reform); annuitize other assets; provide support during financial down turns (watch out with disincentives to save); financial returns.

Asset allocation and financial returns

- From a historical perspective, 2nd pillar assets have increased enormously during the last decades in Emerging Countries (around 7-8% in real terms by year in LAC)
- Financial crisis has recently imposed strong volatility to DC portfolios, getting concern from general public.
- Difficult to explain short term volatility versus long term performance.
- The underperformance of some pension managers could be one reason of low returns, but what have been really key are regulatory requirements (e.g. quantitative requirements to invest a high proportion of PF in domestic treasury bonds; required composition of portfolios).
- Benchmarking is necessary but needs careful study: what is the ideal structure; who defines the benchmark (regulator, wise men committee, the industry)?; how to explain it and make it understandable to workers?
- Life cycle investment (LCI) makes sense, but needs to be combined with adequate regulation for asset allocation, portfolio differentiation (equities/bonds) in each stage and worker's characteristics besides age (e.g. wage slope, likely frequency of contribution, gender, etc).
- With respect of LCI, idiosyncratic factors also needs to be considered. In some countries people wants to chose (although finally they do not do that).

Competition

- Fees in pension industry is a concern, especially in Emerging Countries.
- Structural problems are relevant. The presence of high informal economies (e.g. around 15%- 20 % of active participation in pensions for Mexico, Colombia and Peru), reduces the power of demand forces.
- Important to recognize that competition and coverage have a strong interrelationship.
- Fees also are affected by particular circumstances: excessive administrative requirements by law; capital markets fees; supervisory fees.
- Regulation on asset allocation: (1) fees is the same for portfolios concentrated on bonds and for those concentrated on equities, when the latter are more expensive to manage (at least 100 bp). It could be advisable to charge different fees; (2) minimum-return-regulation introduces a "not desirable" short term activism in PF asset allocation.
- How to provide information?. In many countries, fees differ on 100 bp between the most expensive and the cheapest pension fund manager. How do we introduce incentives to make contributors move to the cheapest PF company? (assuming fees is the most relevant factor).
- Sales costs in PF industry needs a serious debate.

Starting all over again? Beware

- Does 2nd pillar need to strengthen its sustainability?. Yes. **The mix of negative returns during crisis, low coverage and fees, is not good.**
- But, **every case is different** (interaction between private and public schemes, maturity of the system, financial depth, institutional development).
- **Try to extrapolate other pension models** (e.g. the Swedish experience) towards emerging countries **could be a mistake, specially if there are other pension models working for decades.** It is better to build on the institutional structures developed (especially if there has been positive outcomes achieved). Watch out with experiments.
- In LAC, the Chilean Model, with all their pros and cons, has allowed to develop specialized supervisory and regulatory frameworks during the last three decades and their results in terms of financial prudence has been remarkable. **"Start all over again – proposals" could impose serious risks.**
- Something that is perceived in **recent reports from multilateral organizations** is a **lack of recognition** of the positive outcomes achieved by DC pensions reforms. It seems that has been forgotten the **chaotic situation of pension systems before reforms.**
- **"New Reforms"** that not underline the importance of the first steps undertaken during the nineties, could finish with regretful results specially when politicians used to interpret things the way they want.



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