fondazione RODOLFO DEBENEDETTI

Dealing with the New Giants

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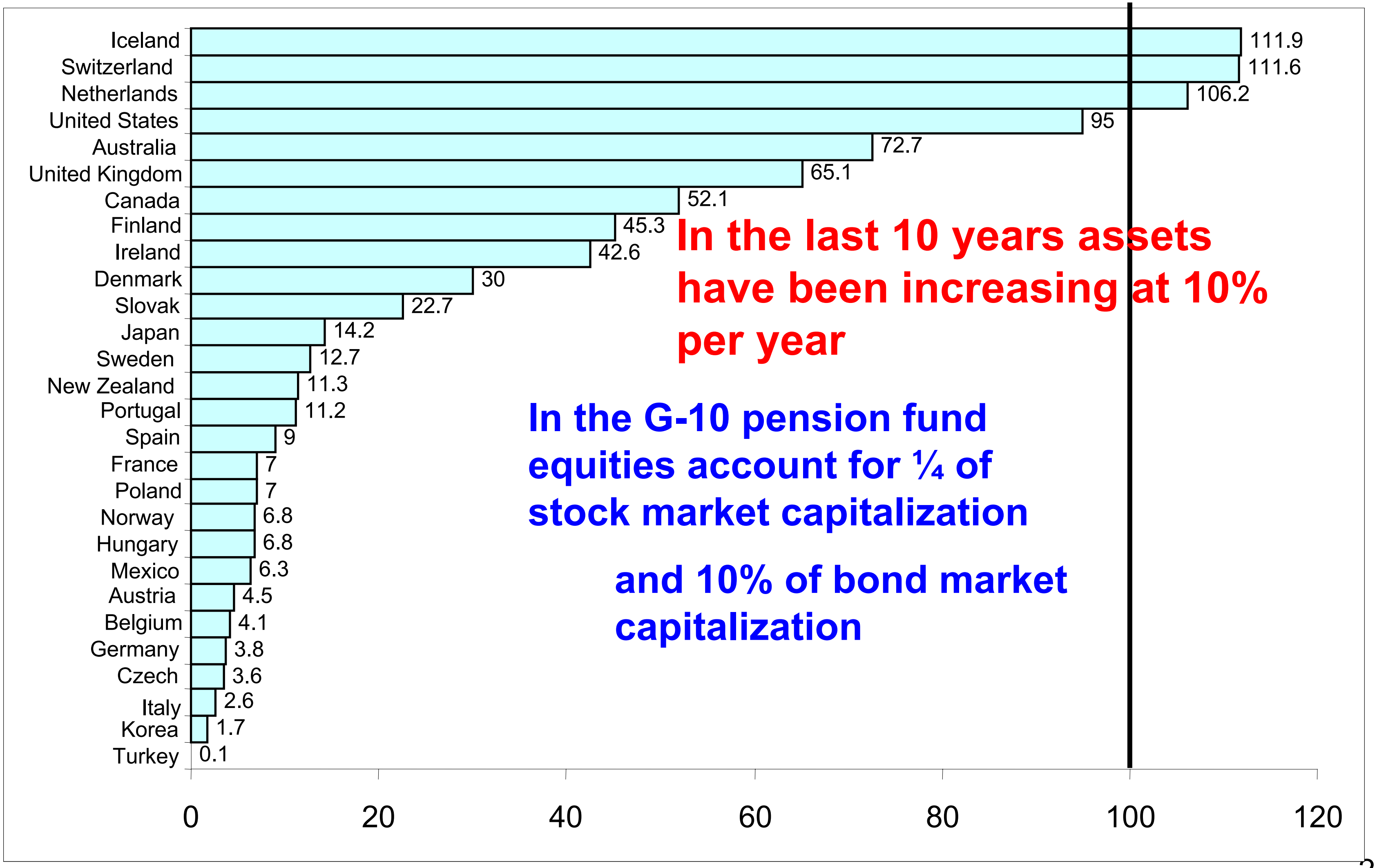
Netspar

Pension funds assets (% of GDP)



In the last 10 years assets have been increasing at 10% per year

In the G-10 pension fund equities account for ¼ of stock market capitalization

and 10% of bond market capitalization

Source: OECD, Pension Markets in Focus, 2005

Outline of the 8° Geneva Report

1. Facts about the pension fund industry
2. Looking into the black box: the optimal organization of a pension fund
3. Market-based solutions to match pension liabilities
4. Optimal risk-sharing arrangements
5. Labor market perspectives

One-handed approach

We take a stance in the debate on:

- Reforms of PAYG systems and labor markets
- Governance of pension funds and financial literacy
- Accounting and funding standards
- Risk-sharing arrangements and human capital investment

Our recommendations

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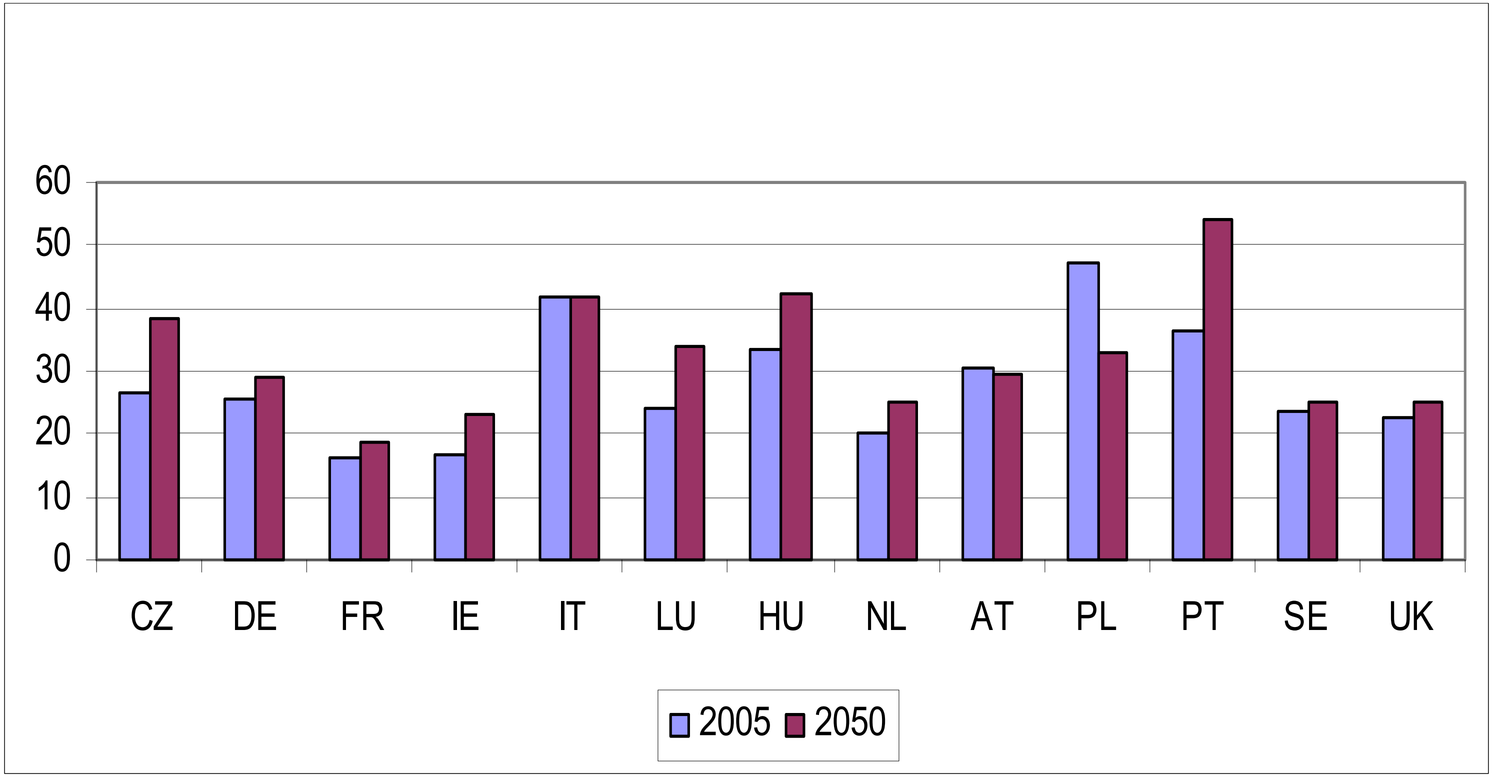
Living longer, working less

(Average cohort-specific average length of working life and life expectancy at 65 in the EU15)

Cohorts	Average length of working life	Life Expectancy at the age of 65
1925	45.80	14.09
1930	43.92	16.12
1935	41.52	17.32
1940	37.64	17.57

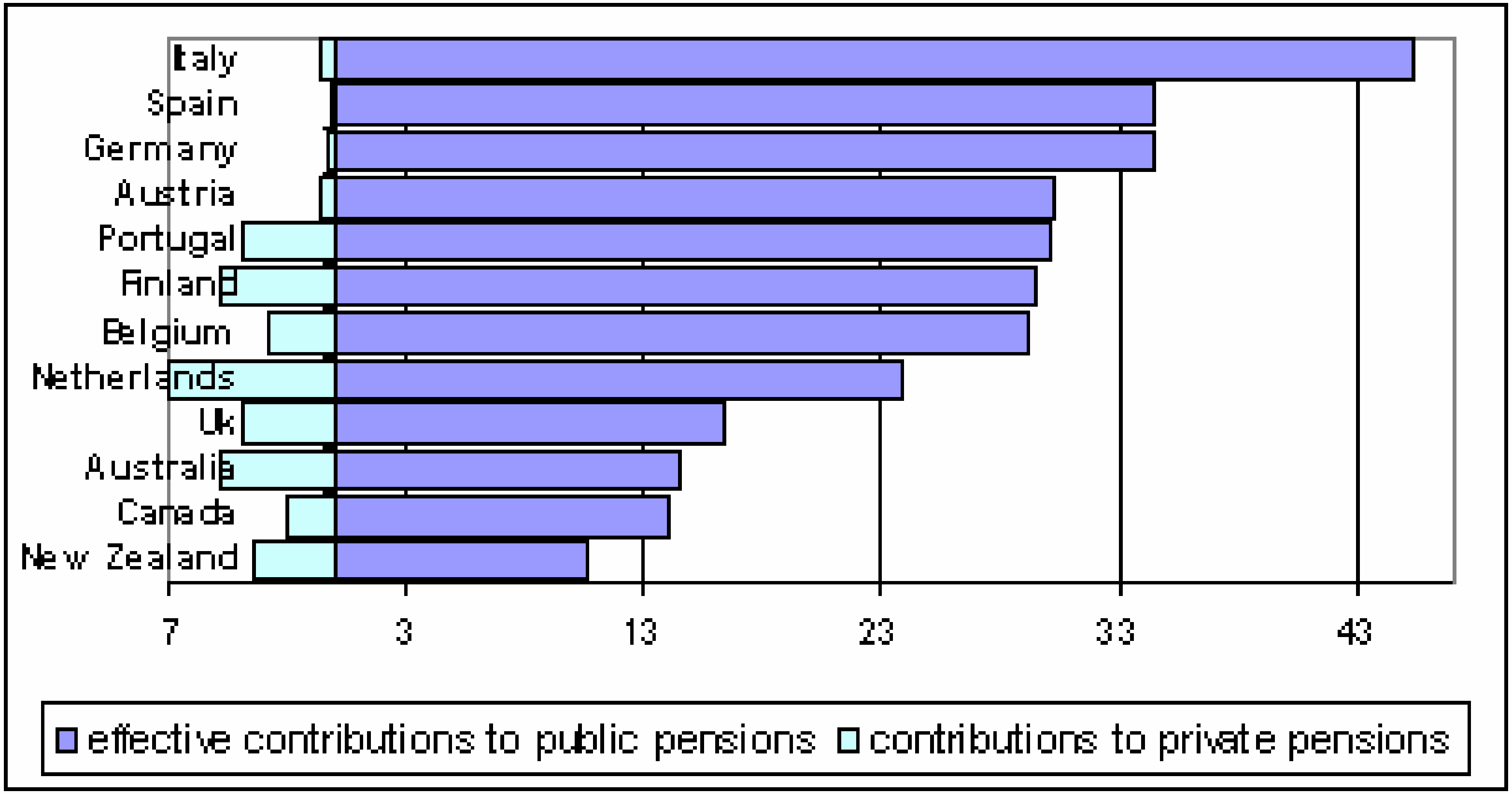
Source: ECHP for average length of working life, OECD (2004), Health Data (2004) for life expectancy at the age of 65

Reform PAYG in order to avoid further increase of contributions



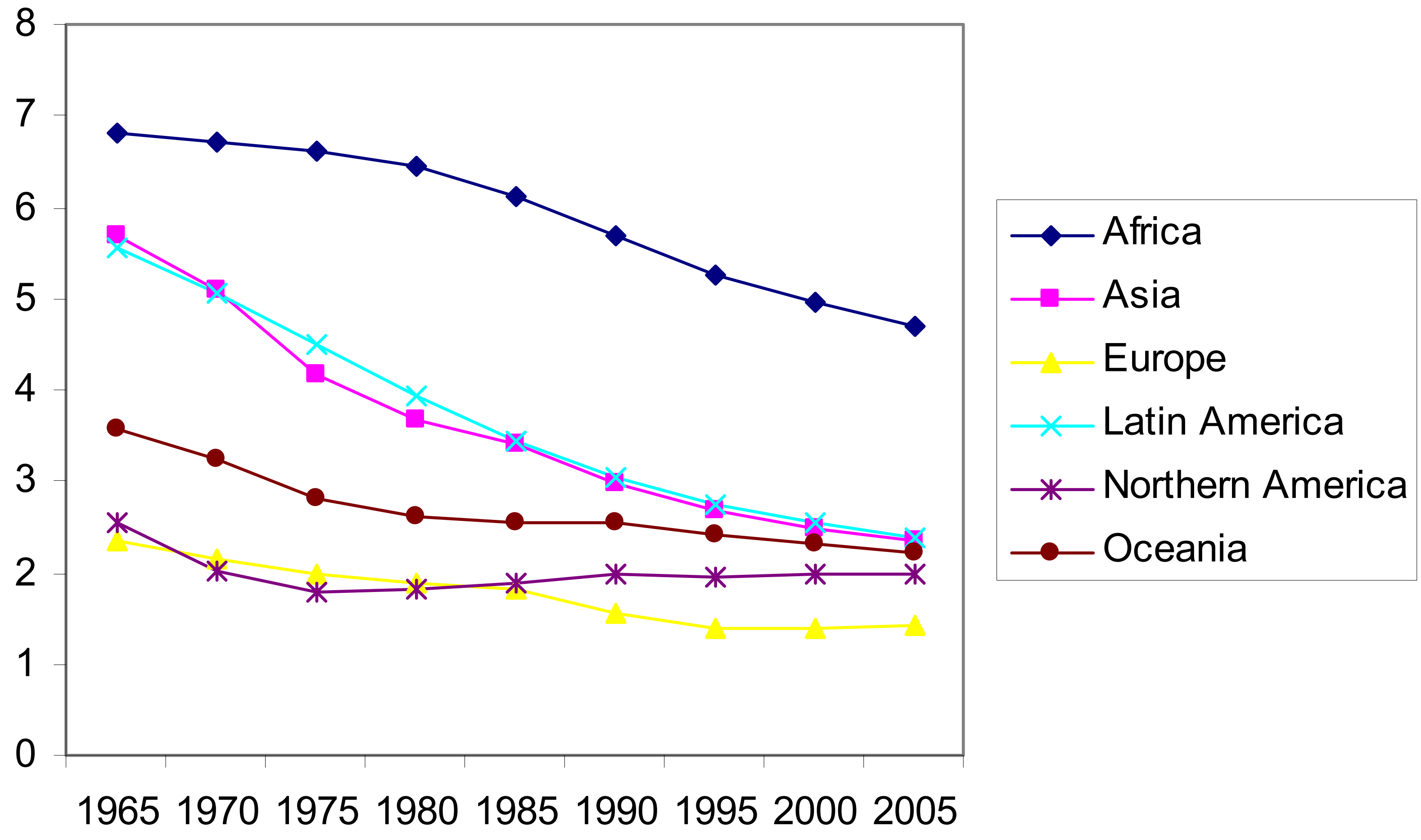
Equilibrium contributions at unchanged policies as a % of gross wages

As large contributions to PAYG crowd-out private pensions…



..preventing diversification of risk

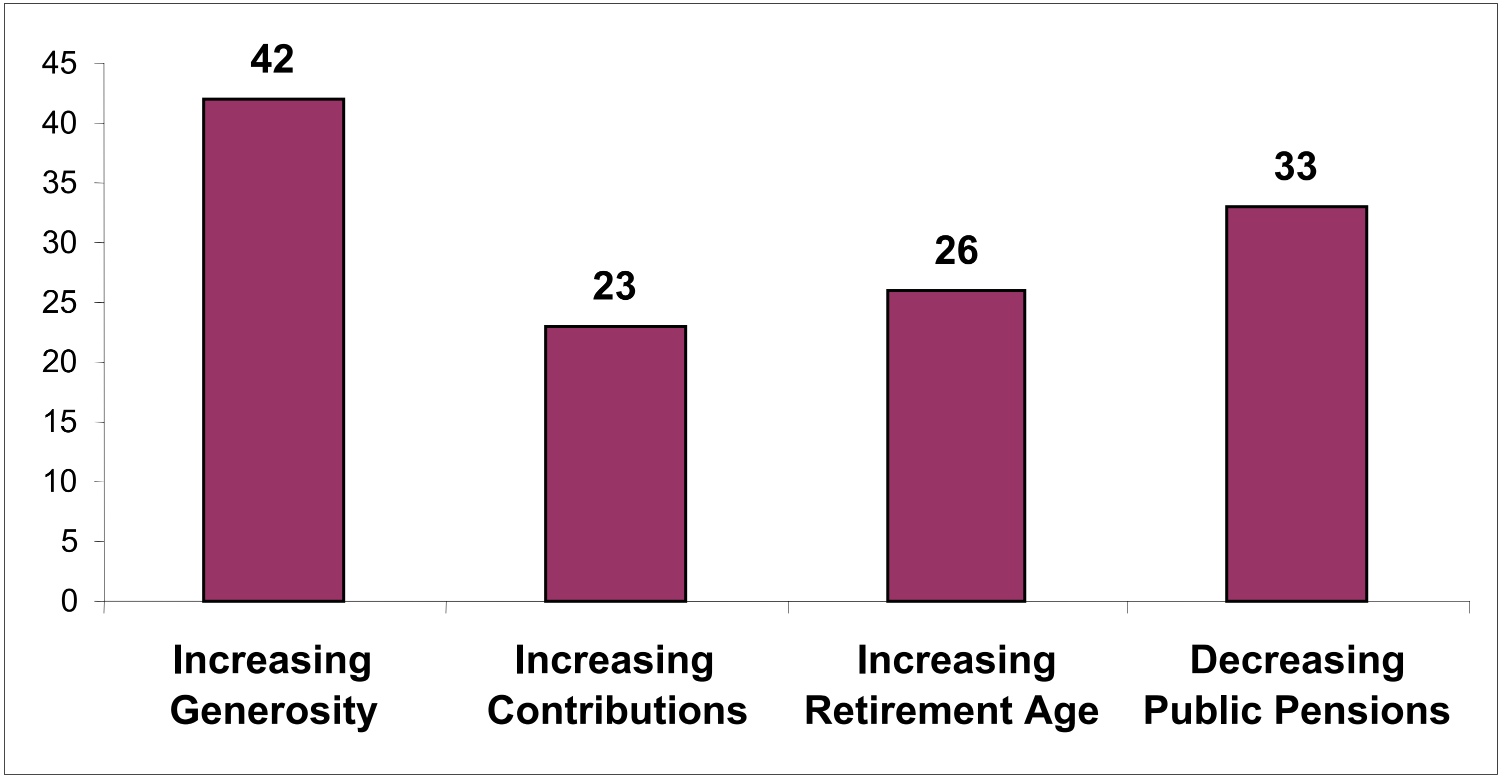
(funded schemes can better cope with fertility risk)



Source: UN Population Division

But reforms of PAYG are mostly going the other way round

Reforms of Public Pensions in Europe, 1986-2002



Source: fRDB Social Reform Database

Reform PAYG via automatic adjustments

- Lengthy political decisions prevent timely adjustments of PAYG systems to demographic shocks
- And lags in adjustment crowd-out funded schemes
- Use automatic adjustment. Example: In NDC systems, annuities can be indexed to life expectancy

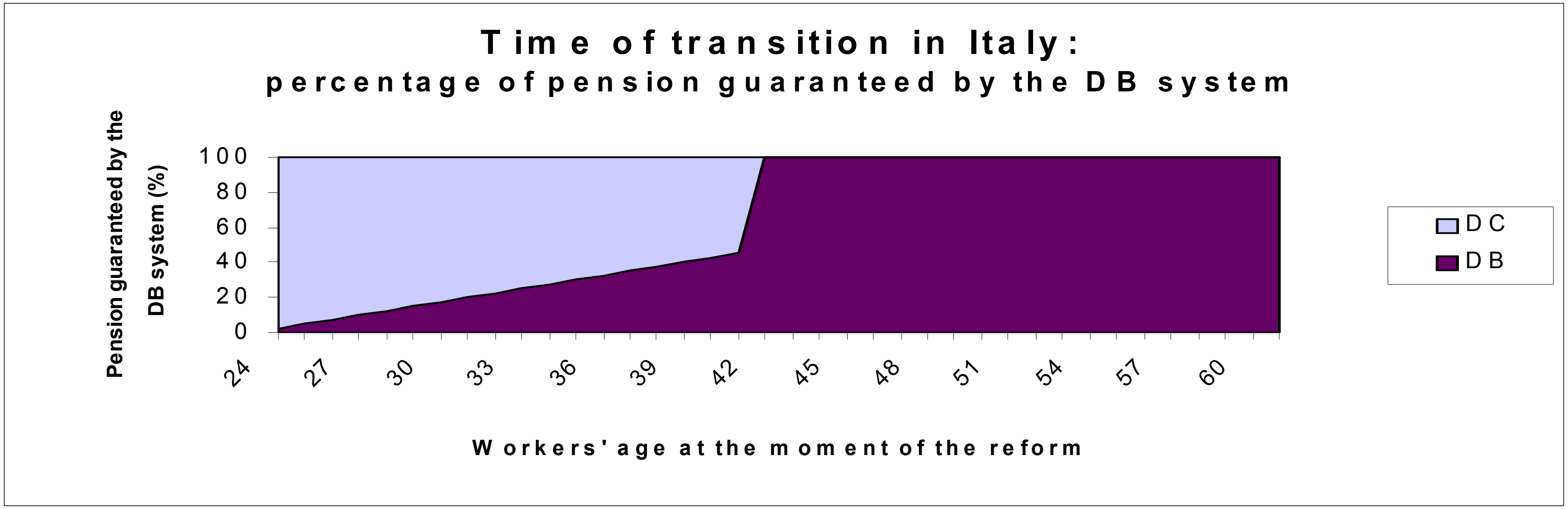
Introduce notionally defined contribution systems

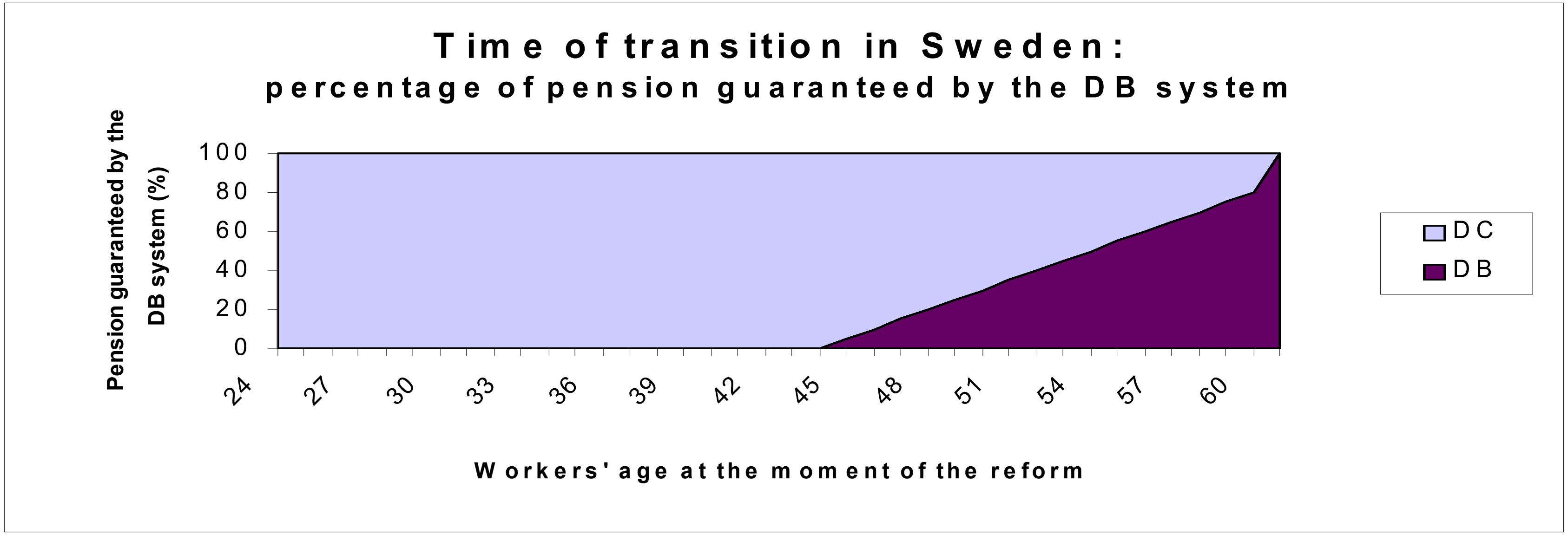
- NDC systems mimic funded DC systems
- Easier for workers to compare returns of the two systems and manage their pension portfolio
- Worker as residual risk bearer: more responsible about retirement savings
- More flexibility in retirement decisions
- Better labor market incentives

Allow youngster to accumulate rapidly pension rights in collective schemes

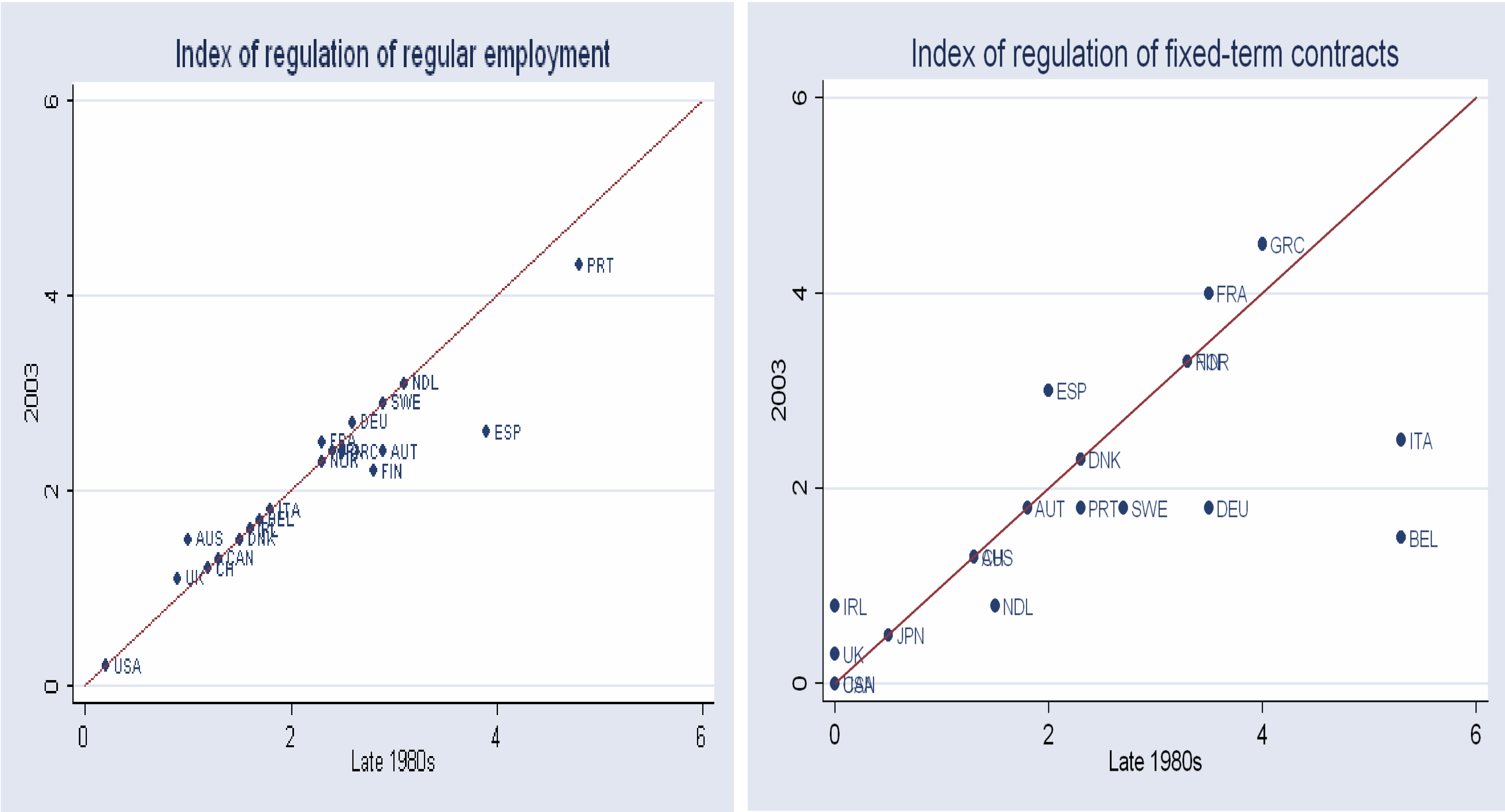
- Politically feasible reforms of pensions and rigid labor markets created dual regimes in pension entitlements, job security (temporary vs. permanent) and wages
- New problem of sustainability related to breaks in career and lower contributions (e.g., temporary worker in Italy after 40 years receives a pension of less then 5,000 Euros per year)
- Collective arrangement schemes should treat differently young and old generations. Hybrid DC (for young) - DB (for older people) schemes.

Two-tier regimes in pension reforms





Two-tier reforms in labor markets



Dual regimes and human capital

- Dual track reforms have perverse effects on human capital investment
- There is no incentive for employers to invest in training and retraining
- While workers do not perceive human capital investment as buffer to shocks: risk is concentrated on temporary workers, often independently of their skill levels

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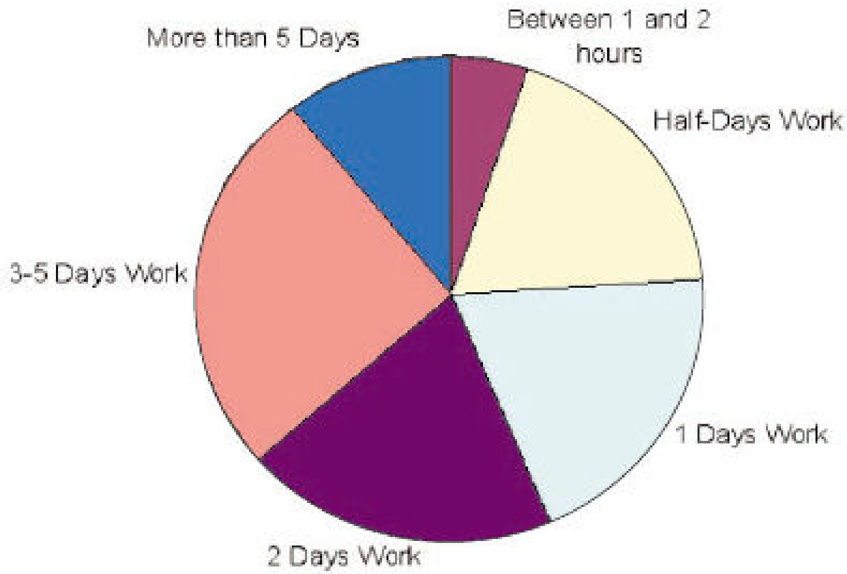
A stand-alone, two-tiered governance of pension funds

- Pension funds should be organized on a stand-alone basis (or at least be ring-fenced) with i) supervisory and ii) executive boards
- *Voted* employees representatives, organized in trade unions, should be represented in supervisory boards only
- Pension funds should exert their control rights on the companies they have a stake in, but at the level of investment managers only

Train the trustees, include outside professionals, and limit reliance on pension fund advisers

Time devoted to their role by UK pension fund trustees
(per month)



Source: Greenhalgh and Campion, 2005

Provide financial education … and default investment options

- Evidence of widespread financial illiteracy among older Americans and those with less financial education do not plan for retirement
- Risk of pension mis-selling
- Need to develop financial education
- Encourage collective pension plans with a few default options

Define minimum standard for reporting ("Orange Envelopes")

You can receive a pension from more than one source
Besides their national pension, many people also receive a pension from elsewhere. This may be an occupational pension from their employer or perhaps a pension from their own private pension saving. This money is not described here, but it makes your total pension higher.

If you draw your national pension from

age 61: With 0% growth you receive SEK 8,800 per month	With 2% growth you receive SEK 13,000 per month
age 65: With 0% growth you receive SEK 11,600 per month	With 2% growth you receive SEK 18,400 per month
age 70: With 0% growth you receive SEK 16,700 per month	With 2% growth you receive SEK 29,300 per month

Example: Your national pension at age 65 and zero per cent growth consists of: SEK 9,400 income pension (incl. any supplementary pension) and SEK 2,200 premium pension (for the calculation assumptions for premium pension, see *Forecast* in the Glossary).

Make your own forecast on the internet
Go to *www.pension.nu* and use the amounts below, which come from pages 2 and 5 of this annual statement:

SEK 702,476 SEK 18,385

Would you like more information?
Visit *www.pension.nu* (the Insurance Office) or *www.ppm.nu* (the Premium Pension Authority). You can also phone the Insurance Office's help line on 020 – 524 524.

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Value DB liabilities on a mark-to-market basis and encourage market innovations

- Provides transparency and market discipline
- Allows for market-based risk management
  - Get rid of interest rate, inflation and currency risk through overlay derivatives
    - Swap overlays: eliminate unpriced interest rate risk
  - Once overlay strategies are in place, ‘free’ asset allocation
    - Move back to equity to take advantage of priced risk
    - Diversify into new asset classes (e.g. private equity, commodities)

Harmonize standards at a global scale

- Harmonize accounting and funding standards
  - Among each other (e.g. regulatory funding standard versus business accounting standard IAS19)
  - Across countries: level playing field
- Valuation
  - move to clear references for discount rates to value DB liabilities
  - Nominal funding requirements but real ambitions
    - nominal focus make pension funds more vulnerable to inflation risk (by lengthening duration of nominal bonds)
      - give in to money illusion instead of correcting it

Limits to liability driven investment

- Danger of pro-cyclicality (flexibility versus discipline)
  - Low interest rates may raise saving and reduce investment
    - Falling bond yields widen funding gaps and increase demand for bonds: pension guarantees become ever more expensive
- Demand-supply imbalance for long-dated, inflation-linked bonds
  - Obstacles to corporate issuance of indexed bonds
  - Limits to governments flexibility: Weaken fiscal discipline
  - Harm risk taking (and innovation and growth)
- Risk is piling up on banks balance sheets
  - Few payers of longevity, inflation, duration risk
  - Financial stability issue
- Conclusion: limits to liability-driven investment
  - Limit to transferring liability risks to capital markets
  - Risk should be shared among participants *within* pension funds
    - Restructure liabilities rather than only assets: less guarantees

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Stand-alone pension funds rather than corporate or individual plans

- Firm-sponsored plans belong to the past ……. and rightly so
  - Guarantees more expensive: dominate core business
    - Ineffective in competitive, dynamic economy
  - Bad diversification: credit risk employer
    - Workers dependent on single employer
  - Conflicts of interest, multitask monitoring
- Case for stand-alone, collective pension funds
  - Low acquisition costs and less selection (mandatory)
  - Protect individuals against themselves
  - Macro-economic stability: stable long-term investors
  - Participants can share risks internally and exploit capital markets to shed risk externally
    - Participants residual risk bearer in stand-alone funds
      - importance risk sharing

Explicit risk sharing in stand-alone plans

- Explicit contracts on risk sharing (as NDC)
  - State-contingent rules; clear property rights; less discretion and thus less political risks
- Smaller role recovery premia
  - Protect supply and demand on labor market (i.e. human capital) in bust (with low interest rates)
  - Premia more actuarially fair (mark-to-market)
    - Less back loading benefits (labor mobility; diversity careers)
  - Let active workers participate in risk sharing through their pension rights rather than recovery premia
    - Less DB (=guarantees) for active workers
  - Optimal risk sharing through pension rights

Optimal risk sharing: hybrid DB/DC plans

- Pension wealth of young cohorts fluctuates more with risks than that of older generations
  - Young, active participants depend on human wealth rather than pension wealth
    - Young, active participants bear most of priced financial-market and longevity risk: ‘soft’ (= DC=equity=‘junior’) claims
      - They are the ‘owners’ of the non-profit insurer (of the old)
    - Old, retired participants hold most secure (‘hard’=DB=‘senior’)claims
      - They hold debt-like claims (annuities) on pension fund (wage indexed?)
- Consequences
  - Duration of fixed-income liabilities declines
  - Supply of risky capital is maintained: stimulate growth
  - Behavior becomes less pro-cyclical
    - Exploits long horizon of the young to buffer shocks (lower marginal propensity to spend out of financial wealth): ‘solidarity’
      - Less need to adjust premiums to adverse shocks
      - Pension funds as stable long-run investors (in spite of volatility)
  - ‘Hard’ rights in real terms and cohort specific
    - reward the young for risk taking (less back loading)

Labor market: accumulate, maintain and use human capital

- Prevent decline in return on financial capital
  - Invest more in human capital: walk on two legs
    - Raise effective retirement age: more durable human capital
      - Avoid vicious circle with maintainance human capital
    - Fight concentration work effort in child-bearing years
      - Combine career and parenthood over life cycle
        - » Life course perspective: feminization of work
- Flexibility labor market
  - Flexible, gradual retirement as risk absorber to prevent risk-shedding scenario (‘soft’ claims are legitimate)
    - Wage and career flexibility, lifelong training, flexible work arrangements, no statutory retirement age
  - New career patterns: protect human capital young parents
    - Feminization of work: fight two-tier labor markets
  - Tie worker less to single employer
    - Better diversification: employment security rather than job security
      - Full portability of pension rights: less back loading
        - » Stimulate enterpreneurship elderly