Second pillars: they should not be broken promises

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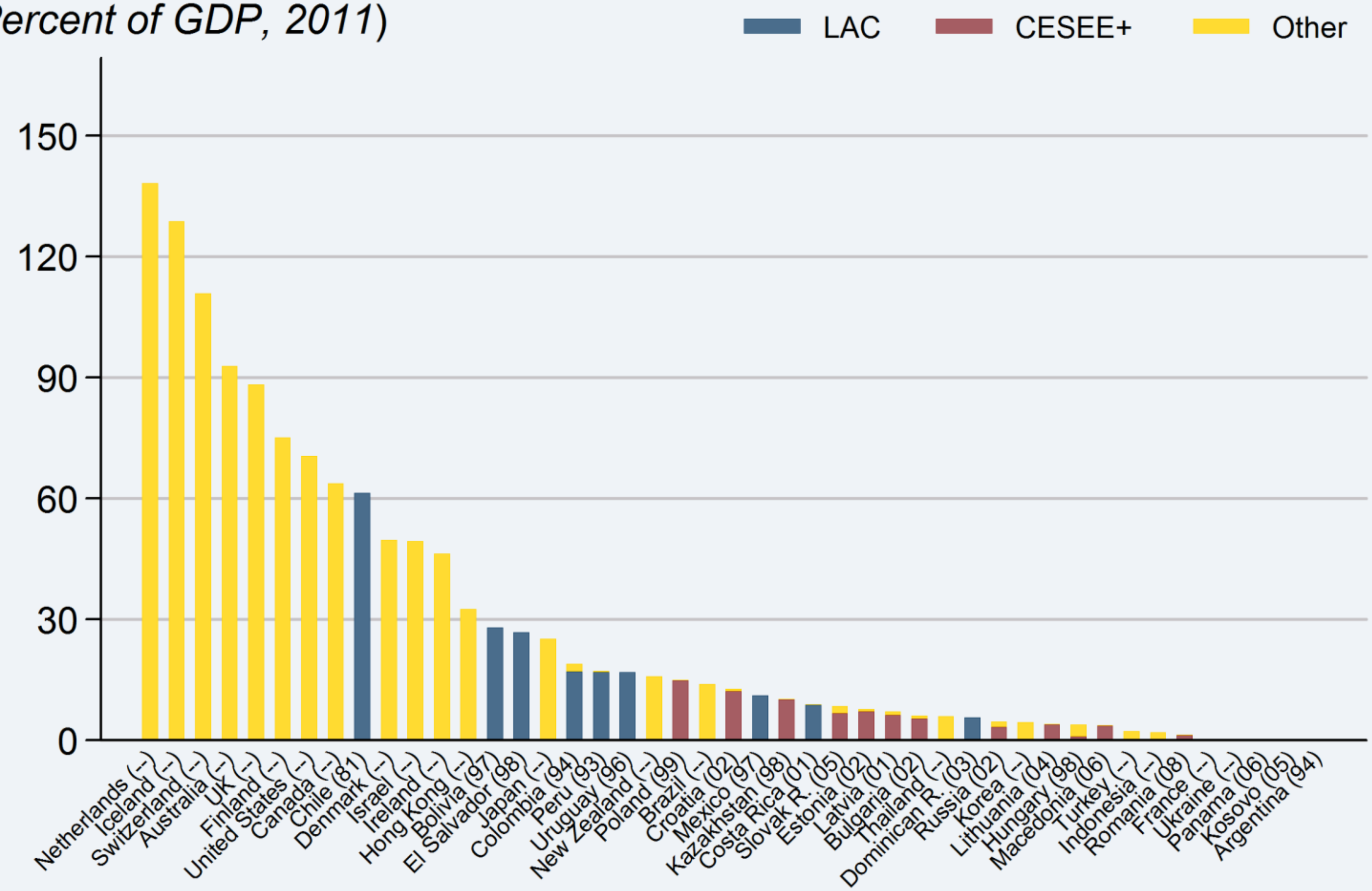
Outline

- Two key challenges with mandatory decentralized DC pensions (second pillars)
- Select institutional design failure of the accumulation phase
- Policy priorities for the post-crisis period

Consumption smoothing, capital formation and macro risk sharing

Private pension funds savings

(*Percent of GDP, 2011*)

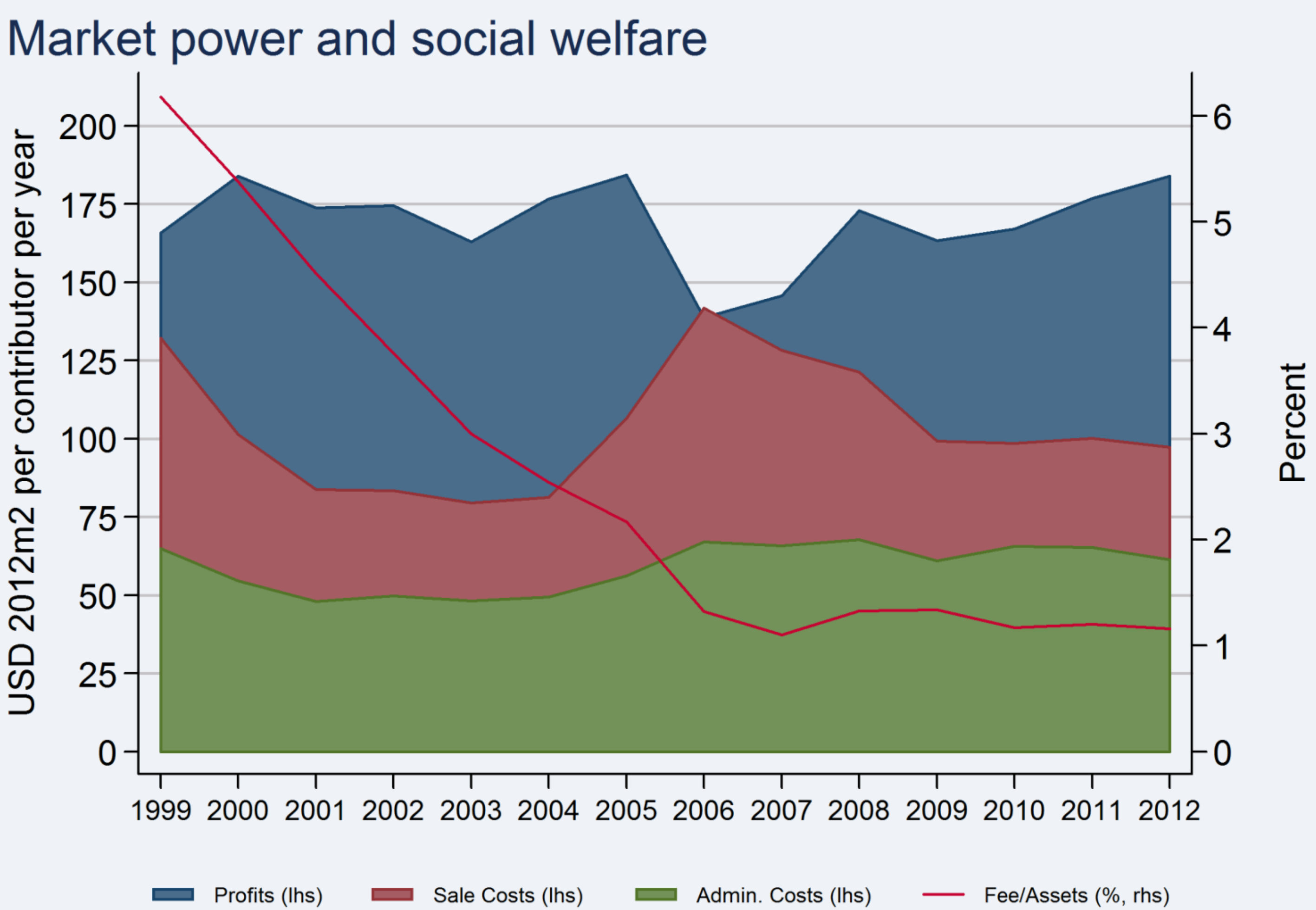


Sources: Various supervisory authorities, Impavido *et al*. (2010), OECD, World Bank, IMF WEO and staff calculations.

1st challenge: “mandatory” = market power

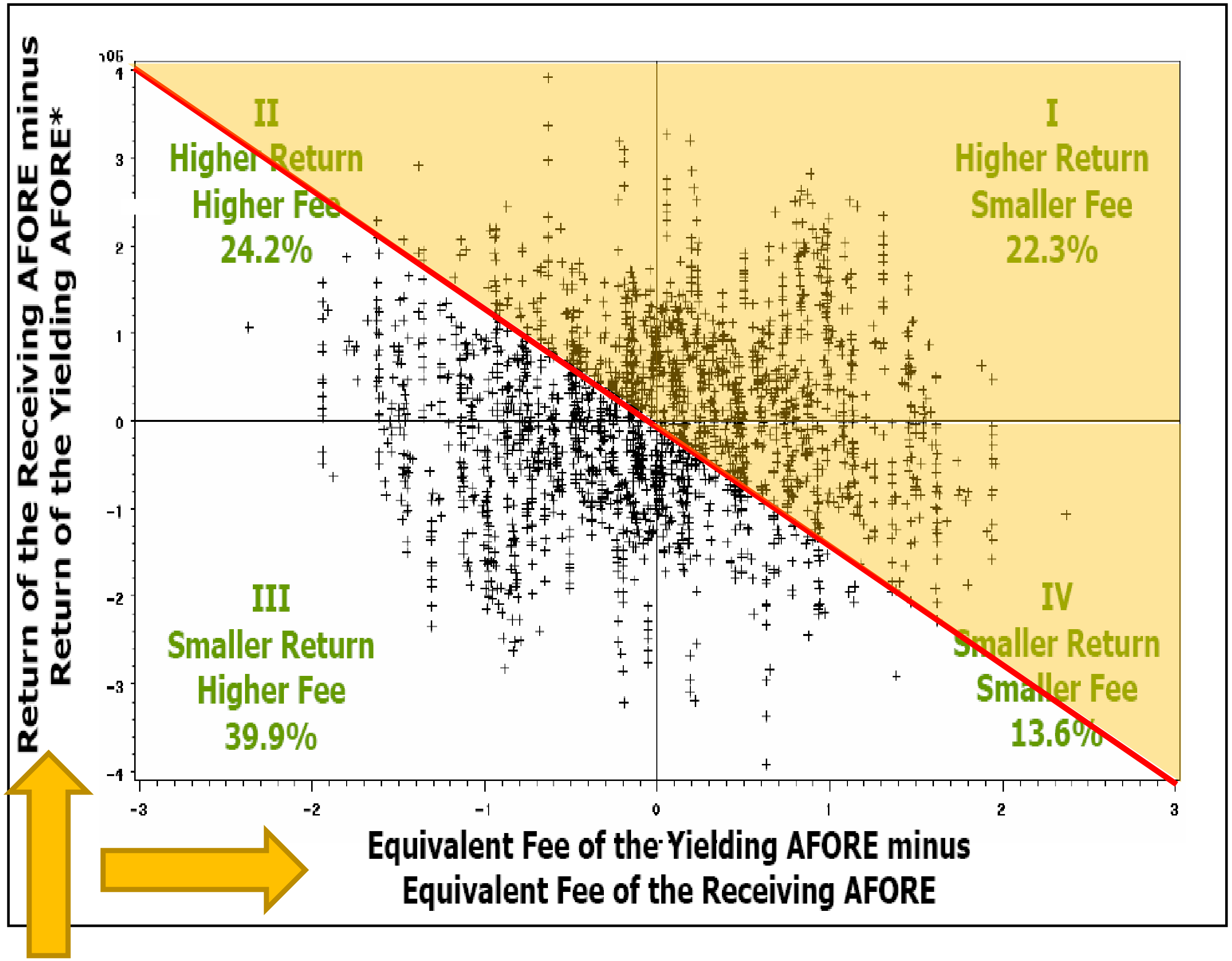
- Pension (quasi) markets have high barriers to entry with large sunk costs and economies of scale
- The mandatory element generates a highly inelastic demand and heuristic consumer behavior
- Yielding excessive market power, no within market competition and welfare loss to participants

The consequences of market power



Sources: SBS and staff calculations.

Marketing expenses have low educational value

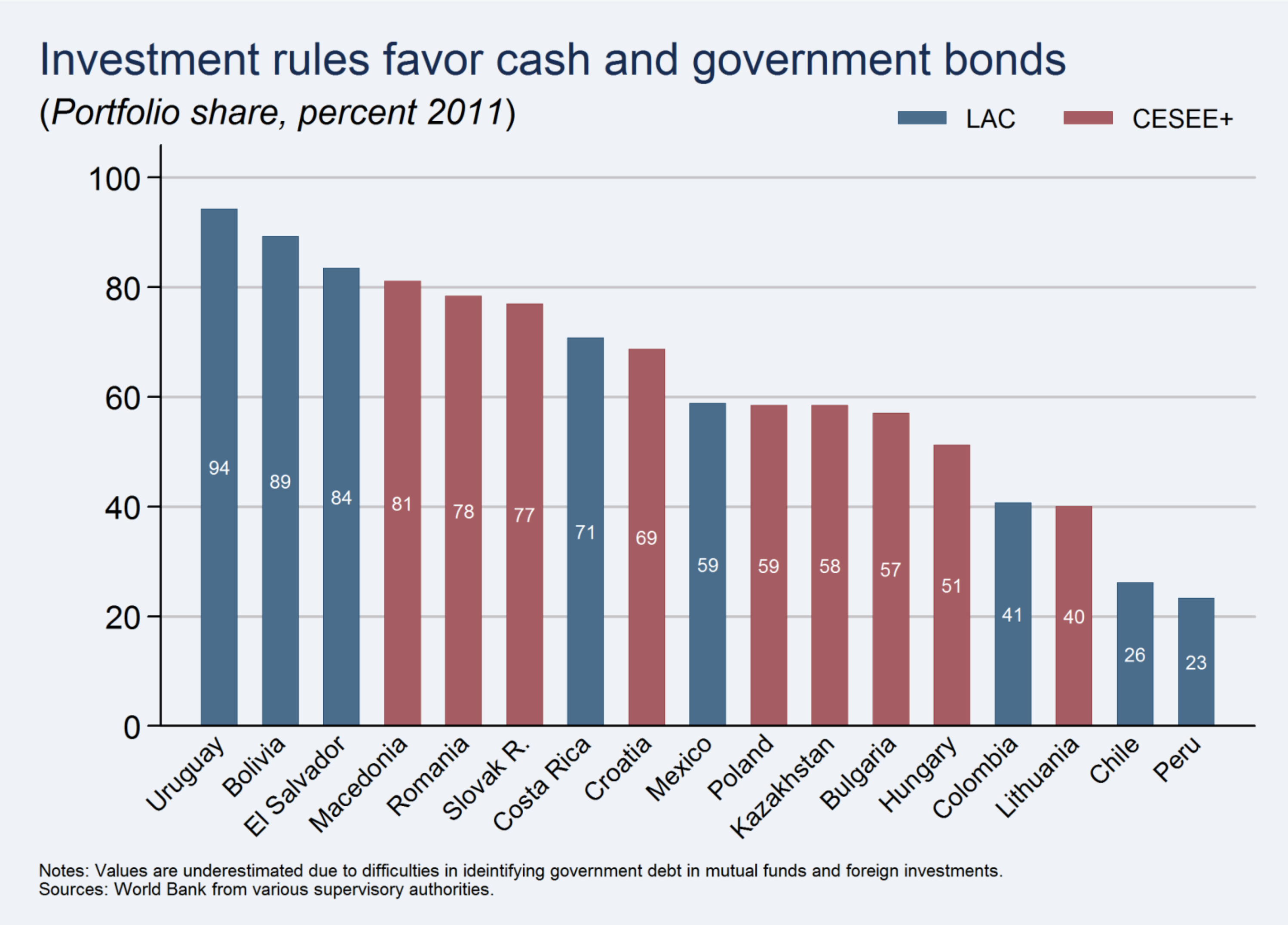


Source: page 46 of Impavido et al. *New Policies for Mandatory Defined Contribution Pensions : Industrial Organization Models and Investment Products.* (The World Bank, DC). http://go.worldbank.org/TW6TW4NMU0

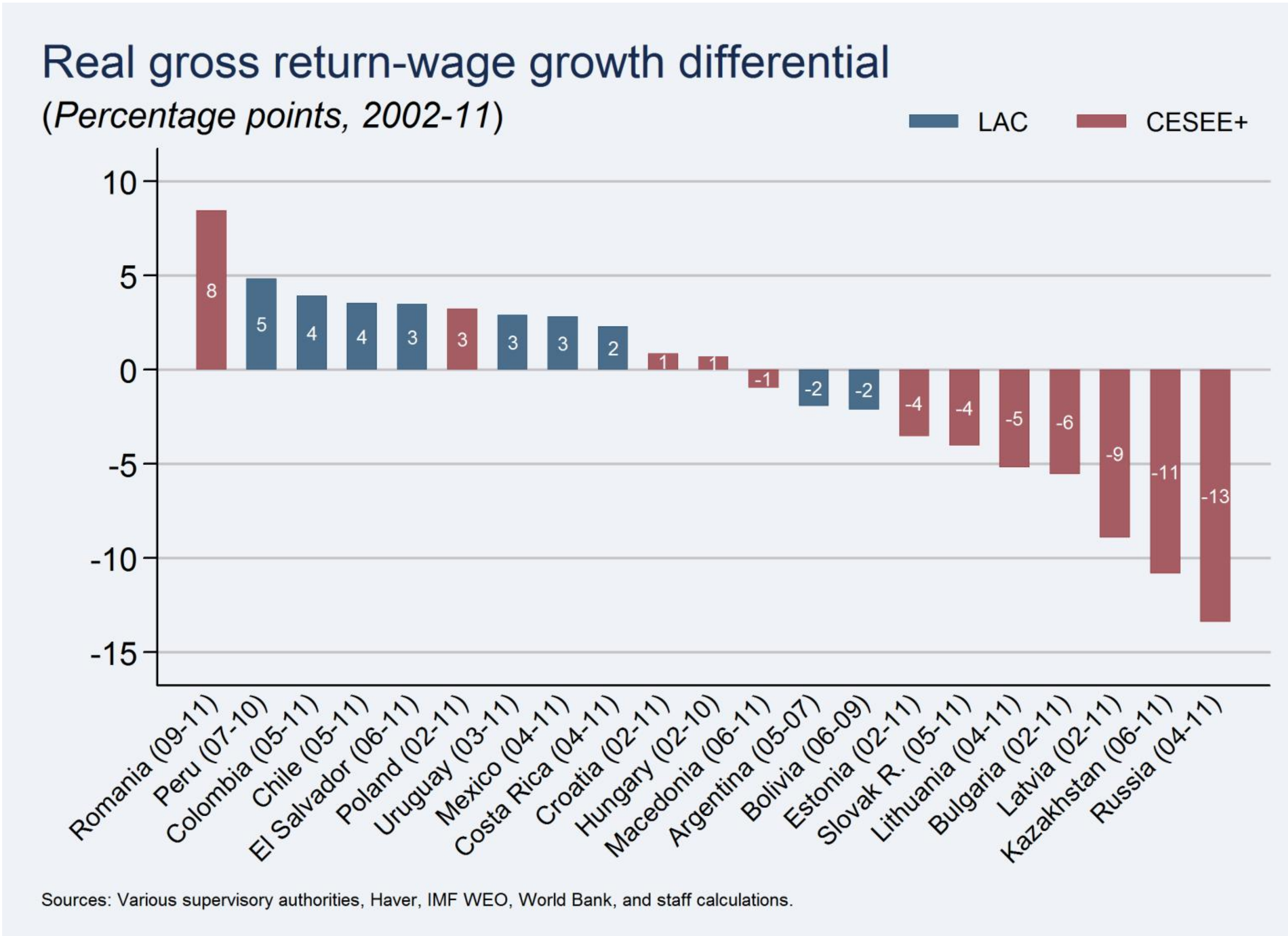
Current tools have varied impact on market power

- "Soft" interventions
  - Uniform rate regulation, bundling, simpler fee structures, centralization of high sunk cost functions
- "Hard" interventions
  - Caps on fees, restrictions/bans on switches or marketing expenses, monopsony agreements
- Procurement
  - Public procurement, hybrid I/O models, assignation rules (flow, stock, undecided).

2nd challenge: "DC and funded" = investment risk

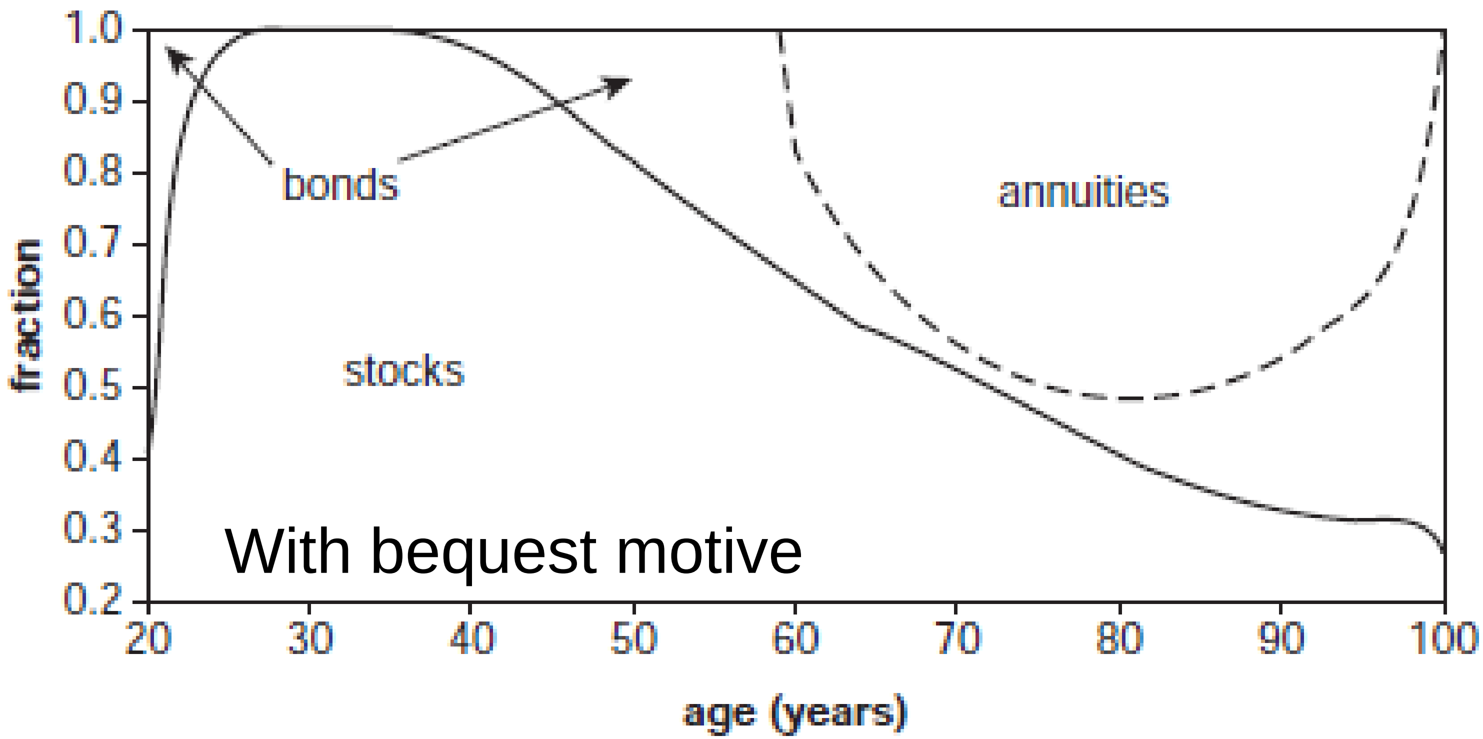


Managers have a short-term horizon



Contributors have a long-term horizon

- Expected replacement rate benchmarks (and human capital considerations) would yield strategic asset allocations aligned with the preferences of consumers



Conclusions: market power

- Maintain a decentralized I/O
  - Regulate like utilities
  - Eliminate incentives for marketing
  - More procurement: competition for the market

- Move to a centralized I/O
  - Strong governance
  - Procure passive investment in few global indices

Conclusions: investment risk

- Modify investment rules and products to:
  - Promote international diversification
  - Introduce deferred real annuities
  - Introduce long duration real fixed income instruments
  - Minimize investment options

- Require performance disclosure on the basis of long term benchmarks

Thank you!