

financial & private sector development

Pension Funds Reform and Capital Market Development: Threats and Misconceptions

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Threats and misconceptions

- Debt financing of the transitional deficit
- Expecting spontaneous surge of capital market development
- Promoting home bias
- Improper incentives

Debt financing of the transitional deficit

- Governments use the pension funds to finance the transitional deficits

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- Government impose restrictions for investing in domestic equity and international securities

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- Government bond market crowds out the development of the domestic bond market
- Pension funds end up heavily investing in government securities.

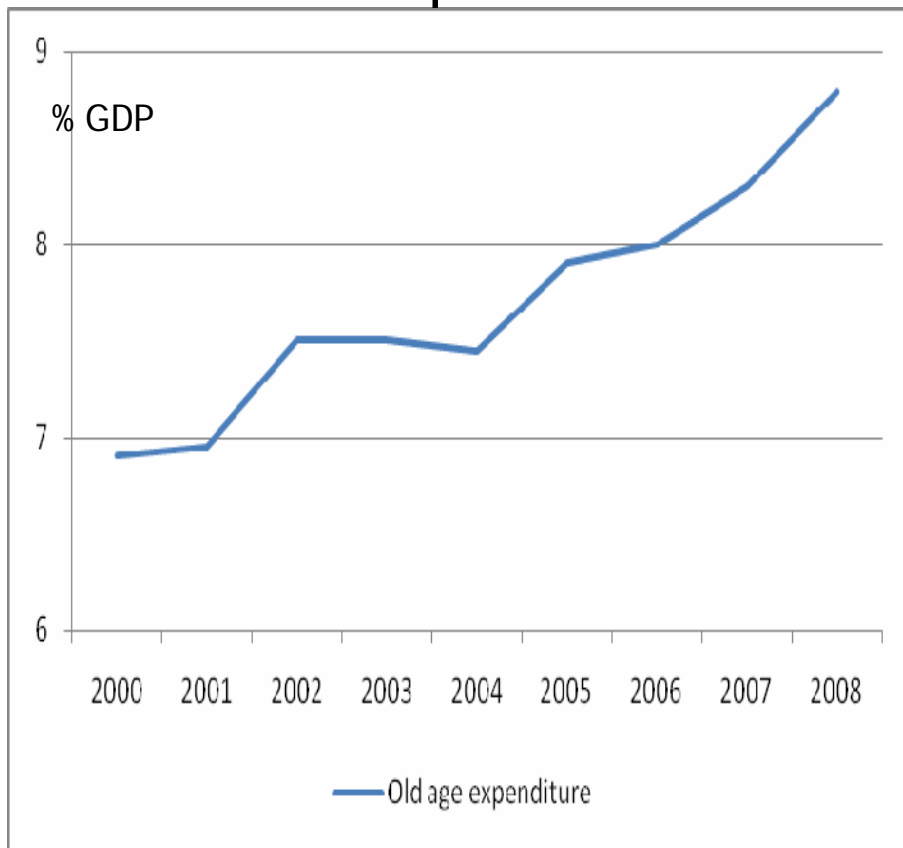
Little value added to contributors.....

Over indebted governments want to turn down the pension reform*

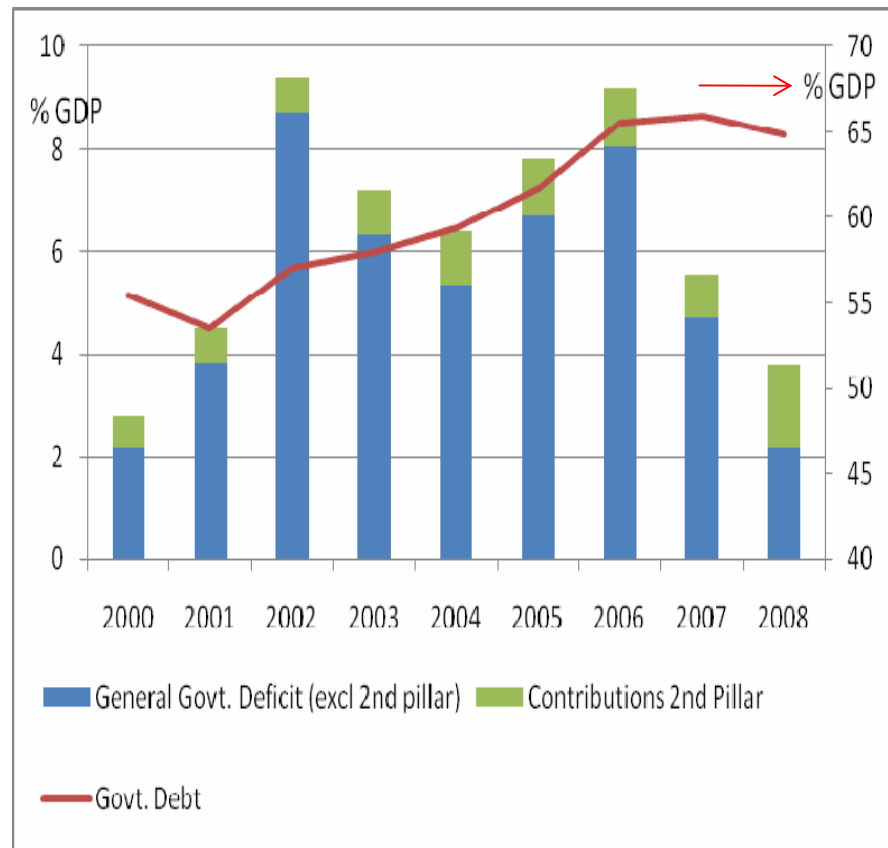
* We have seen this movie...

Hungary followed expansive fiscal policies during most of the decade...

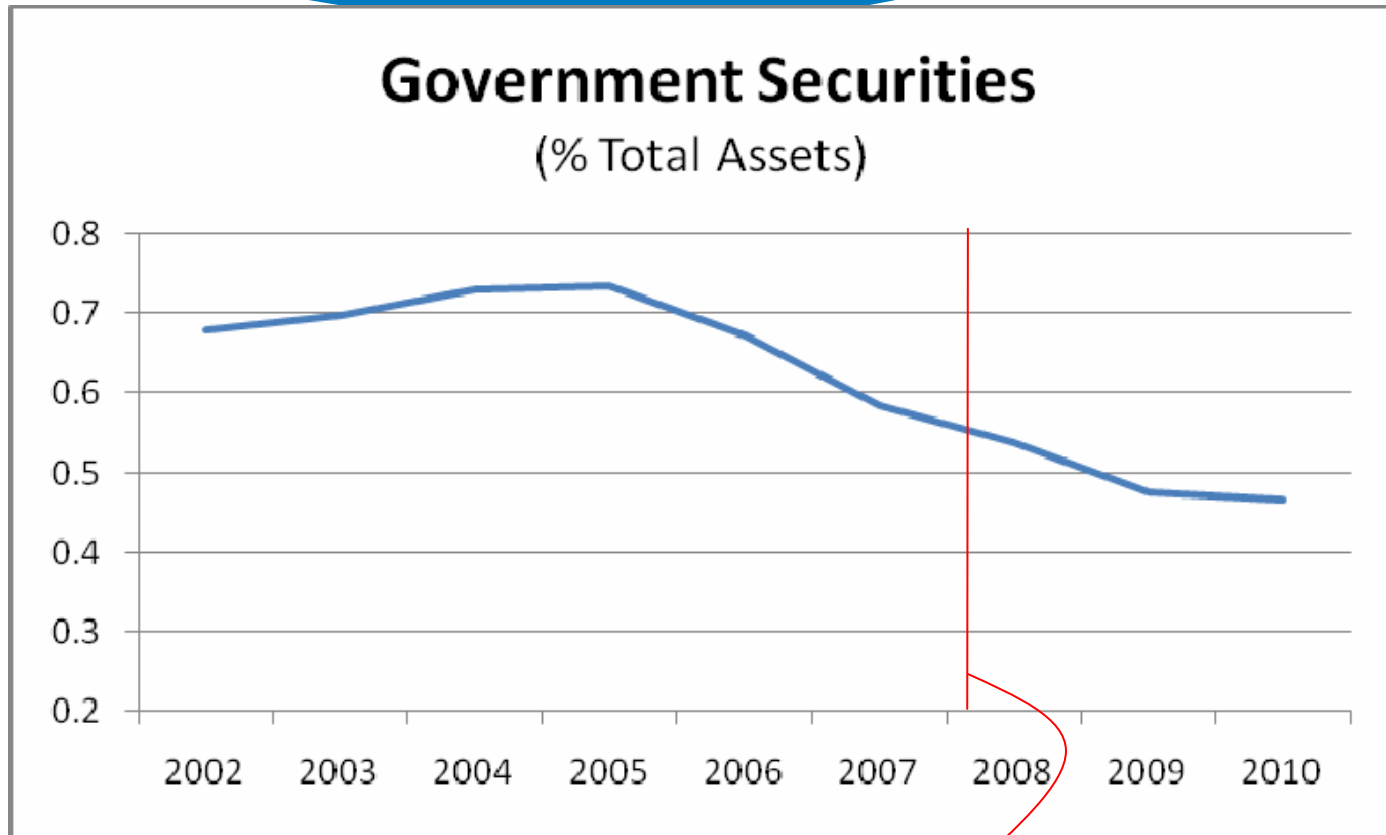
Old Age Retirement Government Expenditure



Fiscal Deficit and Government Debt



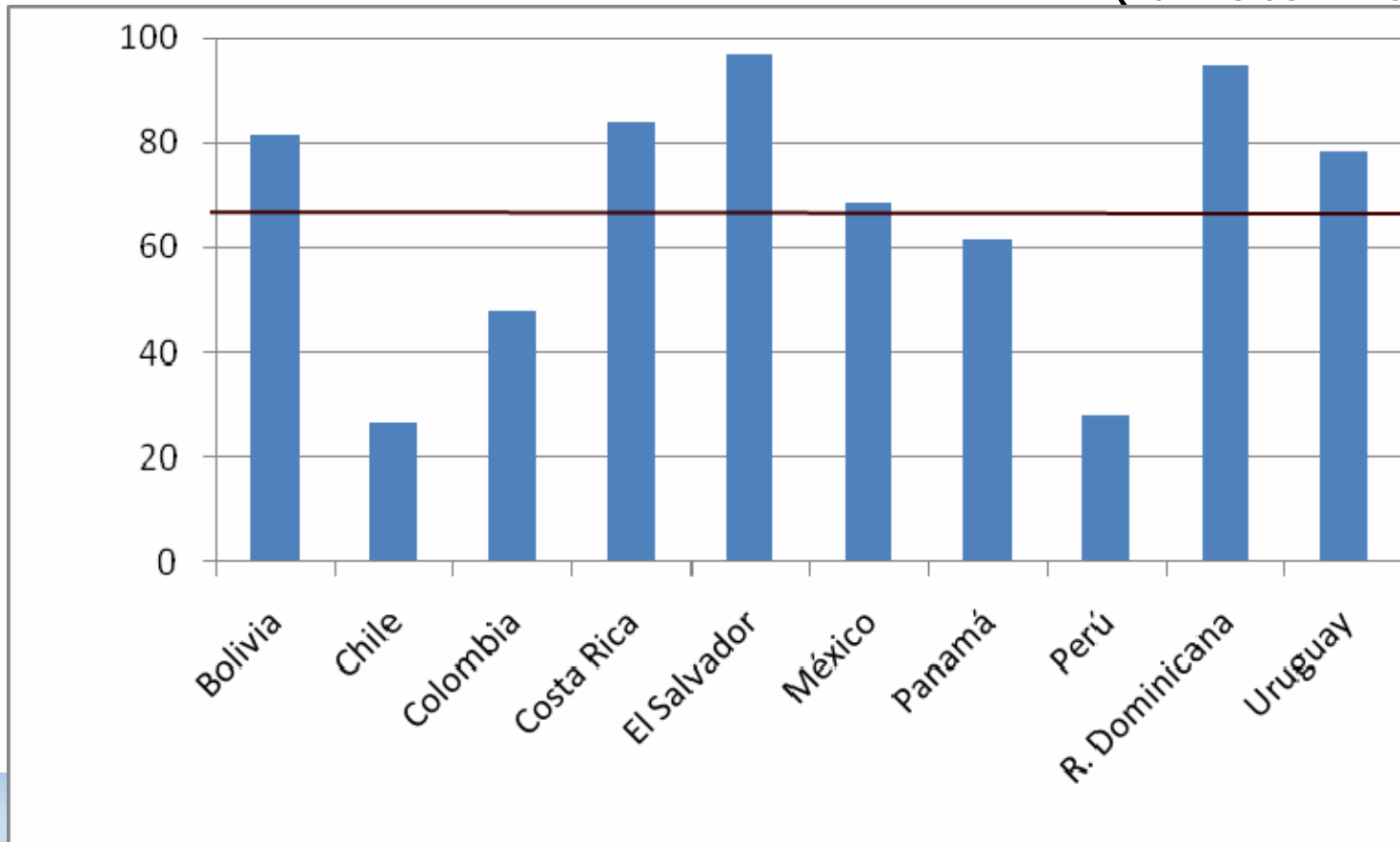
It is not a surprise that Hungarian pension funds were heavily invested in government securities...



Pension funds reduce their government debt exposure when the government had difficulty for financing the deficit

Pension Funds In Latin America

Pension Fund Investments in Treasury Bonds and Bank Deposits
(% Total Assets)*



• June 2010
• Source: AIOS

Expecting a spontaneous surge of the capital market development

- In most of the countries, pension reforms became orphans right after the laws were enacted.
- The head of pension supervision became the champion of the reform...but the most important issues of pension reform have nothing to do pensions, but with fiscal and financial policy.
- Since 1990s, the Chilean pension reform has been championed by a high level committee from the MoF. The objective of this committee is to promote a sound development the capital market
 - Identifying market needs and facilitating the development of instruments pension funds to invest, e.g. domestic infrastructure (highways, ports, etc).
 - Taking action against abuses by market players on risk premium in tender offers...corporate governance laws
 - Strengthening supervisory capacity

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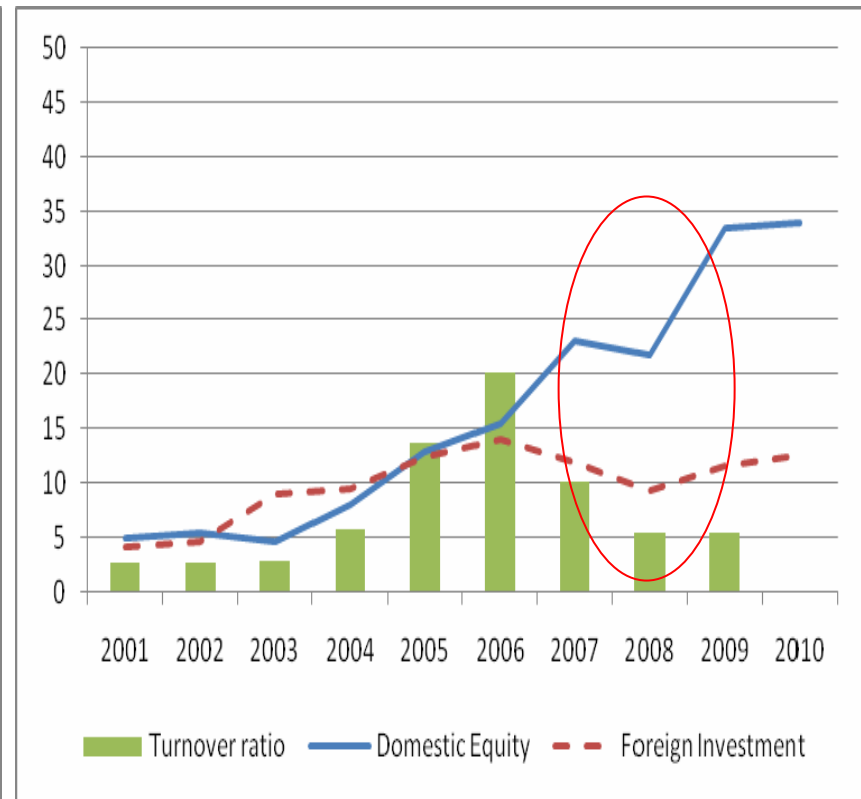
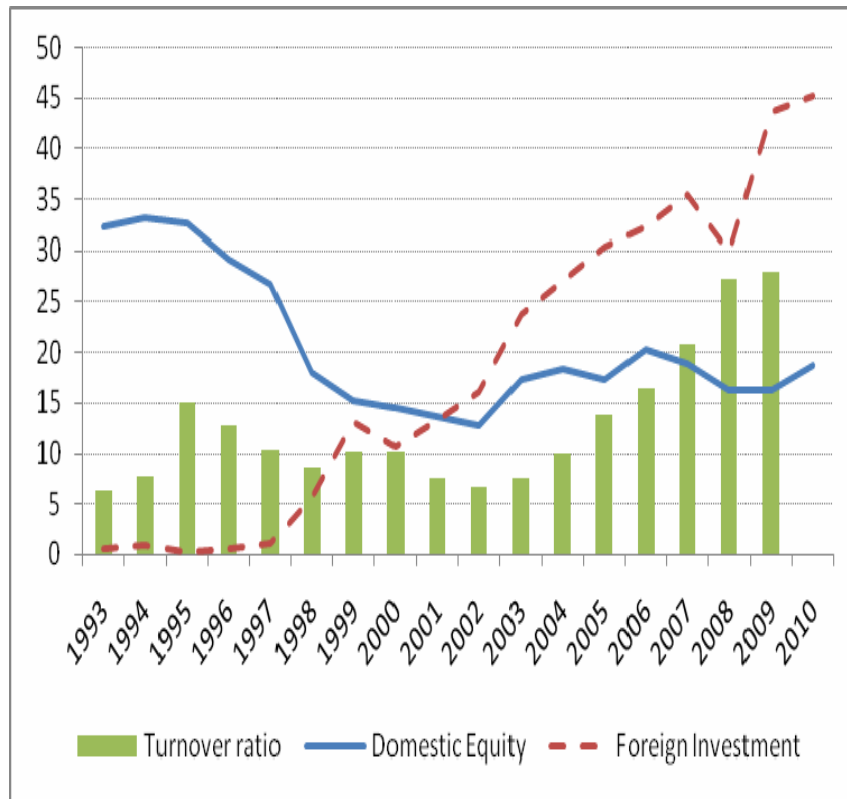
Promoting home bias

- Starting from low levels of liquidity, pension funds rapidly become the dominant player of the domestic equity market
- Since their participation become essential for pricing, pension funds cannot sell their securities without affecting their price
- Since buying their securities is the only strategy that protects the value of their investments, equity markets become easily overheated with pension funds reforms.

Chile and Colombia: investments of pension funds (% total assets)

Chile

Colombia



Source: World Bank

Improper Incentives for pension fund management companies

- Pension funds management companies with multiple objectives deviate the focus of the pension funds
 - Collection of contributions, payment of benefit, account management, customer service, and finally portfolio management.
 - Competition in areas other than portfolio management are pointless
- While caps on fees is resulting on political battles to reduce the fees charged by pension fund management companies, competition on fees has resulted in collusion
 - Caps on fees below the equilibrium have resulted in lack of incentives to invest in instruments other than bank deposits (Slovakia, Romania).
 - Fee structures with large proportions of success fees have also resulted in lack of incentives to invest in risky assets (Costa Rica, Dominican Republic)
 - Automatic enrollment in pension funds or tariffication may align incentives
- Guarantees
 - Imposing provision of guarantees to the pension fund management companies is likely to¹⁰ result in severe distortions in the asset allocation (Slovakia, Romania).

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Thanks!

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