Insulating Old-Age Systems From Political Risk

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Key Latin American countries have substantially revamped their old-age pension programs of late, responding to immediate financial problems plaguing public old-age support systems and substantial population aging in the next decades. Mexico's recent adoption of a mandatory, defined contribution system is a good example of such a system-wide national reform; other governments having undertaken similar reforms include Colombia, Peru, Argentina, Bolivia, Ecuador, and of course Chile with the most widely discussed, and oldest, pension package of its type, launched in 1981.[1] But in country after country, analysts are now recognizing that pension reform requires much more than a one-time law change. Rather, reforming the old-age system is proving to be a continuous and ongoing process, requiring repeated regulatory and financial paradigm shifts as the institution shifts away from a defined benefit pension model toward a defined contribution model. In this paper I argue that this reform process has beneficially alerted stakeholders in the pension system to the inherent risks they face. But because pension reform has come to be seen as an ongoing and dynamic process, it also is subject to increasing political stresses. Thus I argue that it is useful and probably essential to develop mechanisms that can protect the pension system from political pressures, as well.

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[1] See World Bank (1994), Demirguc-Kunt and Schwarz (1996), and Mitchell and Barreto (1997) for references.

Risks Facing Pension System Stakeholders

We posit that the goal of a well-functioning pension system is to assure older people that they will not sustain substantial consumption shortfalls in old age. Making this target concrete is not always easy; for instance, many Latin American countries have set a percent of the national minimum wage as the standard for old-age income. Alternatively, in the US, a government-set absolute poverty line is used as the goal of old-age government pensions (in constant purchasing power); by contrast, many US private pension plans target a 75% replacement rate (i.e. the old-age benefit is targeted at three-quarters of the retiree's pre-retirement pay).

Choosing the old-age benefit target for the old-age system is of critical importance, since shortfalls produce demands for additional reforms and sometimes subsequent overhaul.[2] But rather than focus here on what the old age consumption target should be, we instead have chosen to examine four main factors that tend to produce deviations from the intended goal. Specifically, we propose using a risk management approach to approach the question of how to design an effective pension system.[3] Stakeholders in a national retirement system confront four key risks:

(1) individual risk;

(2) retirement system risk;

(3) country-wide risk; and

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[2] See Fields and Mitchell (1993) for a discussion of the various old-age pension targets that pension systems have adopted.

[3] This sectiondraws heavily on Mitchell (1997).

(4) global risk.

A pension system that credibly and effectively cushions older people against such risks is generally perceived to be the objective of pension reform.

The Threat of Individual and Family Risks

One important source of old-age insecurity results from shocks specific to an individual and/or his family. For instance, a worker experiencing unanticipated unemployment and uninsured disability or illness will likely deplete his private assets rather than saving them for retirement. Alternatively, it is widely believed that workers myopically underestimate their chances of living to old age, hence under-save for their retirement period.

The Threat of Retirement System Risk

Another key source of old-age risk stems from problems with the structure of a pension system itself. These difficulties arise in many guises, but the common element is that the plan sponsor – be it a government, employer, union, or financial institution – sometimes fails to operate the plan in the best interests of the participants. Such problems are seen in US public employee pension plans, where political pressures force pension investments in so-called “economically targeted” projects – investments that are anticipated to have non-financial “social benefits” (and also have higher risk and lower return than more conventional assets). This is particularly likely when pension Boards are selected by politicians or their political appointees, and it results in lower investment returns (and sometimes lower funding levels) than permitted in the private sector (Hsin and Mitchell 1994;

Mitchell and Hsin 1997). In other instances, a plan sponsor may establish a pension where company and pension assets are commingled; this exposes pension participants to the risk of company bankruptcy. As an example, in Germany, the employer recognizes "book reserves" on its balance sheet representing the pension plan's claim on company value, but does not typically pre-fund any major portion of retiree obligations (Bodie et al. 1996).

The Threat of National Macroeconomic Risk

In most countries, the ability of an old-age system to deliver reliable old-age benefits depends heavily on that country's macroeconomic stability. That is, if the system is a pay-as-you-go program, benefit payments will be forthcoming only if the tax authority can redistribute economic assets from workers to retirees. In a funded system, given extensive home-country bias (Davis 1993 and 1996), the strength of the nation's financial services sector powerfully influences the value of old-age consumption delivered by a pension system. Controlling the risk of unexpected inflation comes in as a close second priority, since most funded pension systems are heavily invested in domestic assets that are not always well indexed.

The Role of Global Risk

The global reverberations of recent Asian capital market shocks have made it painfully clear that all countries are vulnerable to international, nondiversifiable, risks. Other nondiversifiable events under this same heading might include massive criminal and civil disruption, global natural disasters, and climate changes as well as epidemics of international proportions. In such instances, the simple fact is that these risks cannot be easily avoided or controlled, nor well financed ex ante.

Institutions Supportive of Pension Risk Management

Risk management analysis teaches that *risk control* and *risk financing* are the two essential tools required to make a system more reliable. In the pension context, then, we seek to identify control and financing mechanisms that can better protect stakeholders against the old-age insecurity risk they confront. A wide range of market institutions and regulatory structures are available to help control and finance old-age risk. We take up in turn each source of risk described above.

Protecting Against Individual and Family Risks

There are several ways in which markets and institutions can be strengthened to protect the individual worker from old-age risk. Most logical is the goal of improving workers' human capital, so that a greater earnings capacity permits them to secure and keep higher-paying jobs, save more, and work longer. While governments usually perceive immediate reasons to invest in worker education and skills, health care, and sometimes labor market mobility, it is not widely recognized that these investments have important long-term payoffs for retiree wellbeing. Another mechanism that can curtail individual risk in an old-age system is to invest in financial literacy. Recent research in the US defined contribution context has demonstrated conclusively that employer-supplied educational programs boost worker participation in pension plans markedly, and these financial literacy efforts also induce workers to invest more in equities than in the past (Clark and Schieber forthcoming). Other analysts argue that specific pension plan features and regulations can powerfully increase workers' incentives to pay into their plans, including (i) tighter links between contributions and retirement account accumulations; (ii) rules permitting easier pension portability when workers change jobs; and (iii) tax incentives encouraging pension system participation instead of system evasion.

A second way to improve workers' ability to cope with individual risk involves financing, especially through insurance mechanisms. Protecting against old-age consumption shortfalls requires having a certain level of assets, of course, but also requires having a strong and reliable annuity system that can protect against the risk of living too long. Mitchell et al (1997) have shown that private annuity markets do suffer from adverse selection, but this problem appears to be diminishing substantially over time, at least in the US. Similarly, disability and unemployment insurance systems offer the opportunity – at least in theory – for private financing of some individual risk. A great deal more research is needed on how private insurance markets are developing in the Latin American context, and how these can help workers deal with old-age risk effectively and efficiently.[4]

Coping with Retirement System Risks

Again, it is useful to distinguish between mechanisms to control/avoid risk avoidance, and methods of financing risk. Avoidance is often achieved by

[4] There remains the risk of low lifetime earnings, a risk that most private employment-based insurance is poorly suited to handle. Some would argue that this type of risk can best be handled by social welfare programs rather than old-age pensions (Mitchell 1997).

establishing a monitoring and oversight structure that controls plan sponsor behavior. This can be achieved by formalizing requirements for record-keeping, reporting and disclosure, and performance standards, concerning pension participation, eligibility, asset management, funding, and other services. For instance, when a pension plan has assets under management, it is generally agreed that "investment and expense performance standards should be established for the asset managers in terms of services rendered, investment returns, and administrative costs".[5] A range of other mechanisms is also available, most notably in the US and the UK the "prudent man" rule under which pension plan fiduciaries can be held personally liable if the plan is not managed according to trust law. Additional regulatory practices have been adopted mandating that a pension system mark to market its assets (sometimes daily, as in US 401(k) pensions) and make public any key assumptions regarding liability and investment accounting. Finally, giving pension participants the ability to move their funds from one pension plan to another, and to sue managers if necessary, may have a beneficial impact on retirement system performance. Only thus, it is argued, will plan stakeholders (or their delegates) take responsibility for monitoring system performance and exercise their rights to "exit" the plan should performance be unsatisfactory.

Financing retirement system risk is another (though not necessarily an alternative) approach to system risk management. One fairly effective technique in

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[5] For data on retirement system service delivery and administrative costs see Mitchell (1996a).

the US public pension arena is to require pension Board members to purchase trustee insurance (Hsin and Mitchell 1997). This has been demonstrated to improve pension funding and raise returns, probably because insurance premiums rise where pension system malfeasance is apparent. Thus the insurer acts as an agent for the stakeholders, to improve fund management. Other mechanisms to insure pension risk have been adopted in the US, Canada, and to some extent in Germany, where a solvency fund is created guaranteeing pension benefits in the event of plan sponsor failure (Bodie et al 1996, Pesando 1996, Ippolito 1996). Nevertheless, there are inherent risks associated with this approach as well, as we shall discuss next.

How Controlling Country Risk Helps

In the case of country-specific risk, the question arises, how to control/avoid risk associated with country-level economic fluctuations, and how if at all can these risks be financed? Most would agree that a pension reform rests heavily on a country's banking system, since virtually all old-age programs depend on banks for the collection of contributions. In addition, funded programs tend to hold government and commercial bank assets in their retirement portfolio. As a result, some experts have concluded that banking reform is an essential first-step to pension reform (Patrick 1996; Schmidt-Hebbel 1993; Stiglitz 1993). Other experts emphasize stock market reform, with its attendant positive effects on economic growth.[6] A parallel and approach is to engage in serious reform of the legal system,

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[6] See Demirguc-Kunt and Levine (1996a and b), Levine (1991), Holzmann (1996), and World Bank (1996).

increasing the chances that corporations properly report and disclose long term investment contracts, and suffer legal consequences if they do not. This applies particularly powerfully to the insurance sector in many developing nations, since confidence in insurers is generally at a low point (Outreville 1990, 1996 b and c).

A different but not necessarily mutually exclusive method of controlling country risk therefore relies on international diversification of the pension portfolio (Kotlikoff 1995), on the argument that macroeconomic and inflation risk can be somewhat hedged with a global portfolio.[7] A partial step in this direction is to have governments issue inflation indexed bonds. This was only recently implemented in the US, but has been in place for years in several Latin American as well as European nations. Pension funds can then use these assets to issue inflation-indexed pension benefits, as the demand arose. Additionally it may be useful for governments to issue (real) sovereign debt guarantees, affording protection against inflation as well as other types of country-specific risk (MacIsaac and Babbel 1994). How these instruments might be used to finance government guarantees of minimum pension benefits – as seen under the Mexican, Chilean, and several other pension reforms – has not yet been evaluated in depth and deserves much more attention (Pennacchi 1997).

[7] Recent research by Baxter and Jermann (1977) concludes that developed country pension portfolios are far too concentrated in domestic market capital assets, since peoples' human capital is nondiversifiable, and labor income growth and domestic capital market returns are strongly positively correlated. Whether similar conclusions would apply to developing countries is not yet known.

Managing Expectations Given Global Risk

As noted above, when internationally nondiversifiable shocks hit, there are likely to be no private market instruments that credibly insure or finance such events. As a result, it is probably most effective for a pension system to acknowledge that in some states of the world private markets will not pay off as anticipated. In this instance, managing expectations may be the most honest, and most effective, role for risk managers.

How Politics Can Influence Pension Structures

How can politics influence the environment for pension reform? One reason that this matters is that a well-structured, sustainable old-age system should have a life expectancy of hundreds of years, since only in this way will workers' expectations of benefits when old be effectively met. In this light, the highest priority of old-age system reform is to structure an environment in which such long-term retirement claims are believed to be sustainable for the long run. Of course, achieving this is more likely if a government can impose, and commit itself to, a regulatory and legal structure for the long term. In this sense, designing a credible pension reform requires a long-term political commitment to a sustainable pension environment.

Focusing first on the pension system itself, there is the question of how to structure the necessary pension supervisory and monitoring agency. Most Latin American nations have adopted such a government structure, whose job it is to ensure that laws are implemented, taxes collected and assets invested, and administrative costs overseen. As Mitchell (1997) has emphasized, it is critical to have this agency operate independently of the pension funds themselves. This reduces that chance that a politician might sway investment decisions, or channel private funds into "targeted" investments earning below-market returns or embodying above-average risk.

Moving beyond the pension system to other financial structures supportive of pension reform, it is critical that governments formalize the "legal and accounting procedures, the organization of trading and clearing facilities, and the regulatory structures that govern the relations among the users of the financial system" (Merton and Bodie 1995). Since bank bonds represent a substantial component of pension fund assets in most countries, banking regulations are generally seen as critical for pension reform. Just as governments have a crucial role in formulating – and enforcing – banking regulations, they also have a prominent role in establishing a rating agency to oversee investment valuations. In Chile, for instance, a Risk-Rating commission is said to have been instrumental in the growth of the stock market, and consequently in pension privatization, in that nation (Bustamante 1996).

Most countries undergoing pension reform also need to develop considerable political will needed to reform the national insurance law and regulation. In some cases the idea that insurance pricing should be managed via a competitive market runs against tradition, yet if insurers are to be better protected against politicians' influence, it will be necessary to establish better rules under which insurers are licensed, in which insurance reporting and disclosure takes place, and rules requiring minimum capital requirements and investment portfolios (Demirguc-Kunt 1996). For example, some governments restrict the asset levels and asset risk held by insurers, to limit the probability of default (Brady et al 1995). Many nations also try to spell out what happens in the event of an insurance firm insolvency, and some governments establish guarantee funds to cover this eventuality. Linked to this is often a myriad of rules regarding insurance commissions, seeking to protect consumers from fraudulent agents.[8] More international competition in insurance will hopefully standardize risk and reporting rules, thus enhancing government oversight functions.[9]

A different way in which political risks can be controlled has to do with a nation's legal system, which recent research argued is intrinsically related to the health of its investment environment. For example, evidence shows that markets protective of shareholder rights produce better investment growth (La Porta et al 1996). In the pension context, the analysis implies that pension participants are most likely to benefit from a common-law type system in which investor rights are upheld over managers' interests.

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[8] In many developing countries, state-owned monopolies restrict competition and keep insurance product prices high; however the view that the insurance sector deserves "infant industry" protection is losing favor (Kruger 1997; Skipper 1987; Outreville 1996b).

[9] Elsewhere I have suggested the usefulness of an international financial advisory organization offering regulatory guidelines for insurers and disclosure standards as well as reserve requirements in insurance as well as for the other financial sectors discussed earlier (Fields and Mitchell 1993; Mitchell and Fields 1994). Presumably these guidelines would make insurance companies globally more competitive and less costly in the long run.

Finally, many experts also recommend that labor market reforms be undertaken as a mechanism supportive of retirement security, and potentially reducing of political opportunities for pressure. This is particularly true in countries that impose extensive formal sector regulation including high taxes and labor protections, regulations that make the labor market inflexible and unresponsive to market forces. Such protections typically entrench the interests of a small group of employees to the detriment of the many outside the formal sector, and make a pension reform more difficult to achieve. For this reason, some pension reformers have argued that public sector employment must be reformed early in the process, along with reductions in protective labor legislation. This was achieved in Chile, for instance, where severance pay benefits were cut and union power curtailed – dramatically increasing the pension system's appeal to a wide range of workers rather than just a small formal sector group (Edwards and Edwards 1991). In general, building support for pension reform will ultimately depend on how widespread the system is, and how powerful is its grass-roots support. Greater coverage and wider participation would be anticipated to increase the long-term resilience of the pension system.

Conclusion

Pension systems the world over have begun to recognize, and then to seek to control and finance, the key risks confronting system stakeholders. In turn, analysts now are starting to acknowledge that successful old-age system does not act alone, but depends on the long-term credibility of several market and regulatory institutions – in both financial and nonfinancial sectors. An environment in which these institutions are sheltered from political interference greatly increases the long term chances of survival of the old-age retirement system.

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