Pension Reform in Russia

from legislation to implementation

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Private Pension Guarantees Principles and Application

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Guarantees in private pension schemes

- what are they, why do we have them, how do they emerge -

Loss-limiting instrument, altering the behaviour of risk-averse agents.

Payout conditional on state variables of the beneficiary and/or the contract – but not of the underwriter. Insurance – guarantee continuum along risk/premium characteristics.

In pension systems, guarantees are issued in the form of a minimum benefit equivalent and for provider liquidity/solvency

Guarantees are often issued

- for uninsurable risks or where other factors (e.g. information asymmetry, frequencies, risk-pool) render insurance unworkable
- to compensate for perceived risk differentials
- as a result of political considerations
- to serve as a dumping ground for unresolved policy issues

Principles

Pension reform

-***Increasing individual choice and individual responsibility*** –

- ***Reducing unfunded long-tem pension liabilities-***

(1) Hierarchy of instruments

➢ *Primary*: regulations, supervision, information, public education, freedom of choice, possibility to exercise rights

➢ *Secondary*: Insurance

➢ *Tertiary*: Guarantees

(2) Allocation of liability should reflect the capacity to generate and mitigate risk

(2) Systemic guarantees must be treated separately from pillar-specific guarantees

(3) Not all losses are to be covered by someone else

Context

- risks covered, db vs. dc, analogies, pricing, motivations -

Moving from safe, publicly provided social security to risky financial markets/providers. Culturally motivated perceptions of the State.

Performance guarantees are DB in nature and match poorly DC logic.

Analogies in deposit and small investor insurance. Relative position of mandatory and voluntary savings (both pensions and otherwise)

If guarantees could be properly priced it would be insurance.

Pricing is tough because guaranteed events are catastrophic and uniform pricing contradicts different marginal utilities of individuals.

Risks: performance risk of some kind

fraud and dishonesty

(inefficient or insufficient regulation, supervision)

Performance guarantees

- some questions -

Issue: *replacing a "guaranteed" public scheme with something inherently risky.*

Questions:

(1) income or performance guarantees?

(2) systemic or pillar-specific?

(3) can the liabilities generated be met?

(4) who generates liabilities for whom?

(5) is performance risk is to be covered through guarantees?

(6) is their anybody who can underwrite long-term performance guarantees?

(7) goal or instrument?

Performance guarantees

- rate of return, provisioning-

In DC schemes or in the accumulation phase, rate of return guarantees may be used as goal and as proxies for signalling fraud, negligence or incompetence.

Rate of return guarantees

	Absolute	Relative
Nominal	Prerequisite: low inflation (x%)	Low inflation, relevant benchmark (x% around benchmark)
Real	(cpi+x%)	(x% around real benchmark)

Each has shortcomings (undue risk avoidance, herding, etc)

Provisioning by fund manager, by fund or external reserve scheme, depending on the legal arrangements. Principle: those should pay who generate the risks.

Fraud and dishonesty

- protection, insurance, guarantees-

Fraud and dishonesty occurs because of

-inadequate (too static) regulation and supervision

-People intent on walking through the open door

Fraud and dishonesty causes losses because of

-information asymmetry

-limited financial literacy

-limited room to act in self-defence

Protection ≠ Insurance ≠ Guarantees

First, people must be empowered to protect their own interest

Second, market-based instruments (insurance) must be made available

And only then should the issuance of guarantees be considered….

Financing

- fees, liquidity, external resources -

Guarantees are contingent liabilities which need to be backed by assets.

Assets can be collected

- ex ante (fees)

(It's money in your pocket you can use right away but risks of under- or overfunding are big. Greater moral hazard. Investment problems with limited hedging opportunities

- ex post (fees, or loc repaid after levying fees)

(You can't act as quickly but funding is exact. Financial liability may be better attributed)

Contingent liabilities may be best finance by "contingent assets", e.g. drawing rights on the capital of the risk generating entities, cat bonds, etc.

Question: is there anyone else but the state who has enough money?

If so, do we need a separate financial construction?

Institutional issues

- organization, legal standing, governance -

Guarantee: implicit or explicit legal agreement

Law + Money

Question 1: is the law or the money specific enough to justify a separate organization?

Question 2: are there any such special interests which can only be represented by a guarantee agency?

Options

Private		**Public**	
Independent		**Government controlled**	
Institution	**Department**	**Stand-alone**	**Within Government**

Hungary – Developments

- past and present -

- **Minimum benefit guarantee**
- **Annuity underfunding: lending to underfunded annuity providers**
- **Fraud/liquidity: balance due based on statement prepared in 45-135 days**
- **Default pension fund**
- **Legal representation**
- **No role in liquidation**

- ~~Minimum benefit guarantee~~
- **Annuity underfunding**: ~~lending to underfunded annuity providers~~; ***guarantee of continuous annuity payment***
- **Fraud/liquidity**: ~~balance due based on statement prepared in 45-135 days~~; ***choice of valuation date***
- ~~Default pension fund~~
- **Legal representation**
- ~~No role in liquidation~~; ***administrator can only act with the Guarantee fund's knowledge/approval***

Some conclusions

(1) You probably can't avoid guarantees

(2) Provide all instruments necessary for people to protect themselves in DC phase

(3) Provide partial guarantees against fraud, dishonesty during DC phase

(4) No performance guarantees should be installed *but*

(5) Performance indicators may signal fraud, negligence or incompetence – reasons for supervisory action

(6) Provide full protection of annuities provided that you can control your exposure. If not, there should be mandatory annuitisation….

(7) No need for a separate guarantee agency

(8) Ex-post financing should preferred