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Market Reforms in Pension Systems

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SUMMARY PAPER

My comments in this paper draw heavily upon last year's report of a BIS Working Group of which I was a member. The report, "Institutional investors, global savings and asset allocation" is available at: <http://www.bis.org/publ/cgfs27.htm>

Market Reforms in Pension Systems

Broadly stated, the purpose of a private pension is to provide an income stream that offers an individual an assured and reasonable standard of living in retirement. Moreover, being private, that pension needs to be funded over an individual's working life rather than out of government consolidated revenue. Such a simple definition raises many fundamental questions that need to be addressed if markets are to successfully support a private pension system. A few issues to consider:

Who Bears The Risk For Delivering A Pension In Retirement?

In many mature markets, it has historically been the corporate sector that has played the leading role in providing private retirement incomes. This has been most common through defined benefit (DB) schemes. But for a variety of reasons – such as rising worker mobility and significantly greater costs for the employer – the shift towards defined contribution (DC) schemes has been accelerating. Responsibility for providing an adequate private retirement income is being progressively shifted from the corporate sector to households.

DB schemes have been most prominent in the public sector, with private corporate schemes typically opened only to higher-paid, white-collar employees. Coverage was, therefore, sporadic. Over time, coverage of DB schemes has narrowed with many schemes now closed to new employees. DC schemes have become increasingly prevalent. An issue, however, is how to provide individuals with the tools to successfully take-on and manage this risk. One avenue is to follow Australian experience and channel the bulk of householders' plans through institutional markets. Yet research evidence, most of which is based on US experience, suggests that there is considerable inertia and myopia regarding retirement decisions that can threaten the capacity of DC plans to provide adequate retirement security. Selection of a suitable default plan for an individual is extremely important.

Moreover, the significant rise in life expectancy over recent decades has added another complexity to the delivery of an adequate private pension. How does a person manage uncertainty about how long a pension stream of income needs to last in retirement? Annuities may provide a solution, though to date, their relatively high price has not provided much of an incentive to investors.

What Asset Markets May Be Required?

The build-up of a private pension system requires the growth of markets beyond bank deposits. While offering stable returns, relatively poor rates of return for bank deposits has seen the rapid rise of managed funds as a savings alternative.

An appropriate asset allocation is the principle means by which financial risks are managed in a pension fund. Generally, funds need to be accumulated across a range of assets in order to provide the benefits of diversification. But there has been much debate about the extent to which funds should be directed into the equity market given its risk/return characteristics for providing a pension in retirement. Despite these concerns, equities typically make up a major proportion of the portfolio in both DB and DC schemes. For some countries, such as Australia, the equity risk premium has been large, at least on an historical basis. But, this need not be the case for all countries, nor need it hold over future periods.

More recently, an approach, loosely termed as asset-liability matching, has sought to better align the cash flows required for paying a pension with an appropriate mix of assets. This has generally led to much larger proportions of fixed interest assets in portfolios. Nominal bonds, however, suffer from the risk of an unanticipated inflationary surge. As a result, bonds indexed to a price series has been seen as an appropriate solution. Indeed in several European countries, the regulators have been at the forefront of this approach. However, as market participants have increasingly adopted the approach, there have been quite large, and unintended, consequences for some markets.

Many other asset classes have been put forward as being suitable to improve the risk/return trade-off for portfolio returns. For small and/or developing markets diversifying into offshore markets may be beneficial. Other classes – including real estate, infrastructure bonds, private equity and an array of strategies within the hedge fund universe – have become increasingly popular for many pension funds. Returns from some of these asset classes, however, have yet to be thoroughly tested in all stages of an economic cycle or over a reasonably long time frame.

What Is The Role Of The Authorities?

Markets do not exist in isolation to regulation and supervision. Authorities may play a catalytic role where there are impediments to the start-up or the smooth operation of a market. This may be as simple as providing participants with standard documentation for certain transactions. Regulators may be called upon to provide elements of essential infrastructure to ensure that transactions can be undertaken efficiently.

Given markets are founded upon confidence and trust, it is incumbent upon authorities to ensure the regulatory framework is designed to foster both. A proper accounting framework is fundamental: does it pass requisite transparency and reasonableness tests to allow investors to make well-informed decisions? In addition, markets can quickly become dysfunctional where investors see they are being gamed by “insiders” – appropriate governance and disclosure rules are yet other essential elements.

Authorities need to be aware that changes in a regulatory framework can have major effects on the dynamics of some financial markets. A change in an accounting or a taxation rule, for instance, may generate or unwind significant distortions in a market. A suitable transition policy may be needed to ensure that market adjustments remain reasonably orderly. Likewise, much care needs to be taken by authorities should they seek to introduce some captive elements to holding pension assets. Such regulation can significantly alter the dynamics within a market bringing about large price changes, and potentially offsetting many of the supposed benefits of the underlying rule change.