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SECRETARY'S CIRCULAR NO. 94/83

To: Members of the Executive Board
From: The Secretary
Subject: Report on High-Level Seminar on Public Sector Pension Reform

Attached for the information of the Executive Directors is a report on the high-level seminar on public sector pension reform held during the week of August 8-12, 1994.

Mr. de Fontenay (ext. 38848) is available to answer questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

IMF INSTITUTE

Report on High-Level Seminar on Public Sector Pension Reform

August 8-12, 1994

Introduction

The seminar on "Public Sector Pension Reform" organized by the IMF Institute, in cooperation with the Investment Office and the World Bank, and with financial support from the Government of Japan, was held during the week of August 8-12, 1994. The purpose of the seminar was to give senior officials from member countries an opportunity to discuss the experience of their public pension schemes and to help those countries contemplating changes in the present arrangements. Speakers were experts from the actuarial, legal, and financial professions, as well as staff from the Fund and the World Bank.

Participation and Organization

Participants were invited from 39 countries. A list of the participating officials is given in Attachment I. The geographical composition of the group was: 11 from industrial countries, 8 from "transition economies," and 20 from developing countries. Priority was given to countries that had recently introduced major changes in their retirement schemes or were contemplating pension reform. A number of participants made available for the seminar a brief description of pension arrangements in their countries.

The seminar, which was opened by Mr. Alassane Ouattara, Deputy Managing Director, covered the economic aspects of pension reform, notably its potential contribution to a higher savings rate and to the development of the capital market; the operational issues involved in the reform process; investment policy for pension funds; and, finally, the requirements of transition to reformed arrangements for pensions. The seminar closed with a lunch hosted by Mr. P. R. Narvekar, Deputy Managing Director, at which Mr. Lawrence H. Summers, Under-Secretary for International Affairs, U.S. Department of the Treasury, gave his views on pension reform. The program of the seminar is provided in Attachment II.

The seminar benefitted greatly from the availability of a major study by the World Bank on "Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth." The study, which had been initiated by Mr. Summers when he was Vice President and Chief Economist at the World Bank, will be officially released at the 1994 Annual Meetings in Madrid.

Summary of the Discussions

The seminar stressed the importance and urgency of pension fund reform. In many countries, whatever their stage of development, public retirement schemes are absorbing a large and growing part of government budgets, requiring rates of payroll taxation that are a disincentive to employment, and, nevertheless, often fail to protect the elderly from poverty. In industrial countries, pay-as-you-go old-age pension schemes have been hit by demographic changes, notably the aging of the population, by the rise of unemployment, exceedingly generous benefits (including easy access to disability retirement), and by policy errors such as attempts to reduce unemployment by encouraging early retirement. In transition economies, the cost of old-age pensions as a share of GDP has risen sharply since the collapse of central planning.

In many developing countries, the demographic situation means that pay-as-you go pension schemes have a breathing space before they face the issues that industrial countries are now confronting, but this has encouraged excessive generosity, which will prove costly to maintain when the ineluctable aging process sets in. In Eastern Europe, Latin America, and Asia, many countries will match the OECD's present dependency ratios early in the next century, but at much lower levels of per capita income. Furthermore, retirement systems in some countries have been plagued by problems of high administrative costs, evasion of contributions, poor investment performance, and political interference.

Although it was agreed that pension reform was closely linked to a country's social and economic circumstances, so that a blueprint could not be applied in all cases, the "three-pillar" approach recommended in the World Bank's report was seen as a useful reference point. The three pillars are (1) a basic, publicly managed, mandatory pension scheme, which could be means tested, at a flat rate, and funded out of general revenues; (2) a mandatory, privately-managed, occupational pension scheme, linking benefits to contributions and fully funded; and (3) voluntary personal savings schemes. The first pillar could also take the form of a state-guaranteed minimum pension under the second pillar.

A multi-pillar system could provide retirees with insurance against the major factors that can push them into poverty, viz., living to an age at which their savings are exhausted, disability, inflation, as well as investment and political risks. Fully funded and competitively managed pension funds offered reforming countries the prospect of raising the national savings rate, deepening capital markets, and reducing the risk that pensions would put pressure on governments' fiscal positions. They also limited the scope for inequity in the treatment of different generations. Portability of pensions was a desirable feature that could easily be accommodated under the second and third pillars. Notwithstanding the title of the seminar, a convincing case could not be made for treating public sector employees differently from employees in the private sector.

It was, of course, accepted that achieving such a system for many of the countries represented at the seminar would be a major challenge that could take many years, not least because capital markets in many of those countries were in their infancy. Nonetheless it was agreed that it was invaluable to have a general framework for analyzing the end point of reform in order to avoid costly mistakes and delays.

Whether publicly or privately managed, pension funds needed to be closely regulated to protect the beneficiaries. A code of conduct for the officers of the funds had to be designed, but no set of safeguards was adequate without effective disclosure. The temptation for the authorities to interfere with the investment policy of pension funds by mandating certain "targeted" investments had to be resisted.

A sizeable part of the seminar covered investment policy. The reasons for focusing on asset management were the poor results achieved by several public pension funds and the desirability of encouraging countries to consider funding at least part of their old-age pension liabilities. Participants were made aware of the complex issues involved in asset allocation and risk management, and the value of professional and competitive management. The costs of restrictive rules on the types of assets in which the funds could be invested were underlined: such rules prevented pension funds from taking advantage of diversification, in particular international diversification, to raise the return and reduce the risk of their investments.

The problems of transition were discussed in the last session of the seminar. Chile's radical reform of its social security system and occupational pension schemes attracted a great deal of interest, but in many countries the preconditions for a revamping of the pension system were not met. An adequate regulatory system, an efficient capital market, and a well-trained cadre of managers and administrators had to be in place. Again, the urgency of an early start was emphasized, especially where a shift from pay-as-you-go to funded schemes was contemplated for new employees only.

Proceedings

The IMF Institute intends to issue the proceedings of the seminar as a Fund publication.

July 29, 1994

IMF INSTITUTE
1994-XX
Public Sector Pension Reform in English
August 8 - August 12, 1994
Participant List

NAME	COUNTRY	POSITION AND AFFILIATION
1. ACKERBY, Stefan (Mr.)	Sweden	Assistant Under-Secretary Ministry of Social Affairs
2. AGUILAR, Roger (Mr.)	Costa Rica	Actuarial Chief Costa Rican Social Security Fund
3. BARRA y Gómez Ortigoza, Cecilia (Ms.)	Mexico	Deputy Manager of Public Finance Bank of Mexico
4. BELTEKI-MAJOR, Mária (Mrs.)	Hungary	Deputy Director General for Financial and Economic Affairs National Bank of Hungary
5. BENDRISS, Mohamed (Mr.)	Morocco	Chief, Pension Fund Division Ministry of Finance
6. BURTON, R. W. (Mr.)	South Africa	Deputy Director General Financial Relations Division Department of Finance
7. CASTILLO, Maria Victoria (Mrs.)	Chile	Manager Financial Institutions Department Central Bank of Chile
9. CLARKE, Laurence (Mr.)	Botswana	Deputy Governor Bank of Botswana
9. DIAGNE, Fatou (Ms.)	Senegal	Director of Payroll and Annuity Debt Ministry of Economy, Finance and Planning
10. DIAZ Ortega, Enrique (Mr.)	Peru	Deputy Superintendent Superintendency of Private Administration of Pension Funds Superintendency of Private Pension Fund Administrations
11. FLIKWEERT, Jaap D. (Mr.)	Netherlands	Counsellor Ministry of Finance
12. FRASCA, Francesco Maria (Mr.)	Italy	Head Supervision of Financial Intermediaries Department Bank of Italy
13. FRENEY, Roger (Mr.)	Australia	First Assistant Commissioner Occupational Superannuation Group Insurance and Superannuation Commission
14. GAJDOSKOVA, Ludmila (Mrs.)	Slovak Republic	State Secretary Ministry of Labor

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NAME	COUNTRY	POSITION AND AFFILIATION
15. GALAZKA, Zofia (Mrs.)	Poland	Director Economic Department State Insurance Company
16. GRASSO, Carla (Mrs.)	Brazil	Secretary for Complementary Pension Ministry of Social Security
17. GUO Shuqing (Mr.)	China	Director Experimental Reform Directorate State Commission for Restructuring the Economic Systems
18. HINZ, Richard (Mr.)	United States	Director Office of Research and Economic Analysis Department of Labor
19. IBRAHIM, Fathy (Mr.)	Egypt	Advisor to the Minister Ministry of Social Insurance
20. JAMES, Estelle (Mrs.)	IBRD	Senior Economist International Bank for Reconstruction and Development
21. KING, Gordon (Mr.)	Canada	Special Advisor to the Assistant Deputy Minister Department of Finance
22. KRAL, Jiri (Mr.)	Czech Republic	Director Social Security Department Ministry of Labor and Social Affairs
23. LIM Han Soon (Mr.)	Singapore	General Manager Central Provident Fund
24. LUBLIN, Yuri (Mr.)	Russia	First Deputy Chairman of the Board Pension Fund of the Russian Federation
25. MANNIK, Georg (Mr.)	Estonia	Director State Board of Social Security
26. MEDAISKIS, Teodoras (Mr.)	Lithuania	Advisor Ministry of Social Security
27. MERCADO Lora, Marcelo (Mr.)	Bolivia	National Secretary Pension Funds
28. MOHAMED, Paduka Sallehuddin bin (Mr.)	Malaysia	Chairman of the Board Employees Provident Fund

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NAME	COUNTRY	POSITION AND AFFILIATION
29. MORGAN, Phillip (Mr.)	United Kingdom	Head of Branch - State Pensions Policy Department of Social Security
30. MUROLO, Felipe (Mr.)	Argentina	Superintendent Retirement and Pension Fund Administration
31. NIKONOFF, Jacques (Mr.)	France	Deputy Secretary General Deposit and Consignment Office
32. NORSTRAND, Rolf (Mr.)	Denmark	General Manager Arbejdsmarkedets Tillægspension (ATP)
33. NUSSBAUM, Werner (Mr.)	Switzerland	Head Division of Pension Plan System Federal Office of Social Insurance
34. ORIOLI, Enrique (Mr.)	Uruguay	Manager Central Markets Regulations Department Central Bank of Uruguay
35. PROENCA, José Nuno Cid (Mr.)	Portugal	Chairman of the Board of Directors Council of the National Pension Center
36. PUNTUPETCH, Virayuk (Mr.)	Thailand	Director, Fiscal Policy Office Capital Markets Policy Division Ministry of Finance
37. SARAGIH, Indomen (Mr.)	Indonesia	Director Pension Directorate Ministry of Finance
38. VALIENTE, Luis Ortiz (Mr.)	Paraguay	Director of Retirements and Pensions Undersecretariat of Financial Administration Ministry of Finance
39. VANKATESAN, K. (Mr.)	India	Secretary, Expenditure Department Ministry of Finance
40. VARELA, Juan (Mr.)	Spain	Advisor to the General Director for Planning Ministry of Economy and Finance

**INTERNATIONAL MONETARY FUND
IMF INSTITUTE AND INVESTMENT OFFICE
SEMINAR ON PUBLIC SECTOR PENSION REFORM**

August 8-12, 1994

PROGRAM

AUGUST 8

- 9.30 a.m. ▶ Welcoming Remarks (Mr. Alassane D. Ouattara, Deputy Managing Director, IMF)
- ▶ Introduction to Seminar (Mr. Patrick de Fontenay, Director, IMF Institute, and Chairman, Investment Committee)
- ▶ The Economics of Public Sector Pension Funds and their Funding (Mr. Vito Tanzi, Director, Fiscal Affairs Department, IMF)

Discussant: Professor William Branson, Princeton University

10.45 a.m. Coffee break

- 11 a.m. ▶ Plan Design Issues (Professor A. David Wilkie, European Actuarial Consultancy Services)
- Defined benefit v. defined contribution plans; inflation protection; obligatory v. voluntary contributions; options (loans, commutation, survivor benefits). Tax treatment of contributions and benefits.

Session chaired by Mr. David Williams, Treasurer and Vice-Chairman, Investment Committee, IMF

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- 2.15 p.m. ▶ Funding Issues (Professor A. David Wilkie, European Actuarial Consultancy Services)
Basic valuation methods. Funding methods. Review of assumptions.

Discussant: Mr. Michael Peskin, President, Michael Peskin Associates, Inc.

3.45 p.m. Coffee break

- 4 p.m. ▶ Regulatory Issues (Professor Roy A. Schotland, Georgetown University Law Center)
Fiduciary responsibilities. Allowable investments. Code of conduct. Supervision.

Discussant: Mr. Jeff Clay, Chief Counsel, Pennsylvania Pension System

6 p.m. RECEPTION

AUGUST 9

- 9.30 a.m. ▶ Recent Developments in Public Pension Fund arrangements--a world-wide survey (Ms. Estelle James, Lead Economist, Policy Research Department, World Bank)

Discussant: Mr. Giovanni Tamburi, European Actuarial Consultancy Services

10.45 a.m. Coffee break

- 11.00 a.m. ▶ Panel discussion on individual country experience (including Australia, Chile, Japan, The Netherlands)

12.45 p.m. LUNCH

Passive v. Active Management (Mr. Jeremy Grantham--Grantham, Mayo and Van Otterloo)

- 2.30 p.m. ▶ Public Pension Reform: general discussion.

3.45 p.m. Coffee break

- 4.00 p.m. ▶ **Operational Issues in Pension Fund Management (Mr. B. Holland, Investment Advisor, IMF)**
Operational issues of asset/liability management and asset allocation; active v. passive management; internal v. external management; controlling risk; evaluating performance; custodians and counterparty risk.

Discussant: Mrs. Hilda Ochoa, Strategic Investments

AUGUST 10

- 9.30 a.m. ▶ **Portfolio Management and Asset Allocation (Professor Kenneth R. French, Director, Financial Research Center, Yale School of Management)**
Decisions on portfolio construction and asset allocation among classes of investments in both domestic and foreign markets. The mean variance model. Concept of risk from the fund's vantage point.
- 10.45 a.m. Coffee break
- 11.00 a.m. ▶ **Portfolio Management (cont'd)**
- 2.30 p.m. ▶ **Risk Management (Professor Kenneth R. French, Director, Financial Research Center, Yale School of Management)**
Strategies to control risk and achieve investment goals; tactical asset allocation; static and dynamic hedging.
- 3.45 p.m. Coffee break
- 4.00 p.m. ▶ **Risk Management (cont'd)**
- 5.15 p.m. ▶ **Workshop on Asset/Liability Modeling (Hal Reynolds, Wilshire Associates)**

Discussant: Mr. David Ordoobadi, Senior Investment Officer, IMF

AUGUST 11

- 9.30 a.m. ▶ International Investing and Hedging
(Professor Bruno Solnik, Ecole des Hautes
Etudes Commerciales, Paris)
What share of a fund portfolio's assets
should be invested abroad; should foreign
investments be hedged?**

Discussant: Mr. Mark Kritzman, Windham Capital Management

10.45 a.m. Coffee break

- 11 a.m. ▶ International Investing and Hedging (cont'd)**

**Session chaired by Mr. John B. McLenaghan, Director,
Statistics Department and Member of the Investment
Committee, IMF**

- 2.30 p.m. ▶ Roles and Risks of Derivatives for Pension
Funds (Mr. David Folkerts-Landau, Chief,
Capital Markets and Financial Studies
Division, IMF)**

**Discussant: Mr. Matthew Pritsker, Board of Governors,
U.S. Federal Reserve System**

3.45 p.m. Coffee break

- 4.00 p.m. ▶ Illiquid Investments (Mr. Nestor
V. Santiago, Director, Pension Department,
World Bank)
Risks and Characteristics of Real Estate,
Venture Capital, and other Private Market
Investments**

Discussant: Mr. David Ordoobadi, Senior Investment Officer, IMF

6.00 p.m. DINNER AND THEATER - WOLF TRAP

AUGUST 12

- 9.00 a.m. ► **The Structure of Equity Markets: The Market 2000 Report**
(Mr. Howard Kramer, Securities and Exchange Commission)
- 9.45 a.m. **Panel Discussion: The Stages of Pension Reform. What are the main steps for countries at an early stage of the reform process and/or with embryonic capital markets?**
(Mr. Robert J. Palacios, World Bank; Mr. Robert P. Hagemann, IMF; and seminar participants)
- 10.45 a.m. **Coffee break**
- 11.00 a.m. **Panel Discussion (Continued)**
- 11:30 a.m. **Summing up of seminar and general discussion**
- 12.45 p.m. **FAREWELL LUNCH. (Hosted by Mr. P. R. Narvekar, Deputy Managing Director, IMF)**
Speaker: Mr. Lawrence H. Summers, Under Secretary for International Affairs, U.S. Department of the Treasury

