

Discussion

**of Ambachtsheer's Paper:
"The Optimal Pension Delivery Organization:
Theory and Practice"**

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Outline of the discussion

- concentrate on conclusions of AMB's paper
- use the Italian private pensions system as a laboratory in which to test the robustness of AMB's conclusions
- argue that AMB's conclusions are indeed robust, with some qualifications
- argue that the Italian system as recently reformed should receive attention -among others- as a possible compromise btw.
 - fully "paternalistic" systems
 - individual accounts DC systems with full responsibility on individual members
- more in general, building on AMB's paper, discuss ways to mitigate market failures in DC environment

AMB's conclusions

1. Broad workforce participation in occupational pension plans managed by pension delivery organizations (PFs) with aligned interests that are also well-governed has significant welfare–enhancement potential.
2. meaning of “aligned interests” : legal structures of PFs that minimizes conflicts of interest (e.g. avoid high costs of mutual funds)
3. meaning of good governance: clear mission, sound organization design, effective management and oversight
4. scale as a crucial element
5. Constructive optimism: Gvt policy can foster optimal pension design

Some key features of the Italian system

- despite reform in mid '90s aimed to stimulate PFs growth (reform linked to that of 1st pillar, that severely reduced benefits), PFs still have a low coverage rate (13% of workforce)
- a new reform, fully in place in July 2007
 - automatic membership in a PF of all employed workers (12m), with a contribution of about 7% of salary (so-called TFR – severance pay)
 - the default PF typically is the “natural” industry-wide, stand-alone, non-profit contractual PF (CPF), established by national labour agreements, usually with voluntary contributions attached
 - a degree of competition btw. CPFs and pension plans offered for a profit by financial providers:
 - open pension funds (OPFs), which support both occupational (group) and individual plans
 - insurance-based individual pension plans (PIPs)

Competition in the Italian pension market

...comes from a complex interaction btw. "collective" and "individual" choice:

- by agreement with the employer, workers may opt-out as a group from the industry-wide CPF and enter an OPF (collective choice)
- individual workers may also opt-out from the occupational PF (either a CPF or a OPF) and choose their favourite OPF, or PIP – but in this case they do not have the right to carry with them the employers' contributions due to the occupational PF

➤ as a result, (at least in principle) the Italian pension market is made contestable, as a whole and in its segments

Relationship with AMB's ideas

- in a contestable market, incumbents are challenged
- industry-wide CPFs are challenged on the quality of governance by the collective opting-out option
 - scale is going to be one crucial issue to be taken into account in the governance of occupational plans
- Run-for-profit pension plans (OPFs and PIPs) are challenged on costs and the alignment of interests
 - collective choice puts pressure on OPFs and has positive externalities for individuals as well (as OPFs host both group and individual members)

Looking more at costs and alignment of interests...

...misalignment of interests coming from the profit-making nature of retail asset management and DC pension products is not enough to explain their high costs (Akerlof (1970) points to the effect on asymmetric info on the quality of items exchanged, not on unduly high costs)

➤ need to distinguish two kinds of misalignment:

- contrast of interest: the ordinary situation btw. sellers and buyers in any market: *“it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest”* (A. Smith, 1776)
➤ it is not a source of market failures *per se*

- conflict of interest: a situation where an agent delegated to a certain activity bears an interest that is not aligned to the interest of the principal”
➤ a true potential source of market failures

Summarizing the sources of market failures in a DC environment...

➤ interest misalignment determines market failures (misselling, high costs) through a design of products:

- prone to opacity and hidden costs (exploiting asymmetric info)
- that hampers choice limiting portability (e.g. front-fees)

➤ demand-side factors also contribute to market failures:

- lack of financial literacy among individual members (and possibly “collective” decision makers)
- free-riding problems connected to search costs

...and summarizing the remedies

- AMB's (and others') remedies:

- automatic enrolment in occupational PFs
- good governance (including search for economies of scale)
- mitigation of conflicts of interest through regulation aimed at transparency, product simplicity, and portability

- well-conceived default investment options
- financial literacy, empowerment to take decisions

- and in addition:

- appropriate market structure (contestability)
- sound interaction btw. group and individual options, and btw. collective and individual responsibility
 - contributes also to social consensus for pension reform