Expanding Coverage of Good Quality Private Pensions

Introduction
Across the globe, greater economic wealth and security, longer lives, and smaller families have increased the need to better secure old-age pension. The United Nations estimates that, by 2050, the share of the world’s population over age 65 will have doubled from 10 percent to 20 percent, with 80 percent of the elderly—nearly 1.3 billion people—living in low-income countries. Despite this likely increase, the coverage of contributory pensions is still low in many countries, including those countries already with an aging population—as shown in figure 1.

Well-structured pension systems with a mix of public and private provisions contribute directly to the World Bank twin goals of (a) reducing poverty and (b) increasing shared prosperity. Achieving those objectives requires high pension coverage that provides adequate income and that is efficient, sustainable, and secure.

Pension funds can also be an important source of domestic long-term capital to fund investment and growth in businesses, housing, and infrastructure. Thus, pension reform is central to broader financial sector development.

Demographic aging, poor administration, early retirement, and unaffordable benefits continue to increase the urgency of pension reform. Expanding pension coverage is a global challenge, because failure to plan proactively will mean rising old-age poverty and unsustainable burdens on public finances.

FIRST Initiative’s Support
To contribute to this very important global agenda, the FIRST Initiative has supported many countries in their efforts to improve the coverage of good-quality pensions and to increase the supply of pension assets that can safely and sustainably fund long-term investment.

FIGURE 1. Global Pension Coverage

FIRST projects have been largely successful in achieving their desired outcomes and positive impact. They have often catalyzed additional funding to support larger reform.

FIRST projects have typically assisted countries in the following five key areas:

1. Reviewing, designing, and reforming
   a. Pension policy frameworks, including fiscal impacts
   b. Legal, regulatory, and taxation frameworks, including investment regimes

2. Providing technical assistance for
   a. Building capacity for supervision, including governance aspects, particularly for investment strategy and management by pension funds
   b. Improving pension market structure and dynamics, including distribution and access
   c. Developing coverage using multiple channels developed in line with the local labor market

### Lessons Learned

After a decade of FIRST-funded pension projects led by the Finance and Markets Global Practice at the World Bank Group, several key lessons have emerged (see figure 4).

**Lesson 1: Reforms should focus on improving long-term outcomes.**
Given the long-term nature of pensions, regulators and pension funds alike must establish long-term outcomes and develop well-sequenced priorities with clearly defined targets and key performance indicators for monitoring and evaluating success. Long-run objectives differ across countries, but regulators should typically aim for greater coverage, adequacy, sustainability, security, and efficiency. Many regulators or supervisors do not have well-articulated objectives. The lack of clear objectives may mean that there could be lots of activity without the achievement of meaningful outcomes for the pensioners and the 

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**FIGURE 2.** Building Coverage with Multiple Strategies

**FIGURE 3.** Multiple Interventions for the Most Effective Solutions

**FIGURE 4.** Key Lessons in Pension Reforms
country. The lack of a long-term objective can also affect pension funds, which may risk constructing short-term portfolios that will not provide the best retirement income for their members.

FIRST has embedded this lesson into the results framework required for all projects. The framework calls for clear articulation on how inputs deliver outputs, how they lead to improved outcomes, and, finally, how those inputs and outcomes create a long-term development impact. This practice forces authorities to think about outcomes and long-term effects before implementation. Correspondingly, risk models should reduce risks to achieving those long-term outcomes. This was evident in recent projects in Albania, Costa Rica, and Turkey, where the regulators started by determining and defining their long-run objectives. That step was followed by developing appropriate metrics before working backward to develop the most effective strategies.

Lesson 2: Pension-specific risk-based supervision is paramount to maintaining security

Risk-based regulation and supervision is important but must be tailored to the pension sector. The focus on capital adequacy and liquidity in banking and insurance is typically of far less importance in pensions. Similarly, short-term viability is less important than long-term solvency for a defined benefit pension or than long-term retirement income for a defined contribution pension. The right mix of regulation and supervision for pensions should be determined by what the system is trying to deliver.

A project in Albania has pursued the goals of expanding pension coverage and improving the efficiency and security of the pension system. In that case, ensuring robust supervision was a prerequisite for instilling the confidence to develop pension coverage. A project in Costa Rica worked with the officials from the Superintendencia de Pensions (SUPEN) to develop a new outcome and risk-based supervision model so that they could (a) better articulate their long-run objective, (b) focus on the risks to that objective, and (c) have more solutions to tackle those risks. The model, which is shown in figure 5, is similar to approaches used in many FIRST projects. The project developed the strategy, systems, staff, and skills to implement the new approach and developed updated regulations for the key risk areas of investment, actuarial funding, governance, operational risk, information technology, and market conduct. The long-run impacts will be to improve the funding of defined benefit plans; to improve investment governance and expertise; and to continue to reduce pension system fees, which will result in higher pensions.

However, effective supervision does not exist in a vacuum. It needs to support—and be supported by—a well-designed market structure and good laws and regulations. Such rules include requiring (a) the use of custodians to reduce the risk of fraud and (b) the use of other fundamental building blocks of a good system. Good risk-based supervision (RBS) involves looking forward and linking back to the focus on good governance. If a fund is well governed, it will be more likely to find and fix problems without the need for regulatory intervention. Most important, modern RBS provides a framework that allows the supervisor to continually monitor and update its focus, typically as a result of an annual strategy. This dynamic approach is perhaps the greatest benefit of a well-delivered RBS system because there is continuity and delivery well beyond the life of the project. RBS can be particularly important in less developed countries, which may see rapid changes in the capital market to which the pension system can then adapt to year by year.

Lesson 3: Good governance underpins good fund performance and risk management

Good governance—delivering a strategy focused on the best interest of the members and having the expertise and systems to execute that strategy—is essential to enhancing pension fund performance and the security of pension savings in industrial and developing countries alike. In many countries, nonspecialists appointed to pension fund boards make decisions that they are ill equipped to handle. Hence, improving the governance of those charged with safeguarding and investing pension assets is one of the fundamental goals of many FIRST projects. A project in Mozambique aims to establish a new public sector pension scheme to expand coverage on the basis of strong governance, investment, and administration. In parallel, the project will support the pension regulator in implementing strong governance practices in the new private pension funds.

Poor investment returns can result from investments into the wrong areas when driven by conflicts of interest or by lack of expertise. A lack of skills leads to either (a) recklessly conservative investment allocations in simple deposit accounts or (b) pension funds that subcontract investments to external managers who cannot be effectively monitored and who offer poor value for money. It is not safe to invest in long-term illiquid assets if those making decisions cannot properly appraise the investments. Nor is it safe if the market structure (see lesson 4)
encourages a high turnover of assets and high levels of switching such that pension assets are not invested for the long term.

Governance needs to be combined with improved investment regulations and a proactive approach to capital market development if assets are to be invested effectively. The integrity and quality of pension fund boards must be improved to maximize those opportunities. Investment regulations should be progressively updated to broaden the range of assets in which pension funds can invest. A project in Colombia focused on improving the range of instruments that the (already large) pension sector could invest in, thereby allowing the sector to support investment diversification and longer-term maturities. As a capital market develops, a wider range of domestic and foreign instruments becomes available for the investment of pension assets. This wider market supports long-term returns. Instruments may include long-term government and corporate bonds, inflation-linked government bonds, and private equities.

Good governance has many other positive effects, such as creating trust among all stakeholders, reducing the need for prescriptive regulation, and facilitating supervision. Hence, many FIRST projects focus on integrating governance, regulation, and supervision. One such project in Brazil assisted the regulator Superintendencia Nacional de Previdencia (PREVIC) in improving the regulation and supervision of governance. The project helped to develop a supervisory methodology that deepened PREVIC’s understanding of how the funds were run, expanding the previous focus on qualifications and track records. Now the Brazilian government is proactively developing the capital market to allow greater investment in a wide range of capital market instruments, including infrastructure.

A project in Guyana focused on developing the first comprehensive pension legislation for the country. The legislation was intended to provide a secure system that could be expanded in the future. The proposed law created a very simple structure to protect members. The regulator had the authority to grant greater flexibility and discretion to pension funds that could demonstrate greater risk management skills and good governance.

Lesson 4: The right market structure increases efficiency
Economies as diverse as India, Kosovo, Malaysia, and Sweden have shown that creating an efficient market structure can dramatically reduce costs and improve governance—solutions that work in both developing and developed countries. There is little point in only concentrating on the symptoms of a problem, such as high fees, without dealing with the causes. If a country has a cost structure that is based on high levels of sales and marketing with large sales forces encouraging excessive churning of accounts, then its structure is broken. In such a case, codes of conduct, training, or regulations on good practice will not deliver real change. Instead, authorities may need to introduce concepts such as automatic enrollment in pensions, bulk auctions to provide asset management, and good-quality default options at retirement.

A project in Turkey helped to develop a new automatic enrollment scheme to expand coverage efficiently by removing the high-cost sales forces at the point of entry to the pension system. The change was made possible by a cost benchmarking analysis, an approach that is mirrored in recent work by the International Association of Latin American Pension Funds Supervisors and that will be used in other regions.

As the focus of reforms turns increasingly to expanding coverage in the informal sector, the need for ultra-high levels of efficiency is even greater. Higher efficiency will enable small and erratic savings to still receive real returns, net of fee. The right market structure will vary significantly between countries depending on the sophistication of the capital market and the strength of delivery organizations in the public and private sector. India’s New Pension System (NPS) has an unbundled architecture with central account administration and auctions for investment management providers. The experience in many industrial countries shows that such problems are not solved automatically as the system grows. In Australia, a recent review recommended introducing auction-style mechanisms for the bulk purchase of asset management services. This approach is geared at reducing costs after the disappointing results of 20 years of growing scale and competition. Likewise, in the United Kingdom, the government created a new not-for-profit provider, NEST, with a requirement to provide administration and investment management for 0.5 percent (50 basis points) of assets under management for any employer that could not find a provider. The U.K. government also introduced a price cap for all providers of 0.75 percent.

Lesson 5: Expanding coverage to informal workers and tackling gender inequality requires multiple channels
Some of the major challenges in expanding pension coverage are to make enrollment, collection, investment, and payout of pensions simpler, safer, cheaper, and more efficient. The most effective combination of channels should be used to reach those goals. The challenges are compounded for developing countries, which tend to have higher levels of informality in the labor market and mobility challenges—problems that can affect access to pensions for women.

Innovations in identification (ID) and payment systems have the potential to solve some of the most challenging areas in pensions. Providing a unique ID is the first critical step, and some countries have begun to use biometric IDs. This practice is especially useful for women in countries where they have no other form of ID. Enrollment can be almost automatic and costless if customers have (a) a unique biometric ID; (b) a basic bank account; (c) access to a low-cost payment system, such as a mobile phone platform or a basic payment card, which makes erratic and irregular contributions viable; and (d) automated government-to-person payments.

In India, FIRST is enabling a pioneering concept to expand coverage to the large informal sector. Authorities are leveraging the national biometric ID system and new pension system to automate the creation of pension accounts. Under the new system, users will have no paperwork to fill out and will not need to visit a bank branch. The system was designed to accept direct contributions from government incentive programs; from users’ micropayment plans; and from third parties, such as domestic employers, industry associations, and self-help groups. Such innovations also help develop accounts that are
portable across time, employers, and geographies, thereby preventing the accumulation of many small pots.

Expanding access beyond large formal employers, which is a natural and obvious channel for many to gain access to pension plans, is particularly important to workers who move between formal and informal employment—many of whom are women. It is difficult to replicate the traditional pension model, which relies on a 40-year career during which regular contributions are made. However, with support from government incentives, people can contribute enough money to increase their old-age income. The use of multiple entities—such as employers, microfinance institutions (MFIs), self-help groups, and financial services providers—can add up, slice by slice, to ensure better coverage. Simple, efficient, and nearly automatic systems can enable coverage expansion for even small employers while eliminating the burden of managing the fund.

In Albania, a project aimed at expanding coverage of private pensions explicitly targets employers as a channel. Some MFIs have the advantage of being close to the customer. However, they lack the capabilities to provide an account that a worker can use with multiple employers, in multiple regions, over multiple decades. Conversely, large financial providers may have the sophisticated systems, but the costs of customer acquisition through large sales forces mean that the potential benefits can be eaten away in fees.

Lesson 6: Pro-poor incentives can support increased coverage
Governments should be careful to target incentives at the population segments that need them, taking into account public pensions. Government-granted enrollment and contribution incentives should be for the benefit of poor people. The incentives must not be regressive. Most pension systems offer some form of tax relief, usually with a cap on the amount of contributions that are tax-free. However, tax relief is of no benefit to people earning too little to pay tax. In the United Kingdom and elsewhere, such people can receive a tax credit. Tax relief as an incentive can be difficult to understand and communicate; thus, different approaches to incentives are needed.

Another option is to use matching payments. For example, the government could pay US$1 for every US$4 contributed. While the evidence on the success of matching is mixed, there are a number of positive examples. In 2013, Turkey saw perhaps the most successful transition from tax relief to matching payments. The approach added about a million new members to the individual voluntary pension system—an increase of 20 percent in coverage. Matching contributions by governments, employers, or both bear strong promise as an effective incentive to motivate participation in industrial and developing countries.

Lesson 7: Financial education initiatives must be simple and frequent
The evidence shows that financial education and literacy are only modestly effective in increasing coverage and reducing costs. Trying to make consumers experts in pensions and investment is extremely challenging. Countries should therefore have modest expectations regarding the effects of such programs and allocate a budget in line with those expectations, especially in cases of limited financial resources. The most promising approach is to have campaigns with a simple message delivered repeatedly through multiple channels. Promoting messages such as “stay enrolled” is more successful than requiring members to differentiate between equities and bonds or risk and returns. Before a recent FIRST project in Albania, knowledge of private pensions was low among employers and workers. Thus, the project placed particular importance on educating key stakeholders. Moreover, projects in Brazil, Costa Rica, and India have included proactive and repeated engagements to increase consumer knowledge and awareness of pensions.

In the absence of high levels of financial education, the importance of good governance and well-designed regulation (as discussed in Lesson 2 & 3) is heightened. Thus, investment plans and payouts need to have sensible default contribution levels, so that members do not need to make uninformed decisions.

Cross-Cutting Lessons Critical for Success of Project Implementation
In addition to the previous seven lessons, three other lessons have been critical to the success of FIRST support for pension reform. They are (a) strong client engagement and ownership, (b) capacity building, and (c) strong stakeholder consultation. These three factors may be obvious to some and may apply generally to other types of reforms. However, they bear repeating given their importance and because in countries where they have been absent, FIRST projects have seen less success.

The FIRST process aims to embed clear client engagement and ownership as part of project development and requires tangible support from clients. The most effective pension projects have been those that are truly owned and led by the client. In Chile and Costa Rica, the FIRST initiative saw very strong levels of demand and ownership from highly motivated country teams. In Chile, the model that was developed was proactively disseminated by the supervisor, and it has become a model of best practice.

In many countries where FIRST works, the pension fund regulator is new or has low capacity. Hence, capacity building remains a central part of all FIRST projects and is applied proportionately as needed. There is little good in a perfectly designed governance, market structure, or RBS system if the authorities are unable to manage the system and adapt it in the future. Projects in Lesotho and Rwanda to develop new laws and regulations were delivered with hands-on training. Capacity building must be delivered in a way that is tailored to each country. Because of the large differences between systems, generic training courses can be of little value. A project in Costa Rica placed particular emphasis on actuarial, investment, and supervisory training given the risk assessment of the supervisor. A project in Albania spent more time on capacity building in the core supervisory elements as well as on developing the outreach to employers and the wider stakeholder community. A project in Chile was able to develop
a sophisticated RBS approach because high levels of expertise and a desire to push the frontiers of what could be achieved already existed. A project in Guyana recognized that resources were scarce and thus focused on designing a very simple system.

The importance of regular and frequent consultation with stakeholders, including pension service providers, government officials, members of parliament, and the media, cannot be overemphasized. For a regulator, operating a system is easier if pension fund managers understand and accept the aims and approaches. Writing a new law is of no use if it does not get passed. Whereas FIRST projects cannot require the passage of legislation, they are developed and delivered with extensive stakeholder engagement in an effort to gain buy-in and to benefit from the specific experience of the stakeholders in that country. Experience has shown that active consultation can often lead to earlier adoption of proposed changes even without the imposition of a new regulations or enforcement actions.

Conclusions
Securing old-age income is an urgent priority for countries globally. Expanding pension coverage and improving the quality of pension systems is therefore a critical development goal. Over the past decade, FIRST has supported the pension reform efforts of many governments, and the key lessons listed in this note can be used as a guide for many other countries.

FIRST pension projects have evolved to focus on a multidimensional approach to improving the desired outcomes. Improvements in one part of the system can be undone by weaknesses elsewhere, so projects increasingly focus on improving legislation, regulation, and governance as well as market structure and supervision.

Going forward, the greatest challenges lie in two areas. The first challenge is to leverage innovations in ID and information technology improvements in financial inclusion so as to broaden access to pensions for the informally employed and the many women previously excluded from pensions. The second challenge is to translate pension assets into long-run investments for the benefit of members and the economy. This effort will likely require interventions not only in the pension system but also in the capital market.

At FIRST and the World Bank, we are committed to continuing to support our client countries in securing old-age income for all.

Acknowledgments
The authors thank Consolate Rusagara, program manager of the FIRST Initiative, for guidance and supervision; Emiko Todoroki, Renske Van der Kooi, and Tony Randle for their peer reviews; and Subita Gurbani and Mutoni Karasanyi for publication and editorial support.

Notes
1. Reforms are aimed at increasing participation in pension plans.
2. The FIRST Initiative is a multidonor trust fund managed by the World Bank, financing technical assistance aimed at strengthening financial sectors in low- and middle-income countries.