



Strengthening Financial Sectors



Donors and Stakeholders Workshop on Law 40 of 2004

Implementing an Indonesian National Social Security System

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Agenda

- **Scope of the Workshop**
- **Goals & criteria**
- **Issues in Law 40**
- **Defined benefits options**
- **Optimizing the system**
- **Modelling system costs**
 - **Jean Noël Martineau, Actuary & Social Security Expert**
- **The way forward**
 - **P.S. Srinivas, Sector Coordinator, World Bank**

Introduction

- **The focus of FIRST Initiative is on retirement; other donors focus on health**
- **Pension reform is an art not an exact science**
- **Law 40 leaves many doors open to creative solutions**
- **Our aim: a process not a conclusion**
 - **Raising important questions**
 - **Illustrating paths and options**
 - **Proposing elements of a business plan****to assist Indonesia in implementing, in a sustainable way, the national social security system it needs**

Empower All Stakeholders

- **Office of Vice-President, Menko Kesra, MOF and other Ministries, all need to build capacity to**
 - **assess priorities,**
 - **understand policy options,**
 - **identify criteria for decisions**
 - **measure impact of alternative provisions**
- **Enhance the capacity of the Ministries and of the Council so that they can match the technical expertise of the Administrators appointed as monopoly providers**
- **Enhance the capacity of the Administrators to restructure and improve their performance to adequate levels**
- **Enhance the capacity of diverse groups of stakeholders to assess and critically review strategic options through exposure to adequate independent information**

Drawing on Global Experience

- « *Averting the Old Age Crisis* » published in 1994 by the World Bank was updated in early 2005 on the basis of research and experience becoming « *Old Age Income Support in the 21st Century* »
- Not a single best model or « one size fits all » but a good template for analysis of the issues and review of lessons learned around the world
- Experience with the political economy of pension reform shows that a 3-phase concept is often applicable:
 - commitment-building,
 - coalition-building,
 - implementation

A 3-phase Process

➤ Commitment-building (Current phase)

- Likely the longest, must be quite inclusive and transparent. Need to share with wider forum and key players a maximum of information about facts/costs and options. Avoid reaching a quick but artificial agreement; wide consensus and buy-in is essential

➤ Coalition-building

- Starts with the exposure of a concrete reform concept. Normally requires the emergence of a champion ready to link his/her political fate with the cause. Quality of the concept is essential as well as openness to fine tuning. Need the support of strong long term projections and sensitivity/risks analysis

➤ Implementation

- Continued active political support must continue throughout implementation for any reform to be successful. Frequent tensions between political readiness and administrative capacity. Requires a firm commitment to implement but only when administrative preparation sufficiently advanced to ensure the success of the system

Evolution of Reform Perspectives

- Increased understanding of challenges to reach the “lifetime poor” and inclusion of non-financial aspects of old age security
- Recognition of the importance of initial conditions and cultural context of reform as well as the macro fiscal monetary and economic environment
- Appreciation of inter-actions with capital market development and administrative costs
- Flexibility and diversification of risks through multiple layers more important than the number of pension elements
- Funding not a model but remains important benchmark

Multi Layer Pension Framework

- **Zero Layer- Non Contributory Social Assistance for Lifelong Poor**
- **1st Layer - Publicly financed and managed PAYGO system to provide basic income protection**
- **2nd Layer - Mandatory funded individual account system creating direct linkage between contributions and benefits**
- **3rd Layer - Voluntary pension savings, individual or occupational**
- **4th Layer – Family and Inter-generational Support for Elderly**

Goals of a Pension System

- **Primary goals:** To provide old-age income that is
 - Adequate: refers to both the absolute and relative level (i.e. poverty alleviation and income replacement)
 - Affordable: refers to the financing capacity of the country, the individuals and the society as a whole
 - Sustainable: refers to the financial soundness of the scheme, now and in the future
 - Robust: refers to the capacity to withstand major shocks, including those coming from economic, demographic and political risks
- **Secondary goals:** To create developmental effects by
 - minimizing negative impacts (e.g. labor market)
 - leveraging on positive impacts (e.g. financial market development)

4 primary content evaluation criteria

- Does the reform make sufficient progress toward the goals of a pension system, and meet distributive concerns?
- Can the macro-economy, the financial sector and the fiscal framework support the reform?
- Can the administrative structure operate the new (multi-layer) pension system?
- Have steps been prepared to establish regulatory and supervisory arrangements and institutions to manage long term assets in a funded layer?

3 primary process evaluation criteria

- **Is there a credible commitment by government**
- **Is there local buy-in and leadership**
- **Does it include sufficient capacity building for implementation**

Law 40 Implicit Policy Options

- **Lump sums versus security in retirement**
- **Long savings build-up period delays providing immediate security in retirement**
- **Pension to be on DB basis; design and financing path open**
- **Termination benefits under Law 13 of 2004 not integrated**
- **Consolidation of assets management with benefits administration**
- **No opening to competition or outsourcing**
- **Role of regions not integrated**
- **Strong push for extension to informal sector**
- **Distinct but yet undefined prudential framework for governance, regulation and supervision**
- **Static normal retirement age**

National Programs Issues

- **No central Clearinghouse/Database for identification, registration and collection**
- **Portability and mobility of labor?**
- **Uniformity across Sectors/Regions/ Categories?**
- **Pooling of funds for similar programs with different administrators?**

Optimize the Structure

An emerging best practice is to unlink assets and benefits to better optimize each component

➤ **Benefit administration**

- **transaction intensive**
- **lower risk operation**
- **mostly clerical personnel**
- **IT support for database maintenance**
- **Direct contact with participants**

➤ **Asset management**

- **High risk activity**
- **Requires strong governance structure**
- **Mostly professional personnel**
- **IT support for sophisticated evaluation & online transactions**
- **Trend is to outsourcing totally or partially**

Civil Servants & Armed forces

- **Independently of Law 40, need to align reporting of costs on best practices and with transparency**
- **Level and design not exportable to whole labor force**
- **Need to resolve the paradox of the Old Age Endowment program being both DC & DB**
- **An option may be to split pension between national basic component and Employer based complement**
 - **Complement could be on regional basis to fit variable HR policies**

Defined Benefit Pensions

A large and diverse family

- **Earnings & participation related**
 - Final average risky, too expensive for labor force
- **Contributions related (but not DC)**
 - More equitable; direct linkage reduces evasion and leakage
 - Career-indexed used in CPP and Europe
 - NDC originated in Sweden, later used in diverse countries
- **Non-earnings related- no gender bias**
 - Flat amount per year of participation
 - Simpler, redistributive
 - Uniform amount
 - Simplest, more redistributive, exportable to informal sector

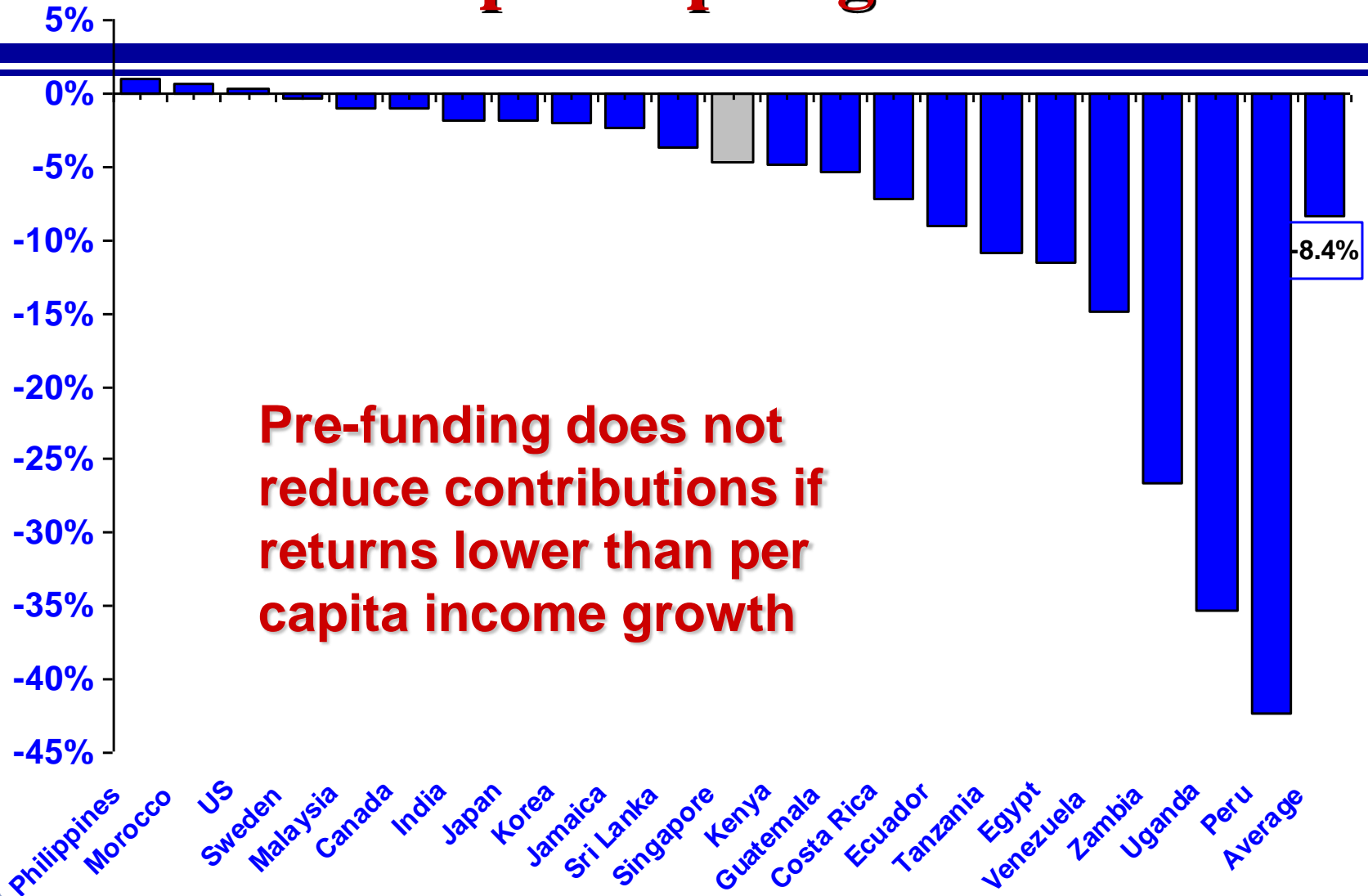
Examples of earnings related DB

Best average	Y% x years x average earnings of best 3 years within last 10 years
Final average	Y% x years x average earnings of last 5 years
Career indexed	Sum of Y% of each year earnings, updated until retirement by Wages or Price Index
Notional accounts	Annuity payable at retirement purchased by Y% of wages accumulated at rate z%/yr, compounded
Career average	Sum of Y% of each year earnings
Target formulas	Annuity purchased at retirement by Y% of some average wages per year of participation

Funding & Financing

- **Old Age Savings Benefit(*Jamsostek DC type*):**
 - Automatically fully funded by level contributions
- **Monthly Pensions**
 - If investments publicly managed, minimize assets through steady state level financing
 - If assets competitively managed, wider choice of target funding levels including as above
- **Civil & military service**
 - Follow national rule for basic part
 - Other liabilities become part of Government interest bearing debt

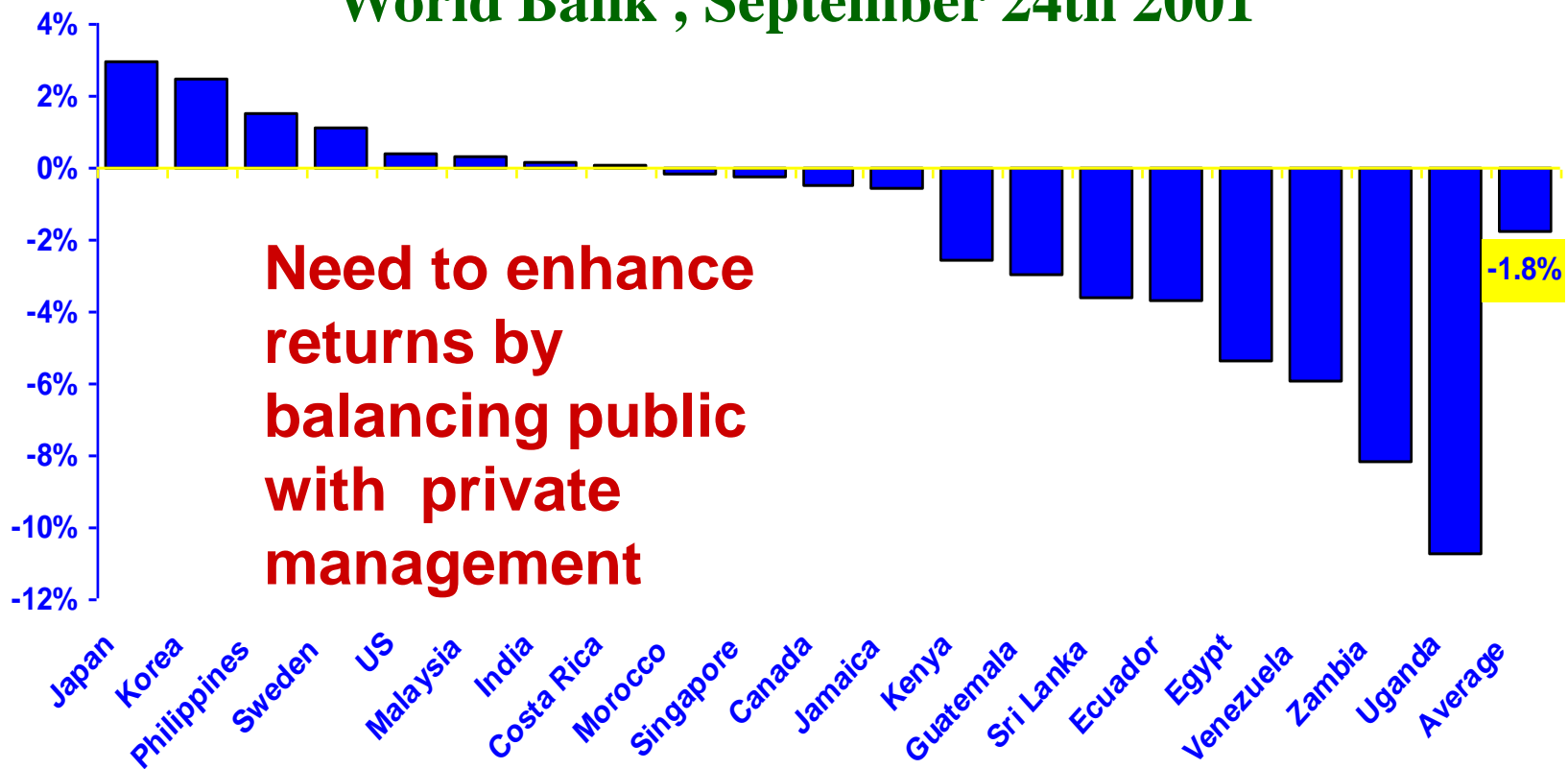
Returns on publicly managed assets vs income per capita growth



Pre-funding does not reduce contributions if returns lower than per capita income growth

Public sector returns vs bank deposit rates

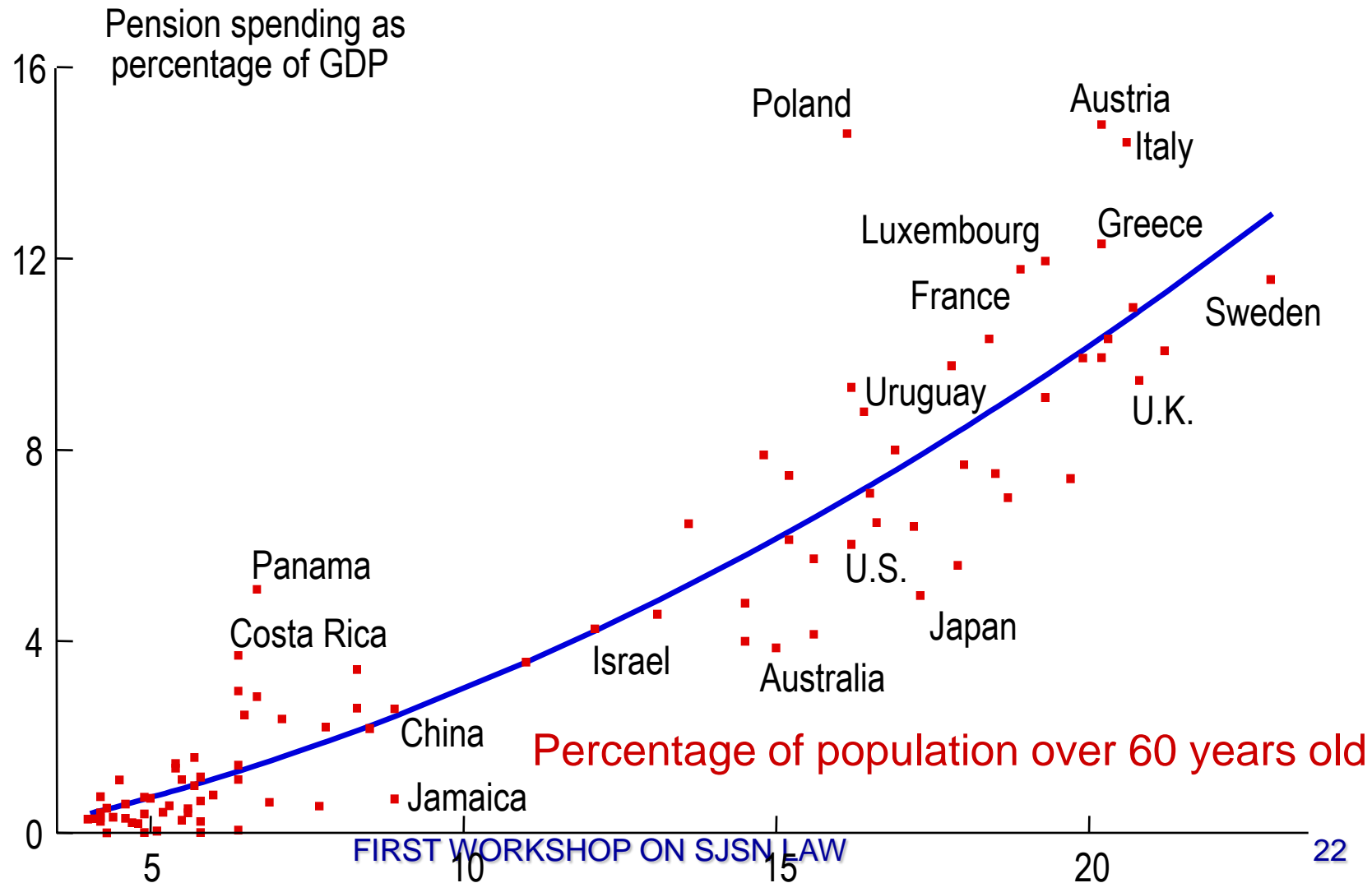
Robert Pallacios, Managing Public Pension Reserves
World Bank, September 24th 2001



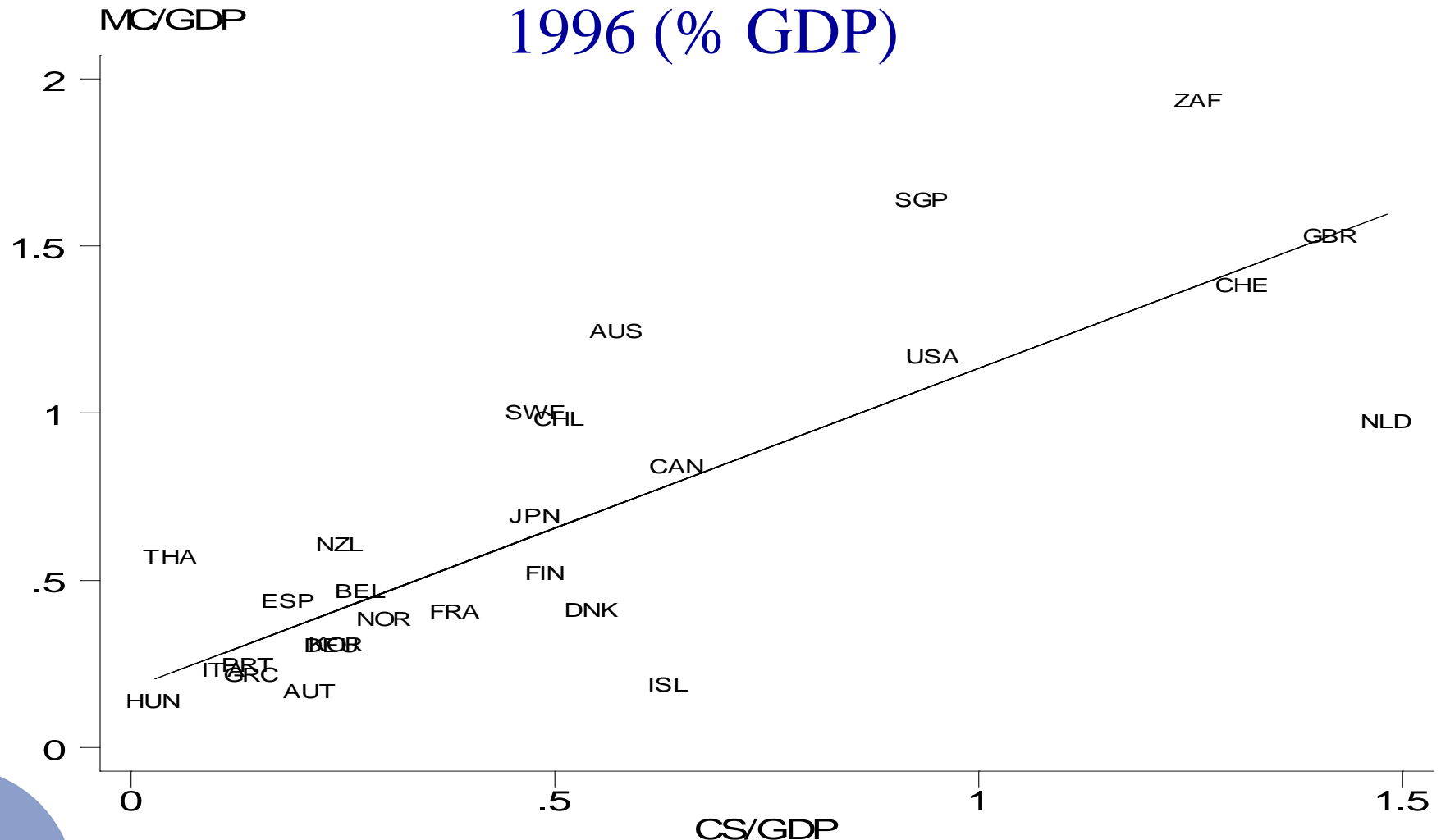
Macro-economic Considerations

- Different forces drive country choices of financing paths
- Demographic trends and impacts on labor force
- Percentage of GNP to public pensions; competition with health, education, infrastructure and other needs
- Interaction with Monetary and Fiscal policies; impact of financing and investment policy on costs and financial markets
- Impact on labor mobility, national savings, financial markets, competitiveness and economic growth
- Compliance, evasion and escape to informal sector

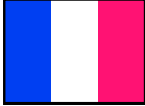
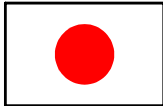










Relationship Between % of the Population over 60 Years Old and Public Pension Spending



Market Capitalization and Contractual Savings



Pension assets as percentage of GNP

	France	~1%		Japan	19%
	Germany	3%		UK	66%
	Bolivia	7%		USA	63%
	Canada	48%		Switzerland	114%
	Chile	54%		Netherlands	105%
	Malaysia	57%		Singapore	65%



Indonesia is about 3.6%

Actual vs Regulatory Limits

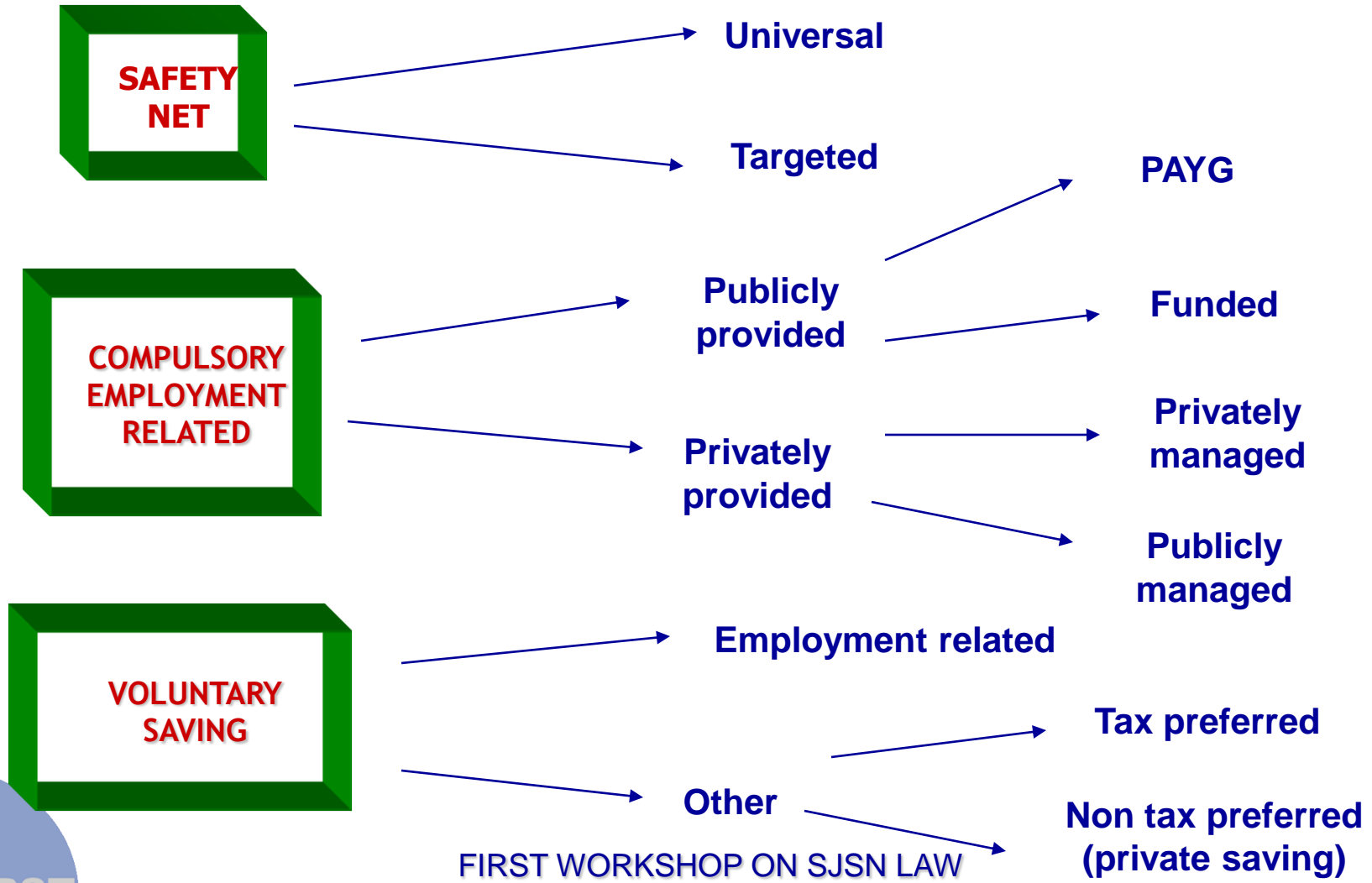
In percent of total fund

Country	Equities		Foreign assets	
	Max.Limit	Actual	Max.Limit	Actual
Argentina	49	7	10	9
Brazil	50	28	~	~
Canada	P	28	30*	15
Chile	39	9	25	16
Columbia	30	4	10	~
France	~	~	~	5
Germany	30	0	30	?
Hungary	50	14	30	3
Italy	P	4	P	~
Japan	30	28	30	23
Mexico	~	~	10	~
Peru	35	31	8	7
Poland	50	28	5	0
UK	P	61	P	23
USA	P	59	P	11

*P = Prudent man rule applies *Abolished in 2005*

FIRST WORKSHOP ON SJSN LAW

Retirement System Components



A Flexible Model

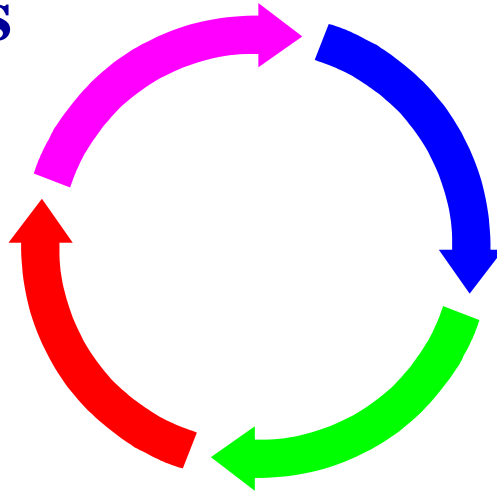
- **Balance specific public role in social redistribution with private role in wealth accumulation**
 - **Public sector returns trail private sector performance**
- **If conditions are right, some pre-funding makes sense for economic and political reasons and can happen in any layer**
- **Strength of Multi-Layer Approach**
 - **Diversification of risks**
 - **Ability to align elements with specific policy objectives in response to country's needs**
 - **issue of balancing benefits and costs, best organization and management**
- **Annuitization of DC accumulations can enhance security in retirement**

The Actuarial Control Cycle

Financial Projections

Risk analysis

**Adjust
Operation
parameters**



**Revise
design and
model
parameters**

**Monitor
Performance
Collect data**

Fundamental objective

Provide sustainable financial security in retirement

- **Requires a shift away from lump sums towards life pensions**
- **Provide structured settlement options for lump sum benefits**
- **Migrate Law 13 severance benefits under Law 40 or under private Pension law 11**

Questions?

