



# Building Institutional Capacity

One of the primary objectives of the Bank’s pension strategy is the sound implementation of policy reforms. In line with this objective, World Bank operations have supported institutional capacity building. This chapter addresses the Bank’s activities for (1) the administration of PAYG systems, (2) the development of actuarial capacity, and (3) the regulation and supervision of funded plans.<sup>1</sup>

Of the 68 countries that have received loans or credits for pension reform activities, including general analytic support and actual reform measures, 52 received loans or credits specifically for institutional strengthening to improve the operation and regulation of their pension systems. One hundred and twenty-nine loans or credits supported institutional capacity building; 48 percent of those operations were adjustment loans or credits, and 52 percent were investment or technical assistant loans or credits (table 5.1).<sup>2</sup>

The institutional development impact of the Bank’s assistance to improve the actual operation of public pension systems has not been sufficient, and its success has been mixed. Implementation of actuarial capacity has been inadequate, with some exceptions, and countries have been unable to track fund balances, which has created the potential for serious macroeconomic distortions. Regulatory technical assistance for funded pillars should be stronger, particularly in view of continuing concerns about the appropriateness of in-

vestment guidelines, the lack of competition among pension providers, and high management fees and administrative costs.

## Improving the Administration of PAYG Pension Systems

Support for PAYG administration has ranged from financial audits to the complete overhaul of contribution collection, pension payment systems, and client services. Europe and Central Asia needed substantial operational changes at the outset of the transition; few computers were available, and employers kept workers’ records without a central client database. Countries in Latin America and the Caribbean also had problems with their PAYG administration. They faced misreporting of entitlements and “ghost” pensioners on the books. Twenty countries received assistance for PAYG systems; a number of them received multiple loans.

*A wide range—but small amount—of investment loans were done for PAYG administration.*

**Table 5.1: Latin America and the Caribbean Heads the Regions in Credits and Loans Supporting Institutional Capacity Building per Capita**

Region	Total			Investment and technical assistance			Adjustment		
	Number of loans	Amount (\$ mm)	Amount per capita (\$)	Number of loans	Amount (\$ mm)	Amount per capita (\$)	Number of loans	Amount (\$ mm)	Amount per capita (\$)
Africa	14	103.2	1.35	9	13.4	0.76	5	89.9	2.42
East Asia & Pacific	5	440.7	1.99	2	10.0	0.01	3	430.7	3.32
Europe & Central Asia	59	1,260.4	1.81	30	204.4	2.06	29	1,056.0	1.55
Latin America & Caribbean	40	1,469.7	2.14	22	74.6	0.26	18	1,395.1	4.44
Middle East & N. Africa	5	45.3	1.22	1	9.4	0.32	4	35.8	1.45
South Asia	6	22.9	0.08	3	4.8	0.01	3	18.2	0.16
Total	129	3,342.3	1.77	67	316.6	1.11	62	3,025.7	2.49

Source: IEG analysis of World Bank data.

Countries in Europe and Central Asia were the most frequent borrowers, receiving more than half of all loans to improve PAYG administration. In general, loans to support pension fund administration were relatively small.

### *PAYG administration in Europe and Central Asia*

The Bank's success with the coordination and implementation of information technology has been mixed. The institutional development impact of the Bank's assistance in Bulgaria was highly satisfactory—the social security organization increased revenue collection and improved client service. A 1993 investment loan also improved the management of the Russian pension system through computerization and organizational improvements.

By contrast, poor implementation of a Hungarian project adversely affected the operation of its pension reform. Information technology implementation in Latvia was inefficient and delayed,

*Investment loans in the Region's PAYG systems have generally been ineffective.*

although the Bank's other activities improved policy planning and evaluation capacity. The Moldova project for PAYG reform experienced significant problems coordinating the implementation of information technology and the redesign of business practices. An ongoing investment project in Romania has had im-

plementation difficulties according to supervision reports. A smaller project for the Kyrgyz Republic had only a modest impact on institutional development, in part because the information technology system was poorly implemented.

### *PAYG administration in Latin America*

With the exception of a loan to Argentina, institutional support for PAYG administration in Latin America and the Caribbean was not effective. The Argentinean project was successful in achieving fiscal savings by re-registering pensioners and removing from the rolls deceased beneficiaries and children over the age of eligibility for survivors' benefits.

By contrast, the Bank missed opportunities for improvements in other countries. For example, Bolivia needed comprehensive assistance to improve its poorly managed state, military, police, and judicial pension systems, but this was not provided. The Bank also failed to encourage the Bolivian government to develop ties with the complementary occupational pension system to stop fraudulent pension payments and to reduce a backlog of tens of thousands of unprocessed claims. In Peru, the Bank did not address problems in the social security agency, which lacked the capacity to administer the system or manage its reserves. In Uruguay, the Bank ignored needed development of local offices, in part because it

did not have contact with officials in the Ministry of Labor and Social Security.

### *PAYG administration in other countries*

Africa received more support for PAYG administration than the Middle East and North Africa, East Asia and the Pacific, or South Asia. Credits in Africa were provided to nine countries, where the Bank funded small pension subcomponents within much larger loans.<sup>3</sup> Cape Verde received the majority of funding with \$5.9 million in three projects. The Bank also supported Pakistan and India with PAYG implementation through small pension components in larger projects. China is the only East Asian country to receive Bank assistance for PAYG administration. The loan, amounting to an estimated \$20 million, was critical in launching information technology improvements in the pension system, although direct support for administrative reform was modest.

### **Actuarial Forecasting**

While *Strategy* does not provide detailed instructions on the evaluative and analytical needs of governments any more than it stipulates financial sector preconditions, actuarial analysis is a mainspring of any government's ability to manage a pension system. *Perspective* reflects that concern by indicating that financial, accounting, actuarial, and governance audits are essential to pension programs to increase transparency, and therefore accountability. Institutionalizing actuarial capacity requires the establishment of a government actuarial office as a permanent part of pension administration. Actuarial projections are generally made on a scheduled basis in developed market economies under a set of demographic and economic assumptions, and findings are publicly available.

To this end, the World Bank has provided worldwide actuarial training using its long-term forecasting model, PROST (see box 5.1). The Bank has been instrumental in educating pension experts and policy makers on the underlying determinants of pension systems, including the impact of demographics and economic conditions. The Bank has been less successful in helping countries establish their own actuarial offices, and PROST has not been easily adapted to fit

### **Box 5.1: Pension Reform Options Simulation Toolkit (PROST)**

The World Bank's PROST is a flexible, computer-based toolkit that advises researchers and policy makers on different options for pension reform. The model is intended to be easily adaptable to a wide range of country circumstances.

PROST assesses the fiscal sustainability of different pension schemes by taking into account pension contributions, entitlements, system revenues, and system expenditures over an extended period. PROST has been used in more than 80 countries, and as of December 2002, 364 people had taken a one-week training program for PROST.

country circumstances.<sup>4</sup> In addition, the Financial Sector has recently started working with the Fund for the Promotion of Scientific and Technical Research (FIRST) and USAID to develop an international program on building actuarial capacity.

### *Forecasting in Europe and Central Asia*

Bulgaria, FYR Macedonia, Latvia, Kazakhstan, and Moldova have received Bank assistance in developing policy offices and actuarial units. The Bulgarian and FYR Macedonian actuarial units both participated in the design of their multi-pillar reforms. The Latvian Ministry of Welfare uses a macro-simulation model developed with the assistance of the Bank to forecast the financial balance of the system. In Hungary, the Ministry of Finance uses PROST to monitor the financial course of the pension reform, but the projections are not published and outside access to the information is limited. Other Central and Eastern European countries, including Croatia and Romania, do not have actuarial offices.

Actuarial modeling has been stronger in Central and Eastern European countries than in the Commonwealth of Independent States. In Kazakhstan, the analysis group in the Ministry of Labor and Social Protection uses PROST for demographic projections, but not for long-run financial analysis. PROST is also used in Moldova, but an actuarial office has yet to be established, and World Bank staff members assist

*Actuarial analysis is essential for a government to manage its pension system.*

*The Bank has promoted actuarial training worldwide through PROST.*

government experts whenever policy simulations are needed. In the Kyrgyz Republic, in-house capacity to perform long-term analysis gradually fell by the wayside. Actuarial projections are not conducted, and there was little ownership of PROST. Both Russia and Ukraine developed actuarial models on their own because they found that PROST did not suit their circumstances.

### **Forecasting in Latin America**

Countries in Latin America and the Caribbean have less in-house actuarial capacity than those in Europe and Central Asia. Bolivia, the only country with functional in-house capacity, made serious mistakes in calculating

*Actuarial capacity is weaker in Latin America and the Caribbean than in Europe and Central Asia.*

the fiscal deficit resulting from the systemic pension reform, which the Bank did not catch or correct. In Mexico, the government found PROST unable to model its lifetime switching option and, as a result, the Mexican government is unable to use PROST to forecast cash flows accurately.<sup>5</sup> Neither Argentina nor Uruguay has the capacity to make the systematic actuarial evaluations needed to develop options to regain fiscal sustainability.

### **Forecasting in other countries**

The Bank has had somewhat greater success in attempts to institutionalize actuarial modeling in China and Korea. Based on Bank recommendations, Korea conducts regular actuarial reviews of all public pension schemes every five years to provide a basis for determining subsequent parametric changes. In China, one of the key aspects of World Bank assistance has been PROST training for national and regional experts; the transfer of knowledge and experience was substantial. Yet data problems and the fragmentation of the pension system make it difficult to institute a national office.

*The Bank has been more successful in actuarial assistance in East Asia and the Pacific.*

The Bank has provided limited assistance for policy evaluation in some countries in Africa through small investment loans, but this has not led to the creation of actuarial offices. While pension audits and actuarial assessments should con-

stitute the first steps in designing pension reforms, this did not occur before Cape Verde<sup>6</sup> and Senegal both took actions to design a proposed multi-pillar system.

## **Improving the Regulation of Funded Pension Systems**

Funded systems have been criticized for high administrative and marketing costs, lack of competition among pension providers, and restrictive investment guidelines. Although costly marketing was recognized as a deficiency of the Chilean reform relatively early on, no Bank investment loans or credits have specifically focused on developing options to reduce costs. Nine loans in Latin America and the Caribbean and eight in Europe and Central Asia supported capacity enhancement for the implementation of funded pillars. Senegal and Cape Verde also borrowed to build capacity for funded pillar implementation. In addition, the Bank is working with the Organization for Economic Cooperation and Development (OECD) to set up regulatory templates, as well as an international coordinating body for pension regulators and supervisors.

### **Regulation in Europe and Central Asia**

The success of Bank assistance in strengthening second-pillar regulation varied considerably. The governments of Kazakhstan and Russia have not always been convinced of the need for international technical assistance and have either preferred to rely on their internal expertise or on national consultants. In Kazakhstan, technical assistance was provided through a reallocation of funds from an earlier investment loan to support the pension reform, but only a small proportion of the reallocated funds were spent. Because of the limited disbursement, the direct objectives of the loan were unmet.<sup>7</sup> The project completion report, however, notes that if success is measured by improvements in pension regulation and administration directly attributable to Bank project supervision, the nondisbursing loan actually achieved many of its development objectives. Later evaluations of Russian technical assistance for multi-pillar regulation were unfavorable, because the 1998 financial crisis delayed the adoption of a proposed pension law, and

eventually the Bank halted the reform because it was not well prepared.<sup>8</sup>

In Croatia and FYR Macedonia, regulatory assistance was neither efficient nor timely. The initial intent of the Croatia loan was to help establish the supervisory system for the mandatory funded pillar, but Croatia moved ahead with its pension reform before the Bank could finish project preparation. As a result, the regulatory structure is more costly than it would have been with stronger Bank support. Two small FYR Macedonian projects included subcomponents to establish the regulatory structure of the funded system. The second-pillar operational environment is more complex and expensive than necessary. Furthermore, the incomplete organization of the regulatory agency was one of the factors that delayed the start of the funded pillar.<sup>9</sup>

### *Regulation in Latin America*

Bank loans for second-pillar regulation have been quite small, although support to Latin America and the Caribbean through adjustment loans has been substantial. Loans for the supervision and regulation of funded pensions often were guided by narrow terms of reference related to specific government requests. In Argentina, substantial improvements were made in accountability and the legal/regulatory system. In Mexico, the government still needs to liberalize pension fund investment regulations and institute proper regulation of voluntary occupational pensions. (But with Mexico's considerable in-country expertise, regulatory shortcomings are not a result of inadequate technical assistance.) Bolivia and Chile also received Bank support for the regulation of funded pensions. The largest loan for second-pillar regulation was to Nicaragua, although the multi-pillar reform is now on hold.

Serious problems are found in the regulatory structures of three other countries in the Region—Colombia, Costa Rica, and the Dominican Republic. While Costa Rica and the Dominican Republic have active loans, they do not address funded pillar regulatory issues. Although Colombian regulatory officials are aware of industry problems, new investment guidelines are needed to permit greater flexibility in asset allocation. In Costa Rica, steps should be taken to reduce the dominant market share of public commercial

banks, and bank-related pension funds should not be automatically assigned to undecided workers.

*Bank efforts have yet to address the high costs of funded systems.*

### **Summary and Conclusions**

The Bank has yet to provide sufficient assistance in building institutional capacity in pension administration and actuarial evaluation. In addition, continuing assistance is needed to improve second-pillar regulation. These shortcomings are, in part, a result of incomplete needs assessments. The failure of administrative projects appears to be related to inadequate World Bank and client supervision, particularly in countries in which capacity is the weakest.

PROST is an invaluable tool for World Bank analysis of pension system design, for teaching and training client countries about factors that affect pension system balance, and for simulating a variety of reforms to ensure a financially sustainable system. However, better directed technical assistance is required to ensure that clients develop local expertise to create and maintain their own models, assess the fiscal balance of ongoing pension programs, and use actuarial modeling to design policy reforms. Many countries trying to implement PROST have been unsuccessful because of a lack of training. (Also, training requirements to create in-house actuarial expertise vary substantially by country.) Some clients found PROST data requirements too intensive, or needed greater flexibility to create country-specific applications.<sup>10</sup>

*More needs to be done in the Region to liberalize investment regulations.*

Bank loans to establish regulatory systems for funded pensions have been limited in number and scope. More successful regulatory and supervisory structures in Hungary and Poland were supported by policy dialogue than by investment projects or technical assistance. This may also have been the case in Latin America and the Caribbean. In that Region, investment limitations and unregulated voluntary pensions create a substantial future risk for participants. Future assistance in implementation will be needed in Regions where Bank activities have been limited, including Africa, the Middle East, and Asia, providing an opportunity for the Bank to be more proactive.