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Pension Reform and Financial Markets

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Dimitri Vittas*

Abstract

The question of the links between pension reform and financial markets has two aspects. One concerns the preconditions in terms of financial sector development for the successful implementation of pension reform, while the other refers to the long-term impact of pension reform on the development of financial markets. This paper argues that pension reform and the promotion of private pension funds requires a small core of sound, prudent and efficient financial institutions, such as banks and insurance companies, but does not depend on the prior existence of well-developed securities markets. Private pension funds and insurance companies are likely to have a beneficial impact on financial market development once they reach critical mass and provided they operate in a conducive regulatory environment.

Keywords: pension reform, financial markets, regulation

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*The views expressed are those of the author and do not necessarily represent the view of the World Bank, its executive Directors, or the countries they represent.

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1. INTRODUCTION

The question of the links between pension reform and financial markets has two aspects. One concerns the preconditions in terms of financial sector development for the successful implementation of pension reform, while the other refers to the long-term impact of pension reform on the development of financial markets. Even a cursory look at the structure of financial and pension systems around the world will reveal a strong correlation between the two. Countries with a predominance of private pension funds tend to have more developed securities markets, while countries with inefficient and insolvent social security systems tend to have inefficient and insolvent financial institutions, such as banks and insurance companies. In between are countries with pension systems that are dominated by unfunded but well-run social security systems. These countries tend to have weak securities markets but sound and efficient banks and insurance companies.

Recent years have witnessed a parallel explosion of equity markets and institutional investors, especially pension funds. Total equity market capitalization as measured by the IFC Emerging Markets Database soared from 2.7 trillion US dollars in 1980 to 9.4 trillion in 1990 and 23.5 trillion in 1997 (IFC 1987 and 1998). At the same time, the annual volume of trading increased even faster from 0.8 trillion US dollars in 1980 to 5.5 trillion in 1990 and 19.5 trillion in 1997. The turnover ratio, the ratio of trading to market capitalization, jumped from 30 % in 1980 to 59% in 1990 and 83% in 1997. The average annual rates of growth over the whole 17-year period amounted to 14% for market capitalization and 21% for the volume of trading.

The persistent growth of equity markets was paralleled by an equally persistent growth of institutional investors. Pension funds, insurance companies and mutual funds have collectively mobilized huge financial resources in a growing number of countries and have surpassed in terms of financial power the traditional importance of commercial and investment banks. In 1980 there were probably no more than 10 countries in the whole world where institutional investors controlled resources exceeding 50% of GDP. These countries included the United States and United Kingdom, Switzerland and the Netherlands, Singapore and South Africa, and perhaps a few more Anglo-American and Scandinavian countries (Vittas 1998a). Fifteen years later, by 1995, nearly all OECD countries have institutional investors with resources exceeding 50% of GDP. Among developing countries, Chile and Malaysia have also joined this group. In Chile, the total assets of institutional investors grew from less than 1% of GDP in 1980 to nearly 60% in 1995. But of greater significance is probably the fact that in countries like the United Kingdom, the United States, Switzerland, the Netherlands and South Africa, the total assets of institutional investors now exceed 150% of GDP.

This paper discusses the two aspects of the links between pension reform and financial markets. Section 2 has a brief review of the different objectives of pension reform in order to set the issue in a proper context. Then section 3 addresses the minimum financial preconditions for a successful implementation of pension reform, while section 4 discusses the conditions that are required for maximizing the impact of pension reform on the development of financial markets. Drawing from US historical experience, section 5 elaborates on the benefits of pension reform for securities markets. Section 6 offers concluding remarks.

2. OBJECTIVES OF PENSION REFORM

Although it is tempting to think that there is a direct link between pension reform, the growth of institutional investors and the growth of securities markets, one should be careful not to put the cart before the horse. The primary objective of pension reform should not be the development of financial markets, despite the broader potential benefits in higher efficiency and economic growth, but rather the provision of adequate but affordable and therefore sustainable benefits. This has implications for the structure of the pension system, the level of targeted redistribution, and the functioning of annuity markets.

The second objective is the creation of a strong link between contributions and benefits in order to minimize any incentive distortions on the functioning of labor markets and avoid capricious and perverse redistribution caused by volatile inflation rates and inconsistent eligibility requirements. Attainment of this objective does not require the creation of funded plans but only the institution of defined-contribution plans or the use of lifetime earnings in the determination of pensions under defined-benefit plans.

The third objective is the generation of long-term savings that would help stimulate the development of capital markets. It is often argued that use of funded pension plans would increase the rate of saving in a country. Although this is possible under certain conditions, it is by no means certain. However, there is little doubt that creation of private pension funds increases the supply of long-term contractual savings. This has important implications for the development of capital markets.

It is possible to avoid the financial collapse of a traditional unfunded social security system by changing its basic parameters and aiming at keeping its cost rate within a reasonable level of payroll taxes. This may require increasing the normal retirement age to take account of

population aging, strengthening the link between contributions and benefits by applying proper actuarial decrements or increments for early or late retirement, combating evasion, and enhancing the administrative efficiency of the system. These objectives can be achieved if both the targeted benefits and the level of payroll taxes remain low. But if payroll taxes become high, then use of notional defined contribution plans may avoid the labor market distortions and high evasion that are likely to ensue. Reducing the size of the informal labor market would raise labor productivity and lead to higher economic growth. However, neither of these solutions would generate long-term savings or would have any effect on the development of financial markets. To the extent that better developed banking and securities markets make an independent and additional contribution to higher economic growth (Demirguc-Kunt and Levine 1996, Levine and Zervos 1998), then only the creation of funded schemes would accelerate economic growth beyond what could be achieved by reducing the size of the informal labor market.

3. FINANCIAL PRECONDITIONS AND THE SEQUENCING ISSUE

Should pension reform be undertaken in the absence of well-developed securities markets? The traditional view was that in the absence of well developed capital markets, funded pension plans would fail because they would be used as captive sources for financing large budget deficits at negative real rates of interest. This criticism of funded pension plans was probably valid before the 1970s when government policies in most developing countries were inflationary and financial market development was not an important objective of government policy. But it overlooked that once government policies focused on maintaining financial stability and on removing obstacles that inhibited the development of markets, both pension funds and capital markets would thrive.

The creation of private pension funds involves a gradual accumulation of long-term financial resources. Initially, at least, the relatively small resources of pension funds can be invested in treasury bills and bank deposits. As pension fund assets increase, a growing proportion can be allocated to longer-term government bonds and corporate securities. This provides sufficient time to a reforming government to take all necessary steps for establishing robust and well regulated securities markets.

Pension reform should be undertaken for its own sake and should not be linked to the prior development of securities markets. The same is also true of insurance reform, which is often closely linked to pension reform. Reforming the insurance sector often implies the removal of repressive regulations that impede competition, innovation and efficiency. Insurance sectors in developing countries are often dominated by state-owned entities with limited participation by private or foreign companies and are characterized by inadequate capital, high operating costs, limited product innovation, low investment returns, lax control over brokers, high levels of receivables, extensive fraud, unduly large claims by some insured but otherwise low claims and settlements for the majority of customers, protracted disputes and long delays in settlement, and generally widespread mutual mistrust between insurance companies and the insured.

Improving financial returns is only one of many actions that can be taken to enhance the performance of the insurance sector. Because of a smaller accumulation of financial assets by insurance companies in comparison to pension funds, the impact of insurance reform on capital market development is also less extensive. In contrast, improving financial returns is more central for pension funds that specialize in offering long-term capital accumulation accounts. Nevertheless, insurance reform may be an essential element of systemic pension reform because of

the derived demand for term life and disability insurance by active workers and of annuity products by retiring workers.

Although fully and well developed securities markets are not necessary for a successful implementation of systemic pension reform, there are some basic preconditions of financial sector development that need to be fulfilled before pension reform can be implemented. These basically include the maintenance of macroeconomic stability with low or moderate inflation and balanced fiscal accounts, the presence of a core of sound and efficient banks and insurance companies, and the creation of an effective regulatory and supervisory agency.

Macroeconomic stability and low inflation are essential because neither the securities markets nor the insurance business can function efficiently under high and volatile inflation. Although the use of indexed instruments may mitigate the problems caused by moderate inflation, any indexation mechanism would tend to break down in the presence of high and accelerating inflation. The experience of Brazil in the 1980s has shown that indexed instruments provide little protection from inflation in periods of hyperinflation. With the acceleration of inflation, price adjustments must be effected at shorter and shorter intervals; otherwise the holders of indexed financial instruments suffer large losses from the erosion of the real value of their assets.

Broad fiscal balance is also important because it is usually the single most important source of high and accelerating inflation. Governments with large, persistent and growing budget deficits are unable to finance them by borrowing and issuing new bonds and are forced to monetize their debt, fuelling and exacerbating the inflationary process. One difficulty posed by the presence of large budget deficits is that systemic pension reform usually entails an increase in the deficit of the public pension (social security) system. This is because pension payments to

current pensioners will continue to be made, while some of the payroll taxes from active workers will be diverted to the new funded pillar. This is why many countries faced with large pension expenditures adopt a gradual process in their pension reform programs.

The second precondition is the presence of a core of sound and efficient institutions. Many developing countries have financial systems that are dominated by insolvent and inefficient banks, often owned by the state or by large private groups. Insurance sectors are even less developed, are dominated by inefficient state monopolies and operate under repressive regulations that inhibit competition, innovation and efficiency. In most developing countries, the problems posed by the underdevelopment of banks and insurance companies can be resolved by opening the market to foreign institutions. Although they tend to engage in some “cream skimming” by focusing on the more profitable and attractive segments of the market, foreign banks and insurance companies bring many benefits to the local markets through the transfer of financial technology and know-how, the training of managerial and other staff, and the adoption of sound business practices.

A core of sound and efficient banks and insurance companies is important for the handling of contributions and other payments, for the maintenance of individual records and accounts, for the provision of robust and efficient custodial services, and for the offer of reliable insurance contracts, especially with regard to term life and disability insurance. Custodial services are particularly important because they require sophisticated computer systems, efficient record-keeping and reporting facilities, and large financial resources.

4. CONDUCTIVE REGULATION AND CRITICAL MASS

Although the explosion of equity markets in terms of both market capitalization and trading volumes is a positive development that promises higher efficiency and economic growth in the years to come, equity markets around the world still suffer from important structural problems. This is especially so in developing countries. Among the most important issues are the small number of listed companies, the concentration of market capitalization and trading in a few large companies, and continuing regulatory concerns regarding the transparency and integrity of markets. These are the policy concerns that were recently identified in the principles issued by IOSCO.

It is tempting to think that there is a direct link between the growth of institutional investors and the growth of equity markets. Such a relationship may exist at the global level, especially if one takes account of the large relative size of institutional investors in the more advanced countries, and especially in the United States. Even a small increase in the asset allocation of US institutional investors to foreign securities is bound to have a tremendous impact on the functioning of equity markets in many smaller economies.

At the national level, however, the direct impact of domestic institutional investors on the functioning of national markets depends on the regulation and conservatism of investment policies. The direct impact is minimal if the institutions are required to invest their large resources in special non-marketable government securities, as has long been the case in Singapore and Malaysia. In recent years participants in the two countries' national provident funds have been allowed to invest directly in tradable securities, including mutual funds. But the amounts involved have been too small and the practice too recent to change the minimal relationship between domestic institutional investors and equity markets in these countries. Both

Singapore and Malaysia have highly liquid equity markets. The annual volume of trading reached 250% of GDP in Malaysia in 1993 but fell in 1997 to 99%. This increase has most probably resulted from the growing interest of international investors in the economies and stock markets of these and other Asian countries as well as from greater trading activity by other local investors. The dominant national provident funds had little to do with the explosion of trading and market capitalization.

Similarly, in Continental European countries such as Switzerland and the Netherlands institutional investors had traditionally little impact on the development of local equity markets. This is because they had tended to invest in bonds and other debt instruments and to place only a small fraction of their resources in domestic and foreign equities. Pension funds and insurance companies used to follow the lead provided by commercial banks in these countries, not only in their investment policies but also in actions taken to rescue and restructure companies with large indebtedness and low profitability.

Institutional investors in these countries, however, changed their investment policies in the 1990s and adopted more modern asset management practices. As a result they have started to take a more active interest in corporate affairs, invest greater proportions of their assets in domestic and foreign equities, and demand better results from the companies in which they invest. In the Netherlands, the annual volume of trading rose from 3% of GDP in 1980 to 11% in 1990 and 68% in 1997, while in Switzerland it grew from 28% in 1990 to 150% in 1997. The large mergers that have taken place, especially in Switzerland have probably affected the very high volumes of recent years, but the growing presence of institutional investors has also been behind this change. As in the case of Asian countries, there has also been a direct impact on

market liquidity from the growing interest and presence of foreign institutional investors, especially from UK and US institutions.

Trading volumes have also risen substantially in the United Kingdom and the United States, where institutional investors have reached levels exceeding 150% of GDP. In the United Kingdom, the annual volume of trading rose from 7% in 1980 to 28% in 1990 and 69% in 1997, while in the United States it increased from 15% in 1980 to 33% in 1990 and 131% in 1997. While large mergers may have distorted the recent US trading levels, there can be little doubt that the markets are more active now than what they were in the 1980s and that the growth of institutional investors has been a major factor in this.

Much of the remainder of this paper focuses on the beneficial impact of institutional investors on the structure and efficiency of securities markets. Experience from Anglo-American countries suggests large potential benefits from the interactive process between institutional investors and securities markets. Institutional investors can act as a countervailing force to the dominant position of commercial banks and thus promote competition and efficiency in the financial system. They can also stimulate financial innovation, modernize capital markets, enhance transparency and information disclosure, strengthen corporate governance, and improve financial regulation.

However, as already noted, the efficiency gains from the development of institutional investors are not automatic. They are less likely to materialize if institutional investors are required to invest only in non-marketable government securities or if they are constrained by quantitative investment limits and conservative investment policies as has been the case in Continental Europe. In contrast, in Anglo-American countries, institutional investors have been able to make a stronger contribution to capital market development. Operating under the

“prudent person” rule, they have also been able to earn higher rates of return than in countries with quantitative investment limits (Davis 1998).

Regulation and conservative investment policies are not the only factors that may inhibit institutional investors from exerting their beneficial influence on capital markets. The absence of “critical mass” is also important, at least for some of the benefits of institutional investors. Chile and other Latin American countries where social security reforms have involved the creation of private pension funds are good examples of this. In Chile, pension funds have accumulated assets corresponding to 40% of GDP. They invest about 25% of their assets in equities. As the Chilean equity market has a total capitalization in the region of 90%, the pension funds own collectively about 10% of the Chilean equity market. Their ability to influence market practices is therefore constrained and not as large as that of UK and US institutional investors, which own over 50% of their respective markets. However, the Chilean pension funds own collectively more than 30% of the equity capital of some large privatized utilities and their corporate influence is much greater in those segments of the market. Nevertheless, critical mass is an important factor that has also affected the market impact of institutional investors in Continental Europe.

Another manifestation of critical mass is in the volume of market trading. Newly created pension funds grow very fast as a result of the contractual nature of pension saving. They have a tendency to adopt a “buy and hold” strategy as they can rebalance their portfolios by changing the asset allocation of new flows, without the need to sell existing holdings. This is especially the case in markets with a few “eligible” equities and may explain, at least in part, the low volume of trading of the Chilean equity market. However, the Chilean restrictions on short-term holdings by foreign investors may also have been a factor, since in Brazil the existing private

pension funds also hold no more than 10% of the total equity market, but trading volumes and market liquidity are much higher than in Chile.

5. MARKET BENEFITS OF PENSION REFORM¹

The long-term benefits of pension reform on the development of financial markets can be discussed under six headings: countervailing force; financial innovation; market integrity; modernization of market trading; corporate governance; and financial regulation.

Countervailing Force. One of the main benefits of the growth of institutional investors is the intensification of competition in the financial system. The development of new sources of finance, whether from new entry of foreign banks, access to foreign markets, or the growth of institutional and other nonbank financial intermediaries (such as leasing and factoring companies) forces dominant commercial banks to become more competitive and to start seeking out their customers rather than waiting for prospective borrowers to visit them. In the United States, this change in bank behavior seems to have taken place in the 1940s and 1950s, followed within a decade or so by other Anglo-American countries, and in subsequent years by most developed and developing countries.

In the United States, the process was stimulated not only by the growth of institutional investors but also by a notable change in the investment policies of life insurance companies, a group of institutions that commanded a significant share of US financial assets since the beginning of the century. In the 1940s and 1950s insurance companies lowered substantially their holdings of government bonds and agricultural mortgages and increased their holdings of nonfarm mortgages and especially of privately placed corporate debt (Calomiris and Raff 1995).

Borrowers who had limited access to the public bond market and for whom the total issue costs of private placements were lower than those of public placements (Calomiris and Raff 1995 and Carey et al 1993) favored private placements. The development of institutional investors also contributed to the advent of competitive bidding for corporate issues of securities. Historically, new issue business was highly rigid and hierarchical and dominated by traditional investment banks (Chernow 1990, Carosso 1970). As institutional investors grew, however, new investment banks established close relations with them and were able to challenge the dominant role of traditional banks. The greater availability of financial resources encouraged corporations to place new issues directly with institutional investors, to replace sole management of their public issues by several joint lead managers, and to set up “Dutch auctions” for their new issues and invite competing syndicates of underwriters (Chernow 1990).

In the 1980s and 1990s, institutional money fueled the operations of corporate raiders, the use of leveraged buy-outs, and the growth of high-yield securities, all of which contributed to greater competition in financial markets and facilitated the corporate restructuring that took place in the 1980s and 1990s. Institutional investors have also supported the growth of venture capital funds and the provision of private equity, both of which help finance new and expanding smaller firms.

Another benefit of the growth of institutional investors was the decline in both new issue and trading costs. The first was not just a result of the countervailing force of institutional investors, but also reflected lower marketing and monitoring costs of issues targeted at institutional investors. Studies report narrower spreads for new issues by companies in which institutional investors are large shareholders (Hansen and Torregrosa 1992, Hansen and

¹ This section draws heavily on Vittas (1998b).

Pinkerton 1982). The fall in trading commissions was associated with the rise of bloc trading that was prompted by the growing importance of institutional investors. Trading commissions for large trades fell by 40% after the abolition of minimum commissions in New York in 1975 (Chernow 1990). Large trade commissions also fell in London after the stock exchange reform in 1986 and in all the stock markets that have followed in the steps of New York and London.

Financial Innovation. The past three decades witnessed major new financial innovations as well as a large expansion of the financial services industry. Most of the innovations in the 1970s were prompted by the increase in the level and volatility of interest rates, but institutional investors, and especially pension funds, were major forces stimulating this innovative process (Bodie 1990). Institutional investors directly or indirectly supported the development of asset-backed securities, the use of structured finance and derivative products, the launching of index-tracking funds, and the offer of synthetic products that protect investors from market declines.

Financial innovation stemming from institutional investors is also evident in those developing countries that have implemented systemic pension reform. In Chile, pension funds supported the development of both mortgage and corporate bond markets (Diamond and Valdes-Prieto 1994) and has invested heavily in public sector bonds. More recently they have encouraged the creation of venture capital and infrastructure funds, although their impact is still rather small. In Argentina, financial innovation has also been promoted by the newly created private pension funds.

Market Integrity. Institutional investors, which are managed by trained professionals, are usually more aware than ordinary investors of the potential conflicts of interest and agency problems facing corporate management and are better able to insist on investor protection

legislation that will ensure market integrity. Investor protection rules cover prohibition and penalties on insider trading and reporting of insider positions as well as rules on self-dealing, takeovers and changes in corporate controls, asset valuation, prospectuses for new issues, and disclosure of audited consolidated statements on public companies. Investor protection rules are generally better developed in countries where large institutional investors hold diversified minority positions in a large number of companies than in countries where institutional investors are either underdeveloped (e.g. Germany) or tend to hold large controlling positions in a small number of companies (e.g. South Africa). At the same time, a stronger legal protection of minority shareholder rights may have contributed to the earlier and on a larger scale diversification into equities of institutional investors in Anglo-American countries compared to continental European countries.

Mindful of the need to protect the long-term interests of workers affiliated to the new private pension funds, the authorities in Chile, Argentina and other reforming countries have taken measures to strengthen investor protection, especially in the areas of insider trading, self-dealing, and takeover rules. The publication of consolidated statements following internationally accepted accounting and auditing standards is not yet fully implemented, although pressures for the disclosure of timely and meaningful information on corporate performance are mounting.

Pension reform led to the development of an effective risk classification system in Chile under a committee comprising public officials and representatives of the private pension funds. This committee rates various instruments for their suitability as pension fund investments. They screen ratings prepared by private rating agencies and thus avoid to some extent the problems caused by an alleged low quality of private ratings. The quality of private ratings is also raising concerns in Argentina. In both countries competition among a large number of rating agencies

seems to have resulted in a lowering of standards. This may, however, be a temporary setback. The quality of ratings is likely to improve once a consolidation of rating agencies takes place and higher quality standards are adopted.

Modernization of Market Trading. Institutional investors also exert pressures for modern and efficient trading facilities. This covers not only the trading activity per se but also clearing and settlement facilities as well as the creation of central depository agencies. Efficient trading systems are characterized by low transaction costs, high transparency, high liquidity, and low volatility. There is often a trade-off between these characteristics and especially between high liquidity and low volatility on the one hand and low transaction costs and high transparency on the other.

Although there are several different ways in which trading systems can be organized, institutional investors have contributed to the development of more efficient trading systems. As already noted, the use of bloc trading led to the abolition of minimum commissions and the restructuring of stock markets in many countries around the world. Institutional investors have also played an important part in promoting more efficient clearing facilities and establishing central depository agencies that facilitate the move to book-entry systems and provide safekeeping services. And they have exerted pressure for modern efficient and reliable back-office operations that have suffered in all countries with emerging securities, markets as existing facilities could not cope with fast growing trading volumes.

Corporate Governance. The role of institutional investors in corporate governance has evolved in line with their growing importance as corporate owners. As long as their equity holdings were small and diversified in a large number of companies and as long as they represented a small fraction of market capitalization, institutional investors adopted a passive

approach to corporate governance. They tended to vote with management and if they were unhappy with corporate performance, they could sell without suffering a big fall in market price.

But with continuing growth in their accumulated assets, institutional investors became collectively dominant shareholders of many nonfinancial corporations. Among large US corporations, institutional investors owned in 1988 86% of the equity of Amoco, 82% of General Motors, 74% of Mobil and 70% of Citicorp (Coffee 1991). With such dominant positions, they could no longer exercise the "exit" option without disrupting the market and suffering big falls in market prices.

Recent attempts to develop effective means for exercising "voice" in corporate affairs are a response to the decline of the "exit" option. In addition, institutional investors have been adopting investment policies based on passive indexation as an effective strategy for achieving diversification with market returns and low transaction costs. Passive indexation policies have limited their ability to divest from poorly performing companies and have increased pressures for more effective monitoring of corporate performance and for increasing the accountability of corporate managers.

Faced with persistently poorly performing corporations, some institutional investors increased their public criticism of overambitious expansion plans, excessive managerial compensation, and anti-takeover defenses that entrenched the position of incumbent managers at the expense of shareholders. Open public criticism has been instrumental in mobilizing collective action by disgruntled shareholders and in raising the threat of regulation and legislation to prohibit the alleged abuse and misbehavior.

Institutional investors have also emphasized the importance of strengthening corporate governance structures and especially of increasing the accountability of managers, a process that is

ongoing. The measures that are contemplated include the following: separating the functions of chairman and chief executive officer and appointing nonexecutive chairmen in all companies above a certain size; electing independent external directors; using cumulative voting for board elections; opening the proxy process to allow greater communication among shareholders; using confidential voting at board meetings; expanding the role of board committees that are independent of executive directors; disclosing the amount and rationale of managerial compensation; and opposing anti-takeover defenses that are designed to protect incumbent managers at the expense of shareholders.

Of these measures, the use of cumulative voting for board elections seems to be the most powerful tool for allowing institutional shareholders to elect directors that are truly independent of corporate managers and play an active part in protecting the interests of shareholders. Of major importance is also the increasing use of board committees consisting of nonexecutive directors to: select and appoint chief executive officers (to avert the perpetuation of the business policies of incumbent management); vet managerial compensation (to prevent excessive packages that are unrelated to performance); approve major expansion plans (to check managerial tendencies for empire-building); and evaluate and respond to friendly and hostile bids (to ensure that shareholders receive maximum value from takeovers).

Financial Regulation. The development of institutional investors requires a robust and effective regulatory and supervisory framework. Although stringent regulations may be imposed at first, especially if a compulsory pension and insurance system is created, over time regulations need to be relaxed and to emphasize transparency and prudence as well as the fiduciary duty of managers toward investors. However, in developing countries with weak regulatory structures, a long-term benefit of creating private pension funds may well be the establishment of new robust

regulatory agencies that have a strong positive demonstration effect on other segments of the financial system.

6. CONCLUDING REMARKS

This paper argues that there are two aspects to the question of the links between pension reform and financial markets. One concerns the preconditions in terms of financial sector development for the successful implementation of pension reform, while the other refers to the long-term impact of pension reform on the development of financial markets.

Pension reform and the promotion of private pension funds requires a small core of sound, prudent and efficient financial institutions, such as banks and insurance companies. Together with macrostability and an effective regulatory agency, these preconditions are important for the collection of contributions and clearing of various payment flows, the maintenance of individual records and accounts, the provision of safe custody of assets, and the provision of reliable insurance contracts. Allowing foreign entry into the local market may enhance the efficiency of banking and insurance sectors.

But pension reform does not depend on the prior existence of well-developed securities markets. Pension funds and insurance companies are likely to have a beneficial impact on financial market development once they reach critical mass and provided they operate in a conducive regulatory environment. Their beneficial effects include pressure for modernization, competition, innovation and efficiency, higher transparency and accountability, and stronger corporate governance.

Securities markets have experienced dramatic growth in most countries around the world. Much more, However, needs to be done to ensure that markets are efficient and transparent and operate with honesty and integrity. Institutional investors are a powerful ally in this process and help establish laws and regulations that protect the rights of minority shareholders.

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