PENSION NOTES

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As the pension systems mature, it has become essential to improve the regulation and institutional framework of the decumulation phase

Executive Summary

Public pension policies in Latin America have concentrated on improving the regulations and institutional framework of the accumulation stage in the individually-funded systems. This is understandable while systems are still young. However, the growing maturity of several of them requires public policies to resolve the challenges arising in the decumulation phase in a suitable and timely manner.

Without reforms, many Latin American pension systems will end up paying lower than expected pensions to only a few members. In addition to adjusting the main parameters of the system, such as contribution rates and the official retirement ages, it is urgent to correct the design of benefits in order to limit authorized withdrawals by members during their active lives, or on retirement, increase the percentage of members receiving pensions, lower the conversion costs of pension balances, and reduce the risks of the decumulation phase.

The regulations must guarantee the existence of an efficient pension market offering future pensioners the possibility of transforming savings accumulated in a pension flow at the lowest possible cost, allowing them to choose between different pension modes, fully aware of their respective characteristics, and how they respond to their needs. If these challenges are not adequately met, the cost in terms of fewer pensions, lower pension amounts, and higher risks for members, could be significant. The efficient development of pension market should also be encouraged, in order to prepare the systems for a growing demand of benefits.

The main obstacle to a growing demand for pensions is limiting such growth by allowing the full or partial withdrawal of the funds accumulated in individual accounts, and the existence of contributory PAYGO systems in some countries, that substitute or complement the individually-funded system. An important challenge for stimulating an educated choice of the most appropriate pension modes, is to invest in education and technical and independent advisory services, which does not occur in Latin America (except in Chile).

On the supply side, the main difficulties for its development are found in the low scale of transactions due to growth limitations; the setting of minimum pension amounts; pension adjustments indexed to the minimum wage, and restrictions on competition, especially in the life annuities market, resulting from the lack of financial instruments that enable matching pension payment obligations with investments, the existence of outdated official mortality tables, and the presence of a number of legal uncertainties.

I. Introduction

For a long time, and particularly in Latin America, the attention of analysts and public pension policy has focused on the problems and challenges associated with the installation of individual savings systems and issues related to the savings accumulation stage, such as contribution amounts and how to manage them, including the investment of the pension funds. The explanation is that these are young systems, in which the vast majority of members are still active in the labor market. Nonetheless, some of these systems have already matured (Chile), or are beginning to do so (Peru, Colombia, Mexico and Uruguay). This maturity is manifested especially in the growth of the number of pensioners (see Table 1).

Table 1
Evolution of the Number of Old-Age Pensioners

Year	Chile		Colombia		Mexico	
	Number of Pens.	P/M (%):	No. Pens.	P/M (%):	No. Pens.	P/M (%):
2012	643,794	6.9%	13,837	0.1%	62,853	1.2%
2013	676,836	7.1%	16,729	0.1%	70,057	1.3%
2014	673,774	6.9%	20,268	0.2%	78,407	1.4%
2015	728,931	7.3%	25,409	0.2%	89,334	1.5%
2016	792,788	7.8%	32,003	0.2%	87,015	1.4%
2017(1)	824,778	8.0%	37,466	0.3%	86,603	1.3%

(1) Chile: August; Colombia and Peru: July. Uruguay and Mexico are not included because their new systems do not yet have meaningful numbers of old-age pensioners. Note: P/M= The pensioner/member ratio.
Source: FIAP, February 2018.

It is therefore appropriate and necessary to pay attention to the specific issues involved in the decumulation stage of pension savings. This pension note presents a synthesis of a FIAP study on the subject, which included five Latin American countries,[1] highlighting the main conclusions of the study, identifying the most relevant lessons and presenting reform proposals that seek to contribute to improving the decumulation stage.

[1] FIAP: "Decumulation Stage of the Individual Saving Pension Systems in Latin America: Diagnosis and Proposals." February, 2018. The countries analyzed were Chile, Colombia, Mexico, Peru and Uruguay.

II. Development

Challenges of the decumulation stage

The main challenges for regulating the decumulation stage include the need to guarantee the existence of an efficient pensions market offering future pensioners the possibility of transforming savings accumulated in a pension flow at the lowest possible cost, allowing them to choose between different pension modes, fully aware of their respective characteristics, and how they respond to their needs. If these challenges are not adequately met, the cost in terms of fewer pensions, lower pension amounts, and higher risks for members, could be significant. For example, a variation of half a point in the life annuities sales price entails a difference of 6% in the amount of the pension that can be financed.[2] Another example: pensioners who choose programmed withdrawal are exposed to the risk of a reduction of their pensions over time, a characteristic that must be clearly explained to them. In fact, estimates for the Chilean case show that after 10 years, pension amounts drop to approximately 90% of the initial amount, and subsequently continued to diminish.

Indeed, the amount of the old-age pension does not only depend on the mechanism used for transforming the accumulated savings into a pension stream. The sufficiency or insufficiency of accumulated savings during active life is a central question: do the accumulated pension savings suffice for financing the desired pensions for the required time? Hence, in addition to the challenge of ensuring that accumulated savings are efficiently transformed into a future pension flow, there is an even greater challenge of getting workers to accumulate sufficient savings to finance their target pension.

In this regard, it is important to remember that there is an urgent discussion on this issue in

[2] Estimates in the case of a male pensioner in Chile, who retires at 65.

Latin American countries with individually-funded pension systems because the available evidence suggests that the vast majority of workers are not accumulating sufficient savings for accessing pensions equivalent to a significant portion of their salaries on retirement. The figures are worrisome. Considering the combination of contribution rates, retirement ages and contribution densities observed in Latin America, it is estimated that average workers' pensions in the countries with larger systems will be somewhere between30% and 49% of their taxable income in the last couple of years of working life. This is a result below the expectations of members, which should draw the attention of those responsible for public policies governing pensions (and the pension funds management industry). Together with providing the members of these systems with the information that will enable them to adjust their expectations to their reality in a timely manner, the necessary adjustments must be made to the system's parameters to ensure that workers, especially those who contribute regularly, can finance pensions that are reasonably proportional to the salaries they contributed on.

Fulfillment of the purpose of the pension systems is threatened if the design of the benefits is not reformed

The fundamental objectives of a pension system are preventing people from falling into poverty in old age and ensuring an adequate flow of income (replacement rate) to members during retirement, in order to prevent their standard of living from dropping significantly.

If the existing benefits design is not corrected, the fulfillment of these goals in the contributory pension systems in Latin America is threatened. This is not just about granting insufficient pension amounts. The challenge is greater, because if deep reforms are not made, a high percentage of members will not receive pensions. In three of the five countries studied (Colombia, Mexico and Peru), the regulations allow the vast majority of members, or all of them, to withdraw the accumulated savings in their individual accounts on retirement, without forcing them to transform anything part of them into pension flows (Table 2).

The individually-funded systems in some countries are also used to mitigate different problems or social needs of members during the active stage, such as unemployment, illness, housing, education or marriage, since they are allowed to withdraw funds from their accounts for those purposes, without being obligated to subsequently return the funds (Table 3). These withdrawals will aggravate the impact of low contribution rates, the official retirement ages, informality, the limited coverage of the systems and insufficient contribution density, on the accumulated balances and the benefits received in retirement.

Table 2
Authorization to withdraw balances at the official retirement age

Country	Chile	Colombia	Mexico	Peru	Uruguay
Official retirement age	M: 65 W: 60	M: 62 W: 57	M: 65 W: 65	M: 65 W: 65	M: 60 W: 60
Withdrawal of balances at the official retirement age	Only Freely Available Surpluses (1)	Yes, full withdrawal when the pension is less than the minimum wage (USD 251 per month) and the member has not contributed for a total of 1,150 weeks (22.1 years)	Yes, full withdrawal when the number of weeks of contributions is less than 1,250 (24.0 years)	Up to 95.5% of the balance can be withdrawn, regardless of the contribution periods	No

(1) Freely Disposable Surplus. The maximum FDS that can be withdrawn is the excess balance over what is necessary for financing a pension greater than or equal to 70% of the average salaries and taxable income declared in the last 10 years prior to retirement, and at 100% of the Maximum Pension with Solidarity Contribution.
(2) 2017, conversion to USD at the exchange rate on 08/31/2017.
Source: FIAP, February 2018.

Table 3
Withdrawal of balances in the individual mandatory savings accounts

Purpose	Chile	Colombia	Mexico	Peru	Uruguay
Unemployment	No	No	Yes	Yes	No
Housing unit	No	Guarantee (1)	No	Yes	No
Terminal disease or cancer	No	No	No	Yes	No
Marriage	No	No	Yes	No	No

(1) Not regulated or applied.
Source: FIAP, February 2018.

Improving and expanding pension options is another important challenge

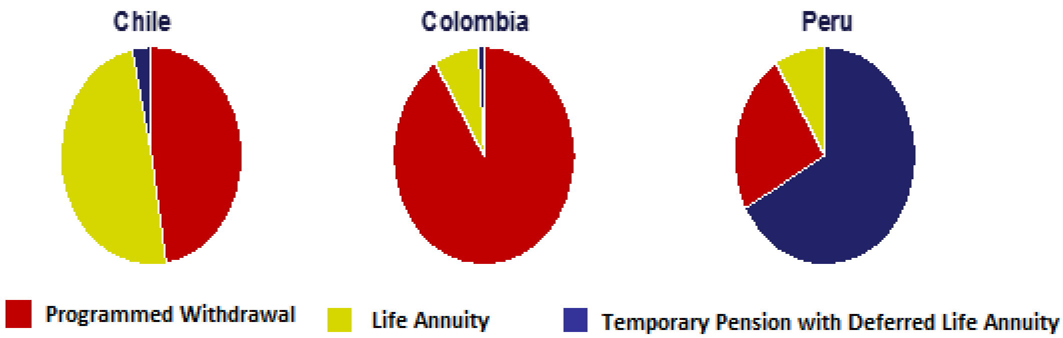
In practice, the pension mode selection options for retiring members are very limited due to regulations that suppress supply and demand (Graph 1).

The main obstacle to a growing demand for pensions is limiting such growth by allowing the full or partial withdrawal of the funds accumulated in individual accounts, and the existence of contributory PAYGO systems in some countries, that substitute or complement the individually-funded system in four of the five countries studied. Furthermore, extending effective freedom of choice between different pension modes requires investment in education and technical and independent advisory services, which does not occur in Latin America (except in Chile). Adequate advisory services would contribute to well-founded mode selection and reduce the risk of a poor decision, which could entail high costs, especially in the case of an irrevocable decision.

On the supply side, the main difficulties for its development are found in the low scale of operations, due to limitations to the growth of demand; the setting of minimum pension amounts; pension adjustments indexed to the minimum wage, and restrictions on competition, especially in the life annuities market, resulting from the lack of financial instruments that enable matching pension payment obligations with investments, the existence of outdated official mortality tables, and the presence of a number of legal uncertainties, generated, for example, by the lack of rules and regulations complementary to the law, and the granting of pension benefits through judicial proceedings (Colombia).

Graph 1.

Participation of pension modes in the stock of pensions paid in 2017



(1) Only the life annuity mode exists, and in Mexico the development of pension modes has been
(2) limited, ***<u>mostly due to the transition of pensions from the former regime</u>***.
Source: Statistics of the Superintendency of each country.

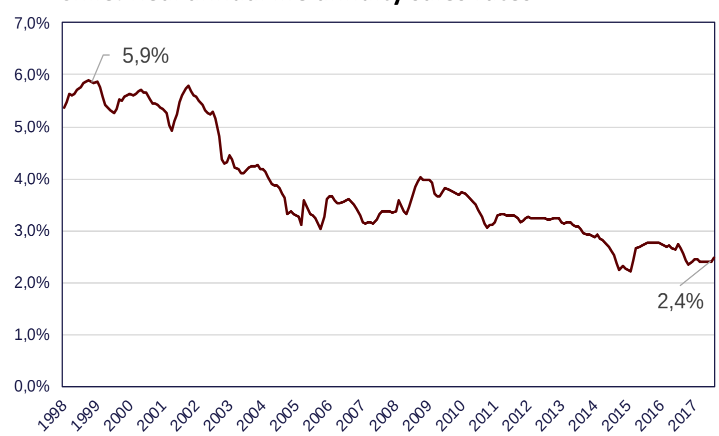
A highly positive aspect observed in the countries of the region is the creation of electronic and mandatory pension amount consultation and offer systems, whereby all the offering institutions simultaneously receive the information of retiring members, and the offers sent by these institutions are presented to members, helping to increase competition and lower information and marketing costs (to different degrees in Chile, Mexico and Peru).

Pensioners are exposed to a number of highly unnecessary risks

The main risks are those associated to interest rates and the return on investments, longevity, the solvency of institutions offering pension modes, and legal risks.

Members close to retirement face a significant risk in the conversion of the balances accumulated during their active stage into a pension, which depends on the trend and variation of the discount rates used for the calculation of the programmed withdrawals and the life annuity prices offered by the insurance companies. For example, it is estimated that in Chile the pension amounts offered in life annuities fell between 33% and 38% from 1998 to 2017, due to the reduction of the real annual sales rates of the life insurance companies (Graph 2).

Graph 2
Chile: Real annual life annuity sales rates



Source: Superintendency of Pensions, Chile.

In the programmed withdrawal mode, the rules and regulations governing the investment of the mandatory pension funds allow members who are five years or less from the official retirement age to be exposed to up to 80% of their variable income portfolio, and pensioners in some countries have an exposure of up to 45% in these types of instruments. This entails a variability risk, and eventually a loss of value in pensions that is excessive for the average member, who has little knowledge and education in financial matters.

Retirees who choose this mode are also exposed to the longevity risk and a systematic reduction in the pension amounts received. None of the countries studied have a longevity insurance that fully covers this risk to pensioners (except switching to the life annuity mode). Furthermore, in the countries studied, with the exception of Chile, programmed withdrawal amounts are calculated using mortality tables that are not regularly updated, and are not dynamic. This implies higher pension amounts in the initial retirement stage, and a more accentuated decreasing profile over time.

On the other hand, pensioners in most of the individually-funded systems who opt for life annuities, partially or fully assume the solvency risk of the insurance companies. This risk is primarily controlled through regulations governing the constitution of reserves, maximum indebtedness, investments that support the fulfillment of the commitments undertaken by the companies, and the balance between assets and liabilities. Only Chile (partially) and Colombia grant State guarantees to pensioners of all the insurance companies, should they fail to comply with their pension payment commitments.

Members face legal risks due to the failure to update the laws governing the pension systems, which have not adjusted the main parameters of programs, and do not define matters that are fundamental for determining the amounts of the benefits received by retirees. In fact, the political process has led to several delays in decisions on parametric changes in contribution rates and official retirement ages, in response to increases in life expectancy and lower interest rates, and the returns on the investments of the pension funds. All the above severely affects the ability of the systems to finance adequate pension amounts.

The retirees of the pension system also face specific legal risks in the decumulation stage, arising from the rules and regulations that define the characteristics and conditions of the pension modes and the calculation of benefits, specifically the official mortality tables, the discount rates used for calculating the necessary unit capital and the survival pension beneficiaries.

Another legal risk that has a significant incidence on the pension system in some countries, is the ratio between pensions and wages. In Colombia, pension amounts must be at least equal to the minimum wage, and in Uruguay, pensions are adjusted in accordance with the variation in the average wage index. Life insurance companies in Colombia have also faced significant legal risks due to judicial decisions that have granted pensions to new beneficiaries in the individually-funded system, after subscribing life annuity contracts, without the companies being able to adjust the value of the pension in all cases.

Most relevant lessons

The main lessons that emerge from the study, and that are relevant for the design of the regulations governing the process and the pension modes authorized in an individually-funded savings system, are the following:

- In order to ensure that pension markets expand and develop, regulations that unnecessarily depress the demand for pensions must be avoided (authorization of withdrawals).

- Pensioners must be allowed to choose between pension modes that protect them from the investment and return risks (life annuities) and others that enable them to assume those risks (programmed withdrawals).

- Choosing between different pension modes is a complex matter. Hence, there must be regulations and institutions in place that help pensioners to decide between the available alternatives.

- Special attention must be paid to the quality of rules and regulations governing pension modes and pension markets, because they have a significant impact on the pension risk.

- The existence of an institutional framework that ensures the regular and technical review of the parameters of the pension system would help to improve the quality of pensions.

Proposals for improvement

On the basis of the findings and lessons learned, some proposals for improving the characteristics of pensions are presented below. Several of them have already been applied in some countries. These proposals are suggestions that undoubtedly need to be defined and developed in detail and will depend on the particular conditions of each country and the social security system in which they would be considered desirable and feasible. The proposals are classified according to the desired objective.

1. ***Increase the number of pensioners (and pension amounts)***

   a) Encourage postponement of the retirement age.

      i. Authorization to postpone the retirement age; continue working while receiving a pension, and freely decide whether to contribute or not when continuing to work after retirement.

      ii. Authorization for those who defer the retirement age to freely withdraw part of the additional balance of accumulated pension savings.

   b) Instead of authorizing the total withdrawal of the accumulated balances in individual accounts on retirement, as occurs in some countries, allow the free withdrawal of part of such balances, subject to the condition of maintaining the necessary capital to purchase a certain minimum pension at a later date.

   c) Calculation of pensions with special tables in the case of workers with lower life expectancy.

2. ***Ensure that authorized fund withdrawals will not harm the pension***

   a) Allow withdrawals only by individuals who defer the retirement age.

   b) Allow withdrawals of part of the balance but demanding that they be returned before the retirement age and adjusting the latter if the withdrawn funds are not returned.

   c) Allow early withdrawals only when their intended use is to purchase insurance against circumstances with an extraordinary economic impact once they have retired (for example, dependence and catastrophic health insurance coverage during retirement).

3. ***Reduce uncertainty regarding the value of the conversion rate of the balance of savings accumulated into a pension flow***

   a) Guarantee minimum rates of return (or replacement rates) for pension savings, subject to contribution densities.

   b) Ensure the conditions that allow the development of different pension modes.

   c) Advance purchase of life annuities.

   d) Improve the regulations governing the formulas for calculating the rates used

e) for calculating programmed withdrawal pensions, and improve the constitution of reserves in the case of life annuities.

f) Establish or strengthen centralized pension contribution systems.

4. ***Lower the pension mode risk***

a) Reduce the programmed withdrawal longevity risk.

i. Review the formula used for calculating programmed withdrawal.

ii. Implement advanced old age insurance

iii. Mandatory purchase of life annuities.

b) Lower the risks of life expectancy tables.

c) Lower the solvency risks of the pension providers.

5. ***Create an institutional framework that supports a process of regular review and adjustment of the key parameters of the system.***

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