FIAP
FEDERACION INTERNACIONAL DE ADMINISTRADORAS DE FONDOS DE PENSIONES

INTERNATIONAL FEDERATION OF PENSION FUND ADMINISTRATORS

OPPORTUNITIES AND CHALLENGES FOR INDIVIDUALLY-FUNDED SYSTEMS IN A GLOBALISED WORLD

Presentations given at the International Seminar "Opportunities and Challenges for Individually-Funded Systems in a Globalised World", organized by FIAP, on May 31 and June 1, 2012, in Mexico.

2012 FIAP INTERNATIONAL SEMINAR

Published and edited by FIAP

Av. 11 de Septiembre 2155, Tower C, Floor 9,
Office 901, Providencia, Santiago, Chile
Phone: (56-2) 2381 17 23
Fax: (56-2) 2381 26 55
E-mail: fiap@fiap.cl
www.fiap.cl

Edition and Publication:
International Federation of Pension Fund Administrators (FIAP)

1st edition: 500 copies, 2012
Cover design: Verónica Muñoz
ISBN: 978-956-8853-09-9

Each article is the exclusive responsibility of its author and does not necessarily reflect the opinion of the International Federation of Pension Fund Administrators (FIAP).

Printed in the workshop of Salesianos Impresores S.A.

OPPORTUNITIES AND CHALLENGES FOR INDIVIDUALLY-FUNDED SYSTEMS IN A GLOBALISED WORLD

Presentations given at the International Seminar
"Opportunities and Challenges for
Individually-Funded Systems in a Globalised World",
organized by FIAP, on May 31 and June 1, 2012,
in Mexico.

INDEX

INTRODUCING THE SEMINAR

Distinguished authorities, lecturers, speakers and commentators; special guests, visitors from over 20 countries from all over the globe, media representatives, colleagues from the Mexican Association of Retirement Savings Fund Administrators (AMAFORE) and friends: I am very pleased to give you all, on behalf of the International Federation of Pension Fund Administrators (FIAP) and of the AMAFORE, the warmest welcome to the FIAP International Seminary 2012.

Cancun is the great setting for our seminar, a place of privileged natural beauty, located within the confines of the ancestral Mayan culture, and is today, without a doubt, one of the main tourist destinations of the world. I am sure you will enjoy it.

FIAP, which currently includes the union associations of pension fund administrators and global financial bodies of more than 15 countries, carries out an intense activity directed towards the exchange of information, knowledge and experience about the pension systems based on individual capitalization and private management of the funds. One of the most outstanding of these activities is its now traditional annual seminar, and we have had the satisfaction of organizing the eleventh version on this particular occasion.

In 2012, we are commemorating in Mexico 15 years from the launching of one of the most transcendental structural reforms of recent decades. Indeed, in the mid-90s it became evident that the traditional pension system of our country's most widespread social security regime was financially non-viable in the medium and long term. Between 1995 and 1997, the Congress approved deep modifications of the social security laws and the Savings for Retirement Systems, with the purpose of providing the pension scheme with financial sustainability, while at the same time reinforcing principles of fairness, information rendering and operating efficiency.

I cannot fail to mention the fact that, 5 years ago, in 2007, the '97 reform was complemented with the transformation of the federal government employees' pension scheme, known as the ISSSTE, along lines very similar to those described earlier.

In the AMAFORE we are certain that there are very good reasons to commemorate these first 15 years of the reform:

- Over 40 million workers currently have an individual retirement savings account.
- The balance of the assets managed by the system is of the order of some MXN 1.7 billion (USD 125 thousand million approx.), which represents about 11% of the GDP.
- The average annual performance of the pension funds has been 6.5% in real terms.
- Over MXN 400 thousand million is channelled into productive investments in Mexico, with the consequent, positive impact on growth, regional development, and job creation.
- The retirement savings funds have been the catalyst for an unprecedented deepening of the local financial markets.
- Last but not least, we have given firm, though still early steps towards the construction of a retirement savings culture within broad layers of the population.

It is in that context that the AMAFORE has undertaken, with a lot of enthusiasm and commitment, the organization of a range of events that contribute not only to the better knowledge and dissemination of the Savings for Retirement System based on individual funding, but also to an analysis and debate of the important challenges that Mexican society faces in terms of demographic changes and pensions.

Acting as the proud hosts of this international seminar, the members of AMAFORE wish to contribute to the exchange of experiences in a way that is serious, pluralistic and constructive, characteristics which have been forever present in the FIAP seminars.

The program of activities that has been drawn up is varied and intensive, and undoubtedly of very high quality. We have the presence of prominent specialists available to us from the fields of academics, public policies, multilateral bodies from the global financial sector and, of course, from the pension fund administration industry.

Among others, we shall be addressing issues related with the corporate governance of the companies in which the pension funds are invested; the adequacy of contributions and how they relate to the structure of the labour market, and the great challenge that the pension funds face, with users who are increasingly demanding and well-informed.

Valuable contributions have combined to make this seminar possible, and I would like to recognize them. First of all, the hard-working, committed FIAP team, led by its president, Guillermo Arthur; secondly, the executive council of AMAFORE, which firmly supported this project since its beginnings; and thirdly I would like to thank a select group of important companies, which provided their generous, economic sponsorship.

I repeat my gratitude to the whole group of distinguished speakers, commentators and facilitators for sharing their knowledge, talent and experience.

And to all of you, to whom, I express my thanks on behalf of FIAP and AMAFORE for your interest and enthusiastic participation.

Oscar Franco
President
Mexican Association of Retirement Savings Fund Administrators (AMAFORE)

INTRODUCING THE SEMINAR

15 years on from the Pension Reform in Mexico

It is hard to put into perspective the magnitude of the challenge of implementing a structural reform of the pension system in Mexico 15 years ago. The most difficult part was the sheer scale of the effort, the challenge implied by a reform of that nature, because of political tradition, the technological challenges involved, the size of the Mexican Social Security Institute (IMSS), the apparent difficulty of modifying the system of contribution payment to allow the worker to choose a Retirement Fund Administrator (AFORE,) and for the payment to get there.

I am deeply grateful to Oscar Franco, president of the Mexican Association of Retirement Fund Administrators (AMAFORE), for inviting me to take part, 15 years later, and my warmest greetings go to Guillermo Arthur, president of FIAP, who reminded us just now that they held their first meeting in Cancún almost 10 years ago.

My warmest greetings go also to Pedro Ordorica, president of CONSAR, who was the creative legal director of CONSAR at that period – and a daring one, to say the least -, and I want to acknowledge and pay tribute to two former presidents of CONSAR who are with us today: Fernando Solís-Soberón and Vicente Corta.

I want to emphasise how important it was for the pension system to have had two people with the talent and human quality of Fernando and Vicente participating in the CONSAR. I told Fernando when he invited me, maybe a few months before the system began operating, that the worst that could happen would be for us to electrocute ourselves in the first payment and be left with no job. Fortunately that did not happen and we have both had highly satisfactory professional careers, I believe.

The pension system can be reviewed in various aspects. The transition from a defined-benefit to a defined-contribution scheme has very considerable advantages for the worker. The defined-contribution system introduces an element of far greater fairness. There tends to be lack of homogeneity between the working careers of men and women and between those who have had the opportunity of better preparation and those who have not.

A system of defined benefits tends to discriminate against those who have had no educational opportunities and those who for structural reasons have less permanent participation in the formal market. There were many workers who had paid considerable sums into the defined-benefit schemes and yet had no pension benefit at all because they did not meet the restrictive conditions. A defined-contribution scheme corrects that deficiency structurally. It gives the workers entitlement to their contributions and ensures their right to receive the resources that they paid in, either in the form of a pension or in the form of the whole accumulated balance. Never again will a Mexican worker lose the resources he/she paid into an individual account, whatever his/her gender and education.

This element of fairness and benefit was the driving force behind the transformation and I believe, 15 years later, that it has given a good account of itself. It has ensured that workers have capital that belongs to them, with the possibility of leaving it to their heirs and naming their beneficiaries.

Ten years after the IMSS reform came into force, the reform of the Institute of Social Security and Services for Public Employees (ISSSTE) also took place. This has various aspects that I shall underline from the point of view of public finance and from the point of view of making the benefits of this type of method available to public sector workers too, but it also has a structural element that is worth highlighting: namely, portability.

It allows inter-system dialogue to occur, meaning that a person can take the benefits, including health benefits, from one system to the other. Another unfair element in our pension system as a whole was that workers who divided their working career between sectors could have a full working career but no pension compensation at the end of it.

The Pension Reform in 2007 (reform of ISSSTE) corrects that unfairness structurally and, by allowing portability, ensures that a person with a career that involves large contributions can choose health services from either of the systems at the end of it and move his/her savings efficiently between systems.

There is another very important element, currently under debate, as to whether or not the AFORES offer added value in the process. One of the elements to be highlighted in our new pension systems is that they allow workers who have very little in the way of resources to save voluntarily and so gain access to a savings service where they benefit from the same advisory services, in terms of quality, talent and returns as those with large amounts of capital.

A worker who placed 50 pesos in the Savings for Retirement System 15 years ago has had a real return of 6.5% per year on those 50 pesos, so far. That is a compensated savings mechanism that could not take place without a system such as the one we are talking about now.

It involved very exceptional technological development, because it was crucially important for the reform to have a database that would act as a mechanism to allow the contribution to be disassociated from the AFORE chosen by the worker.

The money would be collected in a decentralized way and paid into a bank. The money would then be transferred into the individual account without the boss needing or even being able to find out what choice the worker had made in terms of his/her AFORE. This gave workers an additional right in terms of choosing their own destiny in pension matters.

Another fundamental element of the reform, apart from the worker and the benefits I am describing here, was the possibility of developing a local debt market through the system of pension savings. In a context of appalling uncertainty, such as we have today, that fact is remarkable in itself: a good part of Mexico's funding needs are met from a deep, liquid and varied local debt market, with a large quantity of instruments and with a great possibility of supporting not only the Federal Government's public finance requirements through the use of those savings, but also increasing numbers of private sector investment projects of great variety and with very considerable maturity in terms of periods.

Looking at the balance of the big numbers after 15 years, these are certainly relevant. Fifteen years on, the assets held by the AFORES in investment are over 11 points of the GDP. Since the historic beginning: 6.5% yield. I insist that there has been access to that amount from the first peso paid into the AFORES, either by way of mandatory contribution or by individual input.

Of the balance accumulated in the AFORES, which totals one billion, 681 thousand million pesos, 37% consists basically of the returns produced by the savings paid into the system.

One of every five pesos of our internal savings is managed today by the AFORES, 21% of the total internal savings. This is the country's most important source of institutional financial savings, managed in the case of Mexico by those who are with us today.

Nine thousand 120 million pesos have been contributed and are managed today as part of voluntary savings. And if one makes a sector-by-sector and instrument-by-instrument review of the impact created by the AFORES in Mexico, this has been dramatic. In Mexico today we have one of the widest varieties of funding alternatives and the AFORES have been actors in practically all of them.

Important actors in the housing market, important actors through Capital Development Certificates (CKD) in a very wide variety of investment projects --- in addition to a couple of years spent on pilgrimage to enable us to finance eucalyptus trees in Campeche; today it is increasingly usual to see that number of projects being financed in the Mexican economy, with great benefit.

This has been achieved because the pension system, which began correctly in a very conservative manner in terms of management, today has an increasingly flexible and well- adjusted investment scheme. This makes it possible to adapt or allow workers to find a risk profile that matches their life cycle and allows them to have better elements in terms of the portfolio that suits them best, appropriately balancing the risks and returns.

There are obviously important issues pending in terms of how development should continue. There are areas of opportunity in terms of how to achieve a better combination of the resources of the Workers' National Housing Fund Institute (INFONAVIT) and those of the AFORES to ensure better replacement rates, and to ensure a housing market where the main guidelines are defined by the market and not by bureaucracy. We have to continue managing the workers' resources efficiently, rectifying and deepening the investment system of the Specialised Investment Companies for Retirement Funds (SIEFORES) and designing financial products that contribute towards mitigating the investment and longevity risks confronting the life annuity market. We need to work with the industry to reinforce investment analysis skills, whether our own or mandated to third parties, in order to invest the workers' resources in safer ways that maximize their long-term returns.

After 15 years, we have a system in Mexico today that gives legal assurance, that ensures for workers the best returns that the country has to offer, that is absolutely transparent in all aspects including yields and commissions, that offers us a stable source of internal funding and, since the reforms made to the ISSSTE, also offers us portability between systems, all of which allows Mexico to say today that its pension liabilities are not a source of long-term concern.

Pension liabilities tend not to appear transparently on public balance-sheets. When one hears that Greece owes 50% of its GDP or that Japan owes 200% of its GDP, this does not include pension liabilities. Today in the case of Mexico there are liabilities connected with the transition generations, but since each reform was approved, whether in the IMSS, the ISSSTE, the IMSS as employer, the Federal Electricity Commission (CFE) as employer, or Mexican Oils (PEMEX), which is pending, as we said earlier, the liabilities are no longer growing and will be eliminated consistently as time goes on.

At present value, the savings of the pension reforms carried out in this administration amount to over 30 points of the GDP. That is why I insist today, 15 years on, that I believe Mexico leads the field in terms of its pension administration.

I close with a parenthesis before opening: we are in an environment of immense volatility, with a lot of stress and worry in financial markets, seeing how developed countries are facing difficulties to find their funding, seeing episodes of volatility and pressure on our exchange rate, but we are doing so in the context of a healthy economy, without fiscal or financial imbalances, with good balances in its banks, growing in exports, growing in terms of consumption and investment, with growth supported on consumption and investment, on creation of employment and healthy bank credit. I want to point out an additional element that validates all I am saying: it is something that the markets recognise and to which they give weight: yesterday Mexico made an important investment in the Japanese market, in the Samurai market, placing the equivalent of about one thousand million dollars. This proves that Mexico today is an issuer that has access to practically all currencies, in all markets, at all the different terms.

I want to put the importance of that transaction into perspective: it is the largest transaction by an emerging sovereign country in that market without guarantee in the past 10 years; it is the largest issue from a sovereign country outside the Asian zone since the crisis of 2008; it is the first Samurai Bond without a guarantee for an issuer with our credit rating since 2008.

This shows, I insist, that Mexico's variables are solid enough to allow it to be an actor that can issue confidently and on good terms in markets to which we have had no access for a long time, such as the Asian market and specifically the Japanese market.

With that last element, it being the morning of 31st May 2012, I declare the International Seminar "Opportunities and Challenges for Individually-Funded Systems in a Globalised World" formally open, with the conviction that what is debated here will contribute towards the success and improvement of pension systems throughout the world.

Thank you very much.

José Antonio Meade
Minister of Finance and Public Credit - Mexico

INTRODUCING THE SEMINAR

It is my pleasure and privilege to address myself to the Minister of Finance, Sr. José Antonio Meade; the President of the Mexican Association of Retirement Fund Administrators (AMAFORE), Sr. Óscar Franco; the Vice-presidents of the International Federation of Pension Fund Administrators (FIAP); the presidents of FIAP's member associations; the members of congress of various countries who are visiting us; the President of the National Commission of the Saving for Retirement System (CONSAR); members of parliament; and my esteemed friends.

As the Minister of Finance has reminded us, we were here almost 10 years ago, also discussing the work of our pension systems which were then starting up around the world. For 20 years, from 1980 onwards, Latin America and Eastern Europe had been transforming their pension systems from pay-as-you-go to individually-funded systems, overwhelmed by the fiscal burden represented by the deep demographic changes taking place in the world. In a world that was ageing, a world with increasingly few young people, the use of pension-funding mechanisms based on the pay-as-you-go system, in which younger people finance the pensions of their elders, was completely unworkable. That is why systems were slowly changing and individually-funded systems were becoming stronger.

The intensity with which these reforms were carried out varied enormously from one country to another. There was total replacement of the pay-as-you-go systems in countries such as Chile, Mexico, El Salvador, Dominican Republic, Kosovo, Kazakhstan and Nigeria. In other countries the pay-as-you-go system was retained in competition with the individually-funded system, as in Colombia and Peru. And in a considerable number of countries, the pay-as-you-go systems were combined with the individually-funded systems, in the sense that a proportion of the worker's contribution was dedicated to financing the pay-as-you-go system and another percentage to the workers' individual accounts. This is the case in Uruguay, Costa Rica, Poland, and almost all the countries of Central and Eastern Europe.

From then until now, I believe that all countries – and the Minister of Finance reminded us of this – have been reinforcing their systems to guarantee that they really make a contribution to financing workers' pensions and also to the economic development of our countries. However, we have seen a second generation of reforms recently, some of which have already been executed, while others are still in process. There was a reform in Chile in the year 2008 which was, in my opinion, carried out in exactly the right direction: a first basic solidarity pillar was set up for those workers who are unable to fund their own pensions, due to their informal work style or poverty; the second pillar, that of the Pension Fund Administrators (AFPs), was strengthened by providing incentives for those sectors that had lowest contribution density, such as women and young people; contribution was made mandatory for the self-employed; and the third voluntary saving pillar was also strengthened. This last is not a minor issue. In fact, if we look at the speed with which the world population is ageing, it is going to be increasingly necessary to create a pension culture so that workers build up their pensions with voluntary contributions as well as mandatory ones.

Unfortunately there have been other examples in which the direction of these reforms has been very different. It is worth remembering the Argentine case, in which the funds accumulated by the workers were simply used for a completely different purpose from the funding of pensions; or cases like that of Poland, in which the contributions to the individually-funded pillar were reduced transitorily from 7.3% to 2.3%, knowing perfectly well that it is impossible to fund adequate pensions in the future with such a level of contribution.

It is therefore necessary for us to realize that we are immersed in a process of change. I believe firmly that it is always good for us to pause as these systems progress, and look at our strengths and weaknesses. But any review that we make must be preceded by a serious diagnosis, so that it can be the inspiration behind the reform that follows it. It seems to me that if we look at the reasons that have led to this review and then compare them with the emphasis of the reforms, we shall realize that there is no connection between the motives that led to the rethinking or redirection of the systems and the solutions being suggested.

Let us analyse some of the reasons which have been given with the aim of reviewing the pension systems. One of them is the impact that the world economic crisis has produced on the valuation of the pension funds. It is undeniable that we all get wet when it rains. The pension funds are invested in financial instruments and these, in a crisis, naturally show a temporary loss of value. But in dealing with that, what has been said? that the pension systems have caused workers to lose huge quantities of money. It seems to me that such a comment leaves out elements that are extraordinarily necessary to bear in mind at all times. First, that we are talking about long-term savings; we are obliged to contribute to the funding of our system for 20, 30 or 40 years probably, if we consider the rate at which we are ageing. Secondly, that despite the negative effect of the financial crisis on the valuation of the funds, the funds are still there and so are the instruments in which they are invested; these are safe, profitable instruments, even though there may have suffered the buffetings of this crisis. If we analyse the effect that the last 13 international crises have had on the valuation of financial instruments, we begin to understand that the average duration of these crises has been 22 months, after which recovery begins. The yields on the pension funds will recover as the world emerges from the financial crisis, so there is no doubt that impatience to take measures under the influence of despair and fear may turn out to be a bad advisor.

Furthermore, those who criticize this system forget that the pay-as-you-go systems lack fiscal sustainability, which is something that nobody refutes. During the past 10 years, of those countries with "defined-benefit" systems, over 60 have raised the amount of contribution, over 20 have increased retiring age and a further 30 have reduced benefits or increased the requirements to qualify for pensions. I think therefore that the effects that the financial crisis is having on the pay-as-you-go systems are much more serious than those it produces on the individually-funded systems. How could we equate some loss to the fund in the individually-funded system with the postponement of the retiring age by 3 or 5 years, for example, or a 30% reduction in the benefit? I believe, therefore, that impatience can be a very bad advisor when it comes to designing the reforms that the systems need.

The other argument that has led people to think about modifying the system is the fiscal impact that these reforms are having; the argument immediately arises that the transition from a pay-as-you-go system to one of individual funding has a massive fiscal impact.

It is true that there is an increase in fiscal expenditure during the early years of a reform, when the workers migrate to the individually-funded system and start to put their savings in their own individual accounts, while the State has to take over the payment of pensions to those who stay in the old system. However, that effect is reversed after a short time, and the reformed system begins to be much more sustainable compared with the situation that would exist if the system were not reformed. It must also be borne in mind that when these reforms are carried out, they create fiscal surpluses that enable non-contributory pensions targeting the poorest sectors to be financed, because the State no longer has to take responsibility for the pension of those workers who have stable jobs and are therefore able to finance their own pensions.

The other reason that has been given is that, after concerning ourselves for so long about yield, it now seems that the maturing of the systems is leading us to concentrate on replacement rates. What is the replacement rate going to be? How much pension am I going to receive? It seems to me that this is a necessary exercise that we undoubtedly need to do. The quality of the pension depends basically on two elements: yield and contribution density. I therefore believe that what we need to do now is align any diagnoses that may exist and the results being obtained by the pension systems with the solutions that are being studied, because several of the proposals we have received recently bear no relation to these diagnoses.

As I have already mentioned, in dealing with these crises, in dealing with the fiscal impact, some countries have simply reversed their reforms. This is the case of Argentina, Hungary and other countries that are diverting the resources of the individually-funded system into the pay-as-you-go systems. It is also the case of El Salvador, where the workers' resources are being used to finance the old pension system. Obviously, the only thing that this does is aggravate the problem, not solve it. Another solution that has been put forward, even by certain international institutions, is to separate the account administration from the fund management. I do not see how such a measure can contribute to improvement in the great problems that we have in matters of coverage, costs, etc. It has also been suggested that the stock of members should be put out to tender. In Chile a system of tendering was introduced for new members, and was not viewed with much sympathy by the industry. However, it must be admitted that new members are people who have balances that are close to zero. As a result, they are affected far more by price than by the yield they may receive and in any case are only obliged to remain within that system for 24 months. However, attempting to extend this tendering to the whole stock of members, to workers who have made their decision to choose a particular administrator and have funds built up throughout their working life, could undoubtedly produce a very damaging effect on their ownership rights.

So it is that every time we face an economic crisis, these critical voices arise to try to reverse or introduce changes that are not connected with the real problems faced by our system. The problems facing our system are many, but allow me to mention just two on which we should focus our attention. One of them is how to improve the quality of pensions and that depends on the density of the contributions and the yield of the funds. In order to improve the yield of the pension funds, we could make progress in improving the degrees of diversification that exist in investing them. Unfortunately we still have a huge lack of diversification in some countries. If we take the weighted average of the countries with individual funding, we find that they have only 20% of their investments in equities, only 12% abroad, while 50% is concentrated in state securities, so it is very important to make progress towards greater diversification.

It seems to me that it is also necessary to make progress in incorporating the Multi-fund scheme in those countries that do not yet have it. This systems has had advantages not only in enabling workers to choose their risk profile according to their age and other personal characteristics, but also as a good refuge mechanism for those workers who are closer to retiring age at the point when economic crises occur.

The other element which is necessary for improving pensions, as we have already mentioned, is to increase contribution density. This undoubtedly depends mainly on the characteristics of the labour market, but we must also make ourselves responsible for this issue as an industry. A considerable part of this Seminar is going to be dedicated to this matter, to checking the contribution rates and retirement ages that are necessary in an environment characterized by an ageing of the population, to enable more adequate replacement rates to be achieved. We shall also be reviewing the incentives that can be given to voluntary pension saving because, in the light of the ageing of the population, it is going to become more necessary every day for us to make additional contributions in order to fund our pension.

I conclude these brief opening words by saying that I believe the aim of this Seminar is precisely to look into these big challenges that lie before us. I believe that, by making a serious diagnosis, it should help us, in all our countries, to refocus the reforms that must be introduced in the pension systems in order to achieve the objectives mentioned.

An issue that always causes concern is the maintenance of the pay-as-you-go systems, because although proportionally those systems are not very significant, they will always produce a massive fiscal deficit and there will always be the temptation to resort to financing them through the individually-funded systems, as we have seen in certain parts of the world. It is to be hoped that the institutional strengths of countries should prevent this happening, but unfortunately the facts prove the reverse. This contravenes one of the most important principles of individually-funded systems, to which Minister Meade referred: namely, that in this system the worker is looking not at a promise, but at his/her ownership of the contributions that he/she has paid throughout his/her life. I am sure that with these discussions we are going to be able to strengthen these systems, so that they continue in the long term to give the fruit expected of them, in other words, to provide our workers with good pensions and contribute to the development of our economies, which always need more funding for their growth. I hope that the discussions we will have here may serve to provide appropriate guidance for this reform process that is being mulled over in so many parts of the world.

Thank you very much.

Guillermo Arthur
President of FIAP

INTERNATIONAL FEDERATION OF PENSION FUND ADMINISTRATORS (FIAP)

FIAP was created in May, 1996. The legal status of this international institution was granted on 29th June 2004 in the city of Montevideo, by Supreme Decree Nº 801, issued by Uruguayan Ministry of Education and Culture. It currently has eighteen "full members" in sixteen countries and nine "collaborating members." The "full members" are associations, federations, chambers or other institutions that represent the interests of the pension industry in the respective country. Thus, the following countries are represented in FIAP: Bolivia, Bulgaria, Colombia, Costa Rica, Curaçao, Chile, El Salvador, Spain, Kazakhstan, Mexico, Panama, Peru, Poland, Dominican Republic, Ukraine and Uruguay.

The workers included in the FIAP member associations and institutes number more than 119 million as of December 2011, and accumulate more than 562 thousand million dollars in their respective individual accounts.

The "collaborating members" are mainly companies that provide services and products to the pension fund management industry and currently include AEGON Global Pensions; Amundi Asset Management; Larraín Vial; M&G Investments; Pictet & Cie (Europe) S.A.; Principal Financial Group; RiskMathics Financial Innovation; State Street Global Advisor and the Bank of New York Mellon.

The main objectives of FIAP are:

- To contribute to the success of the new pension systems based on individual funding and private management.

- To promote reforms to pension systems that lead to the adoption of pension programs based on individual funding and private management.

In order to achieve these objectives FIAP has undertaken intense activities that include the holding of Seminars, Conferences, Workshops and Round Tables, specialized publications, the creation of a Web site, permanent contact with international organizations and authorities of the different countries, support for its partners in the promotion of improvements to the regulations of the respective countries, participation of its Chairman and Steering Committee in propagating activities of the new individually funded systems, drafting up of documents to refute the criticism faced by such systems and the preparation, of Guidelines to assist in the better design of individually-funded systems regulations.

INAUGURAL LECTURE

LABOUR MARKET TRENDS AND THEIR INTERDEPENDENCE WITH THE INDIVIDUALLY-FUNDED PENSION SYSTEMS

ALEJANDRA COX[1]

1 *Alejandra Cox lectures in Economics and is also Associate Director of the Faculty of Economics at the California State University, Long Beach, U.S.A. She worked as Principal Economist at the World Bank from 1993 to 1996. During this period she worked on labour market issues in various countries, such as Argentina, Bolivia, Indonesia and Iran. Her consultancy work has concentrated on gender issues, legislation, social security, training, wages and other aspects of the labour market all over the world. She is the author of a number of professional articles and co-author of one academic book on the reforms of pension systems and another on the Chilean economic reforms, both published by the University of Chicago Press in 2008 and 1991, respectively. She is also co-author of the "World Development Report 1995" (World Bank), which deals with labour markets in emerging countries and in transition economies.*

This short article takes a look at the trends in the labour market and how these affect individually-funded systems. It also shows the advantages and challenges of the individually-funded systems and then attempts to answer the question: how are individuals and societies going to adjust to the low contribution rates that have been noted in various countries? Finally it presents a few conclusions.

1. Labour market trends

There are three broad trends of importance in the labour market. In the first place, there is a demographic trend that is affecting everyone: the ageing of the population. In the second place comes globalisation, which involves the manufacturing sector's being relocated in countries where wages are low. And the third great trend is the technological change, where the introduction of computers and their low price has meant, on the one hand, a fall in the demand for skills that can be replaced by computers and an increase in the demand for skills that are complementary to them and, on the other, an increase in the demand for formal education, to the extent that there is a high correlation between the skills that are in demand and formal education.

Demographic trends

The ageing of the population is the result of decreasing fertility rates and increasing rates of survivorship. It is predicted that by the year 2050 the population over the age of 65 will represent about 15% of the world population, whereas today it represents only 7%. Although this is very good news for demographics specialists, in that the world has managed to survive and has achieved better health, this is a trend that represents huge challenges for those thinking about pensions.

Globalisation

There are many ways of measuring globalisation, one of the most common being the ratio between exports and Gross Domestic Product (GDP). This ratio, which has been measured for the world economy, was less than 6% in 1950 and grew to 18% in 1995, reaching 26% in 2008. Obviously there was a fall-off after 2008 due to the recession, but it is evident that globalisation, measured in that way, has been dramatic.

Globalisation has been driven mainly by the fall in transport and communication costs. In the year 2000, the cost of transport by sea was 40% of its cost in 1930; the cost of air transport was less than 20% of what it had been in that same year; the cost of a telephone call was 1% of what it was then; and the cost of satellite communications was 1% of the cost in 1970. This change in the costs of transport and communication should have produced a growing economic integration, but the trading policies of the 50s, 60s and 70s slowed that process down. With the opening up that we saw from the 1980s onwards, and a little earlier in some countries, that process regained its momentum and since then we have seen a tremendous expansion of globalisation.

Globalisation has brought in a deeper level of specialisation, depending on comparative advantages, and has generated more flows of capital, resulting in changes in the demand for work in different sectors and regions, all of which calls for adaptation on the part of workers and employers. In view of these structural changes, some countries have suffered high unemployment, and that is what we have seen in the European region, for example, and in many Latin American countries. Other countries, such as the United States, have seen an increase in inequality between people who can cope with changes and those less able to do so, producing a great gap in wages from 1980 onwards.

Technological change

The third great trend is the technological change, and this has to do basically with the introduction of computers at increasingly low prices, resulting in a grand opportunity for the productive sector to lower its costs. However, by lowering costs, the demand for labour has changed, particularly, in favour of education, due to the fact that computers are capable of replacing or substituting repetitive and routine tasks but not capable of substituting personal interactivity or problem solving. So, with computers, this substitution takes place at the expense of people who formerly carried out routine jobs or tasks, and there is an enormous increase in the demand for labour for personnel who are capable of taking decisions and who use their judgment and wish to think.

Autor, Levy and Murname (2003)[2] demonstrate empirically that computers were producing this change in the demand for education in the United States. They wanted to know the reason behind such a huge change in the country's wage inequality. In order to investigate it, the authors use the job descriptions or definitions used by the United States Labor Department and break down each job into tasks. Having done this, they focus on the areas that are repetitive versus the tasks that involve decision-making, and show how a vast change had occurred in the use of employment: a drastic increase in tasks involving decision-making and an enormous reduction in the use of employment on repetitive tasks. Later they make a connection between this definition of work and the levels of education.

In this paper they conclude that in the case of U.S.A., the changes in tasks brought about by computerisation increased employment of university graduates by 3.7 percentage points per decade between 1980 and 1998. Since technological change has affected all the world's economies, we can extend that conclusion, without the details of the exact proportion. In other words, this change has led everywhere to an increase in the demand for education.

II. How do market trends interact with pension systems?

Obviously, the most important trend in the matter of pensions is that of the ageing population. Put simply, the ageing of the population means that the pay-as-you-go systems, with the formulae that were set up in earlier years, have become unsustainable.

There are some countries which have implemented deep reforms. Others have brought in marginal or parametric reforms, such as raising retiring ages, making minor changes in the formula for providing benefits, etc., and many countries have done nothing at all and are simply increasing their fiscal deficits, considering that these systems, which promise benefits, will have to provide pensions for an increasingly large proportion of the population.

However, the globalisation trend, in combination with that of technological change, has unleashed very great changes in relative prices and in the demand for labour in several sectors, which has meant that employment has become more precarious. This has important effects on the way we think of the labour market and how we think of the relationship between workers and their employers.

2 *"The Skill Content of Recent Technological Change: An Empirical Exploration", Quarterly Journal of Economics, 118 (4) November 2003, 1279-1334.*

The individually-funded systems

The individually-funded systems are financially sustainable insofar as the benefits are tied closely to the contributions.

These programs do not guarantee certain benefits at a particular age, but they do guarantee that contributors will have savings and that they will be able to take decisions with regard to the age for drawing a pension, the age for retiring from the work force and whether they wish to continue working when they have already begun to receive their pension, on the basis of information from their individual savings accounts, their life expectancies and their employment possibilities.

So these individually-funded systems place the individual and his decision-making at the centre of the solution to the problem of what to do to finance income in retirement.

The system works quite well for workers who pay regular contributions. In Chile, for example, even with lower rates of return – 5% instead of 10%, for example – an average worker achieves a pension that replaces 57% of his/her final wage.

However, the individually-funded systems do present some challenges. The main one is that they require an intelligent system of regulation and supervision to protect people's savings. They also require control mechanisms to ensure that contributors comply with their obligation to save. The control mechanisms may become very expensive if there is no positive voluntary response from the workers, because there are always ways of declaring less income, ways of remaining in the informal market, in other words, there are ways of wriggling out of the obligation. That is why the law obliges people to contribute, but people need to be convinced that it is in their best interests.

Furthermore, these systems offer low pensions to those who contribute little, either because they have an intermittent relationship with the formal labour market or because they choose to contribute less than what the law stipulates.

III. How do people/societies adjust to the low contribution rates observed?

Most observers fall back on the government solution, in other words, the provision of a basic pension. Some countries provide a minimum pension, with or without a contribution requirement. Others offer benefits guaranteed or targeted at the poorest people, while still others provide benefits index-linked to the Consumer Price Index (CPI), wage index or others. So, the basic pension comes in many versions, with higher or lower fiscal costs and with varying effects on incentives.

For example, if a country offers a basic pension of US$ 100 per month when the minimum wage is US$ 120 per month, it is highly unlikely that anyone earning the minimum wage would have incentives to contribute. The issue that must be kept very clear and borne always in mind is that people are going to look at this benefit or basic pension and compare it with what it would cost them to obtain a benefit of similar level by their own savings.

Countries that have carried out reforms based on individual capitalization of savings have been working on how to deal with the problem of people contributing less than they should, seeking solutions that maintain a set of reasonable incentives, so that these systems remain sustainable and preserve their citizen support. This is a great challenge. While the public sector is engaged in this task of understanding what to do and attempting to propose solutions – sometimes proposing solutions that are both expensive and complicated –, the private sector continues to react to the real situation, and the incentives work.

People respond to incentives

In the case of individually-funded systems, when a person has retired and no longer has to continue paying contributions, his/her wage increases and work after retirement can sometimes be more attractive than work before. I have been working quite a lot with two co-authors on this issue, specifically for the case of Chile, and we have seen how the participation of the elderly, particularly those who are pensioners, has increased since the reform, both for those who retiring under the old system and those retiring under the new one, because in neither case do people need to continue paying contributions. This issue has been explored in other countries and has in fact inspired changes in pension systems of the pay-as-you-go type, as in the United States.

For example, until the year 2000 there was a rule called the *"earnings test"* in the United States, which meant that if a pensioner decided to continue working and earned more than a certain amount specified in the law, his/her pension was reduced by a certain percentage, and even where the system reimbursed those amounts in the form of higher pensions in the future, the effect in practice was that people kept their work income just below that limit specified in the rule-book, while some preferred simply not to work to avoid their pensions being reduced. Once this *"earnings test"* was eliminated, pensioners' reactions have been very clear. There has been an increase in income from work and hours of work on the part of people who are receiving pensions, especially those who were right on the limit.

Changes in "default" choice may change behaviour patterns

People respond to incentives and when the opportunity to continue earning income is available, especially at a higher net wage, many will continue to work and generate income. The point is that people sometimes need a "little push" to accept or find out about the possibility of doing something that they are not familiar with, even though it is to their advantage. For example, companies in the United States often offer people the possibility of putting savings in a tax-free account, with the employers making a "matching" contribution, but often workers do not take up the option because to do so means making a decision: they have to go to the personnel office, they have to think, and quite simply, they do not do it, haven't time, etc. So the idea has arisen of "choice by default". People are told, for example: *"a deduction will be made for an individual savings account unless you come to the office and say that you do not wish this to happen".* When those rules are stated in that way, they may change behaviour patterns.

I am referring here to the fact that when countries begin to realise that people are not saving enough and will have relatively low pensions, these are methods that employers can use specifically to guide workers into doing something that is to their advantage and that they would not do for themselves. In practice, these default choices do persist and it is necessary to be careful to avoid falling into the same problem, with people ending up in a position without taking a decision. As it happens, one of the criticisms levelled at these solutions by observers is that it is rare for a program, whether savings, insurance or any other program offered voluntarily by an employer, to be ideal for all the workers in the company, with the result that employers often refuse or are unwilling to offer these programs, because taking a decision in advance for all workers may mean their being accused of prejudicing someone.

Active choice

An alternative to these default choices is what is known as "active choice". This "active choice" is a choice mechanism which encourages the individual to think about the decision. It limits the possibility that the individual will simply do nothing and avoids his/her going for the possibility of procrastinating or putting off the decision. Taking a decision would have to be an obligation for workers, with some kind of "penalty" if they failed to do so. Basically the employer offers them a "prize" provided that they take the decision, which they lose if they do not take it. For example, *"If you save X pesos, the company will give you Y pesos as a gift"*. Obviously, for this to work well, people must have information and a certain amount of guidance, which is one of the areas where most work is needed.

Financial education

The question of financial education is where we have made least progress. This is a crucial, delicate matter, because people in general shy away from all decisions that involve numbers. This is quite funny because it happens from the time they are at university. My students say: *"I can't…. I can't do maths"*, or *"I'm really bad at maths"*, but they think they can write, and the truth is that when I read what they have written, it is fairly mediocre too. The truth is that they need to learn to write as well.

The point is that mathematics are intimidating, and many people simply shy away from them, but we are all going to have to learn, come what may, and I think that we parents, teachers and employers are responsible for doing the teaching, especially because the people who depend on us will have a chance to improve their future if they understand the concept of compound interest or the idea that there is an implicit interest rate behind a series of term payments.

Employers have a valuable opportunity to improve the financial education of their employees. The media also have an important part to play here. Some quite valuable efforts have been made in the case of Chile. In this country, one of the AFPs already has an agreement with a university, where they have a program designed to enable people to learn financial engineering geared specifically to pensions. These classes or courses are offered to them by people in the personnel offices of companies. In 2005, the Chilean AFPs began to send a Personalised Pension Projection (PPP) to their members. Men aged between 30 and 55 years of age and women between 30 and 50 years of age received a letter with two calculations, which read:

"What would happen to your pension if you:

1. *Pay no more contributions and retire at age 65?*

2. *Continue contributing every month on a wage of $ XX until you retire at age 65?"*

Included in a box below the calculation described above was a note with alternatives for improving the pension, including voluntary pension saving. The result was that those who received this communication increased their probability of paying voluntary contributions by over 4 percentage points (especially in the 45-55 age-group)[3].

3 *See "Better-informed Workers and Retirement Savings Decisions: Impact Evaluation of a Personalized Pension Projection", Superintendence of Pension, Fajnzylber, Plaza and Reyes (2009).*

IV. Conclusions

First, it is evident that we have a situation in which there are long-term trends in the labour market that are not about to be reversed. We have no other alternative but to adapt to them.

Second, given the ageing of the population, we cannot go back to pay-as-you-go systems, because they are unsustainable. Pay-as-you-go systems ought to be prohibited if it were possible to do so.

Third, in order to improve the level of pensions, people need to be responsible. However, people are always busy and misinformed, generally speaking, with their minds on other things. There is a lot that can be done to help people focus on these decisions at certain key moments. For example, each time a person starts working in a company, there is a great opportunity for him/her to check his/her financial situation and consider the levels of saving that are appropriate, given his/her age and family situation. It would be wonderful for employers to have access to how much the person has already saved in his/her AFP account, in order to confront the employee with the real position and be able to help him/her to "get his/her act together", as we say in the U.S.A.

Put simply, there is a lot of work still to do on creating awareness and providing information.

NUDGES AND NETWORKS: HOW TO USE BEHAVIOURAL ECONOMICS TO IMPROVE THE LIFE CYCLE SAVINGS-CONSUMPTION BALANCE

DAVID BLAKE[1]

1 *David Blake studied at the London School of Economics in the 1970s and early 1980s, gaining his PhD on UK pension fund investment behaviour in 1986. He is professor of Pension Economics at Cass Business School, City University London, Director of the Pensions Institute (www.pensions-institute.org) and Chairman of Square Mile Consultants, a training and research consultancy. Formerly he was Director of the Securities Industry Programme at City University Business School; Research Fellow at both the London Business School and the London School of Economics; and Professor of Financial Economics at Birkbeck College, University of London. He won the 2011 Mehr Award from the American Risk and Insurance Association for 'Survivor Bonds: Helping to Hedge Mortality Risk' published in the June 2001 issue of the Journal of Risk and Insurance.*

1. Introduction

Most people are not rational life cycle financial planners. They face behavioural barriers and are subject to behavioural biases which prevent them behaving optimally over their lifetimes. Behavioural economics can help overcome these barriers. This has been shown to be the case in the accumulation phase of the life cycle when people are saving up for retirement: SMART (save more tomorrow) plans have become very popular in the US and elsewhere, for example. We show that it might also be the case in the decumulation phase – when people have retired and they are drawing down their accumulated assets – if they use SPEEDOMETER (spend optimally throughout retirement) plans. Both SMART plans and SPEEDOMETER plans rely on nudges to move people towards behaving optimally. Networks can help too, particularly employer-based networks. One potentially interesting way to implement these plans is to use a life-cycle fund as part of a corporate platform.

2. Most people are not rational life cycle financial planners

A rational life cycle financial plan requires people to accurately forecast: total career income, total available retirement resources, asset returns, interest rates, tax rates, inflation, their longevity or life expectancy, and their medical and other health costs. Most people do not have the skills to do this. The plan would also require people to have the commitment to start and maintain a very long-term savings and investment programme. Many people do not have the necessary commitment to do this either. This is because of behavioural barriers and biases.

3. Identifying behavioural barriers and biases

We need to recognise that, in reality, individual decisions are subject to:

> **Bounded rationality:** Certain types of problems are too complex for individuals to solve on their own. An optimal life-cycle financial plan is a clear example of this. One reason for this is that many people have a poor sense of the 'time

dimension' of their lives. Such people can think about events that are coming up in a few weeks' or months' time and plan for these, such as next summer's holiday. But time horizons such as 5 years', 10 years', 20 years' or 40 years' ahead are all lumped together in some nebulous distant place called the 'future'. Such people find it impossible to imagine themselves being old and financially preparing for this eventuality.

Bounded self-control: Individuals lack willpower to execute plans, especially long-term plans.

In view of these limits on optimising behaviour, we need to change our understanding of individual economic decision making, especially long-term savings decisions, such as those involved in accumulating and decumulating assets in a pension plan.

3.1 Pre-retirement behavioural barriers and biases

The first set of barriers and biases relates to the decision about starting to save. **Procrastination** and **inertia** are bad for saving. Employees fail to join pension plans where they are required to opt in. Saving for retirement means reducing consumption now in order to have a comfortable income in the future. This requires **self-control** which is not always easy. Some people find it as hard to save as others do to lose weight or give up smoking.

The next set concerns the decision about how much to save. It is difficult to know how much to save for retirement. Members may be **anchored** by irrelevant information. Suppose we know the default contribution rate in the pension plan is 5%. Presumably that must be the right rate? Not necessarily if the pension plan is poorly defined. A rational lifecycle financial planner would be able to work out that the appropriate contribution rate would be nearer 15% if a desirable standard of living is required in retirement. This shows how important it is for each of the default components of a pension plan to be appropriately designed.

Then there is the possibility of **cognitive polyphasia**. People can think about the same issue in contradictory terms in different situations: 'I know I should be saving 15% of my income if I want a good pension' but at the same time 'I think I will be able to live on much less when I retire, so I do not need to save as much as I thought, which means I can spend more today'.

The final set relates to what assets to invest in. Most defined contribution (DC) members do not want to make an active decision about what type of funds to invest in. We know this is true since around 90% of plan members choose their plan's default investment fund whether it is suitable or not.

There are many behavioural biases relevant to investment. Many people do not like taking investment decisions because they might later **regret** the decision that they make. This would especially be the case if the investment lost money, since people tend to be prone to **loss aversion**. Often people use **mental accounting** to keep track of their investments. This means that they treat some assets as being currently accessible and others as being accessible only in the future. The separate mental accounts are effectively treated as non-fungible, implying that the marginal propensity to consume from the separate accounts is different; this is sub-optimal. By contrast, a rational life-cycle financial planner would treat all assets holistically and hence have a single marginal propensity to consume from total wealth.

The way an investment proposition is **framed** can have an enormous influence on decisions made by most people, whereas it has no effect on a rational life-cycle financial planner. To illustrate, if most people are told 'you are aware equities are risky', this is likely to have a negative influence on the decision to hold equities in long-term investment portfolios, since most people do not like to take risks. It leads to a strategy of 'reckless conservatism' with investments held in low risk, but low yielding bonds. On the other hand, if the conversation begins 'you are aware that equities tend to generate higher returns in the long run, despite some short-term volatility', then there is some chance that a suitably balanced and sensible portfolio might eventually be agreed.

Another issue is **choice overload/anxiety** which is a common feature of complex problems. Having too many investment funds from which to choose can mean no decision at all is made. Individuals' minds can become frozen like rabbits in a headlight. When faced with difficult choices, individuals often employ **simplifying heuristics** (simple rules of thumb), such as 'choose the default option' on the grounds that someone else must have thought that it was good idea. Since we know that this is common practice, again it shows how important the design of the default is. A related practice is herding: many people just follow the herd wherever the herd is heading on the presumption that someone in the herd must know that it is the right thing to do.

Another behavioural trait is **weak investment preferences**: people do not have strong views on what assets to invest in. This arises, in part, because investment is a genuinely complex problem and, in part, because most people do not understand the issues and risks involved. It means that individuals can be easily led. It also means that the design of the investment choice menu can influence outcomes. Experiments have shown that with a list of five funds, many people will choose the first fund or the middle fund however the funds are listed whether in order of increasing risk, decreasing risk, or randomly.

When it comes to the decision about when to retire, again there are behavioural barriers and biases. One of these is **time inconsistency.** When you are young, you believe that you will be able and willing to work longer if necessary to compensate for inadequate pension savings, even if someone tells you that you will probably not feel like that when you are older. When you are old, you are very likely to regret not saving enough when you were younger, because you do after all want to retire earlier. This is another example of the poor understanding of the time dimension of a person's life.

3.2 At-retirement behavioural barriers

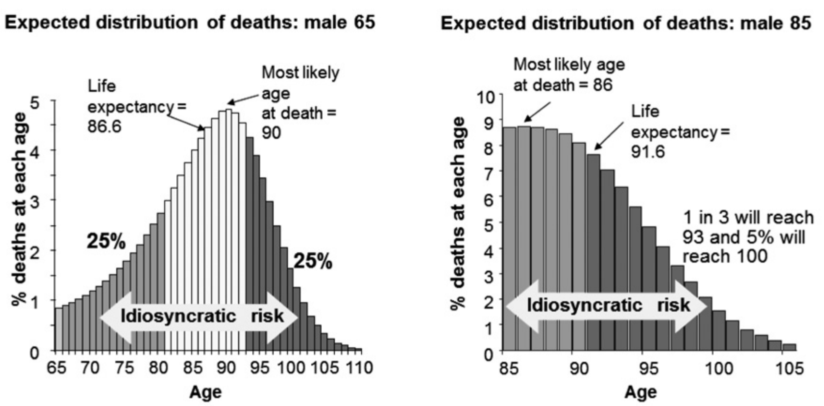
What should be the optimal retirement income strategy? Effective retirement saving needs an optimal decumulation strategy as well as an optimal accumulation strategy. It needs to deal with both *human spenders* – people who run down their resources too quickly in retirement – and *human hoarders* or *squirrels* – people who spend too slowly in retirement or who wish to guarantee inheritance for their children. A properly designed retirement income strategy can help both types.

Many people dislike the idea of buying an annuity to hedge their individual longevity risk, the uncertainty attached to individual lifetimes. Annuities are perceived as poor value and the two most likely reasons for this are that, first, individuals underestimate how long they (and their partner) are likely to live and, second, they have a poor understanding of the potential range of actual lifetimes around the expected life time. Figure 1 shows the expected distribution of deaths of UK males aged 65 and 85, respectively. In both cases, there is a wide range of possible death dates around life expectancy.

There are many behavioural biases relevant to decumulation. First, there is the **illusion of control**: people like to feel in control of their capital but annuitisation leads to an apparent 'loss of control' since they have 'given away' their capital to an annuity provider. Second, there is the issue of **framing**. Studies show that when expressed using a 'consumption' frame, annuities are regarded as desirable: you will have a regular stream of income to support your standard of living in retirement for however long you live. However, expressed using an 'investment' frame, annuities are regarded as risky: you could use capital to buy an annuity and you could die the next day and your investment would be completely lost.

Related to this last point is **regret** and **loss aversion**. Many people feel that annuities are a gamble. However, the probability of dying very soon after purchasing an annuity is very low – less than 1% for UK males at age 65 according to Figure 1 – but this probability is likely to be overestimated[2]. So the 'loss' from buying an annuity is likely to be perceived to be high: dying AND losing all your capital too! Conversely, the significant probability of out-living one's resources if one doesn't annuitise – the probability of living beyond life expectancy is around 50% for 65-year old males – is underestimated[3]. So the 'gain' from annuitising is perceived to be low. As a consequence of this, the 'gain' from annuitising will give a small utility benefit, while the 'loss' from dying early may have large utility loss. Accordingly, people feel that they will be better off by not annuitising and hence unwisely assuming their own individual longevity risk.

FIGURE 1
DISTRIBUTION OF DEATHS



Source: 100% PNMA00 medium cohort 2007.

4. How behavioural economics can help overcome barriers

Behavioural economics combines economics, finance, psychology and sociology. It recognises that individuals do try to maximise personal welfare, but that there are limits to the extent they can do this. Individuals are *Humans* not *Econs* (using the terminology of Thaler and Sunstein (2008)'s *Nudge*) and need **nudging** towards optimal solutions. It also recognises the importance of social norm groups and social

2 *Another behavioural trait is that people tend to overestimate low probability events.*

3 *People tend to underestimate high probability events.*

networks ('people like us') in helping individuals improve outcomes. The ideas come out of the US, so need to be adapted to other countries.

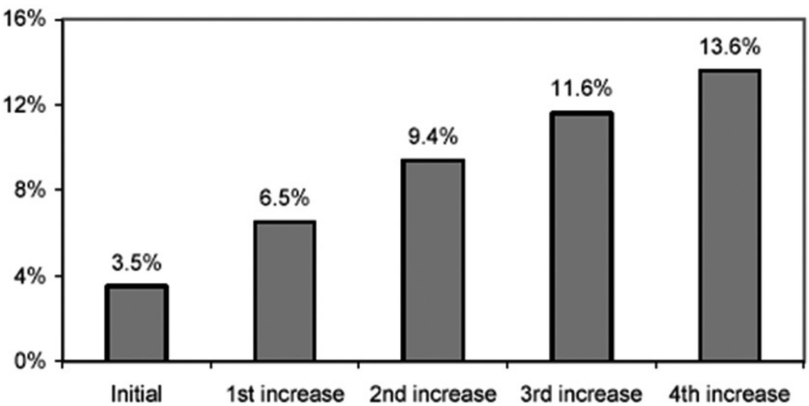
4.1 Overcoming pre-retirement barriers

When it comes to starting to save, behavioural traits have been exploited to design pension schemes that increase long-term pension savings. The classic example is the '*save more tomorrow*' (SMART) plan of Thaler and Benartzi (2004). The plan member agrees to start or increase savings on regular basis, not now but on a future significant date, such as the date of next pay rise.

SMART plans deal with a number of behavioural traits. They accept that individuals have **self-control problems** and would benefit from using **pre-commitment devices**. These include: **auto-enrolment with payroll deduction** – individuals are automatically enrolled into the plan (which is usually associated with a pension plan at the place where these individuals work) and have to make the active decision to withdraw from the plan; **auto-escalation** – the savings rate is initially low, but increases gradually over a number of years (see Figure 2); **withdrawal restrictions** – the plan creates psychological and financial barriers to accessing the funds before retirement.

FIGURE 2

SAVINGS RATES IN SAVE MORE TOMORROW PLANS



Source: Thaler and Benartzi (2004).

The plans exploit **inertia**, since once signed up, workers typically do not cancel the payroll deduction facility. They also use **herding behaviour** constructively: a worker is more likely to join if other workers are joining.

In terms of how much to save, SMART plans recognise the importance of an appropriate default contribution rate. Further, contribution matching by employers provides a powerful incentive to choose a higher and more appropriate contribution rate. Once enrolled, members tend not to alter contribution rate unless automatic annual increases are in place. Again **inertia** is exploited positively.

When it comes to what to invest in, SMART plans deal with **choice overload/anxiety** by having only a small number of investment funds to cover the range of different risk tolerances that individuals have. It is much more important for individuals to know what a particular investment fund does, than what its asset mix is, the knowledge of which will mean little to most people.

To deal with **simplifying heuristics,** it is important to have a well-designed and low cost default fund which utilises a life-cycle or lifestyle investment strategy and automatically de-risks in the lead up to retirement.

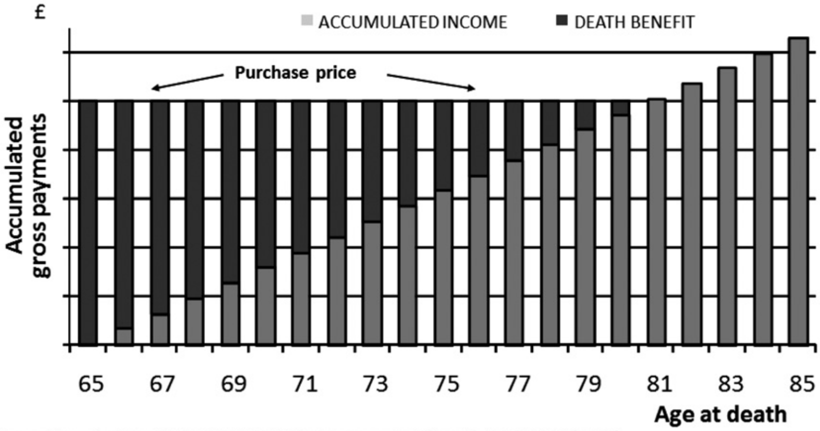
4.2 Overcoming at-retirement barriers

One of the most important requirements is to overcome the **illusion of control** which prevents people annuitising optimally. 'All-or-nothing' annuitisation is likely to be suboptimal as well as undesirable. Gradually purchasing annuities over time might be a better strategy. This deals with: interest rate risk by hedging the interest rate cycle; the possibility that investment returns might be higher in future; the possibility that mortality rates might be higher in future; and the possibly that the individual will enjoy a long period of retirement and will not want to be locked into a low-yielding bond-like investment – which is what a fixed-income annuity is – over an extended period.

The next requirement is to overcome **regret** or **loss aversion**. Any pooling of mortality needs to be perceived to be fair by the public. Currently, this is not true. At younger ages, the annuity mortality cross-subsidy (or survivor credit or mortality premium) gives poor value to those dying early. An annuity is a risk-sharing device in which those who die early cross-subsidise those who live a long time. This is ex-ante fair if all members of the pool of annuitants have the same life expectancy when the annuity is purchased. One solution to this problem is to offer money-back or capital-protected annuities: see Figure 3. Another is to offer impaired life annuities to those who have a reduced life expectancy on account of say a terminal illness or a lifestyle choice such as smoking. So it is not a question of IF but WHEN pensioners should annuitize (see Figure 4).

FIGURE 3

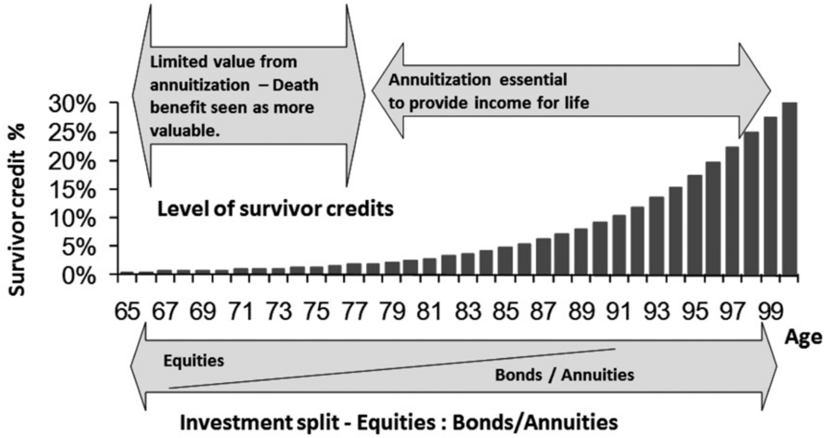
DEATH BENEFITS UNDER A MONEY-BACK ANNUITY



Source: Own calculations 100% PNMA00 2010 plus improvements in-line with CMI_2009_M [1.00%].

FIGURE 4

WHEN TO ANNUITIZE



Source: Own analysis; 100% PNMA00 2010 plus improvements in-line with CMI_2009_M [1.00%].

To deal with **framing**, the discussion should be posed in a way that generates the optimal outcome for most people. Talk about the income stream 'generated' by the annuity rather than the 'loss' of the lump sum. Explain the annuity in a 'consumption frame' – which makes an annuity look safe –rather than an 'investment frame' – which makes an annuity look risky. Emphasize the risk of living in poverty in old age, rather than giving up the lump sum. Studies show that people with annuities are happier: they can spend their annuity payments knowing they have full longevity risk protection. Show a series of photos of decreasing bundles of goods that can be purchased due to inflation.

5. SPEEDOMETER retirement expenditure plans

Blake and Boardman (2012) introduced the idea of SPEEDOMETER retirement expenditure plan as the counterpart in the decumulation phase to SMART plans in the accumulation phase. SPEEDOMETER stands for 'spending optimally throughout retirement'. The plan has five components.

First, make a plan. The can be done either by using an on-line or telephone-based service providing generic financial advice or, if wealth permits, involving a financial adviser whose role is to assist with making and implementing the plan and conducting annual reviews.

Second, secure 'essential' income. The plan manages all assets and income sources holistically to secure essential income. This is defined as the minimum, core inflation-protected income sufficient to meet the retiree's 'essential' needs for the remainder of their (and their partner's) life.

Third, have insurance and a 'rainy day' fund to cover contingencies. The plan uses insurance solutions, when available and cost effective, to cover contingencies. Where appropriate, rely on state support and maximise the benefits available from the state. Where possible, maintain flexibility by holding sufficient assets to meet uninsurable shocks (i.e., a 'rainy day' fund).

Fourth, secure 'adequate' income. Secure an adequate level of life-long income above the minimum if there is sufficient wealth. 'Adequate' income is defined as that needed to achieve the minimum lifestyle to which the pensioner aspires in retirement.

Fifth, achieve a 'desired' standard of living and make bequests. The plan uses a simplified choice architecture for managing any residual wealth with the aim of achieving a 'desired' standard of living in retirement, while allowing part of the remaining wealth to be bequested at a time of the retiree's choosing.

This is a universal plan for all retirees, although not all retirees will have the resources to use all stages of the plan.

A SPEEDOMETER plan deals with behavioural traits through: the use of pre-commitment devices and inertia; the use of defaults; the plan NOT the member deals with the complexity of decumulation decision making; the use of money-back annuities; the use of phasing; positive norming via effective communication.

A SPEEDOMETER plan involves just four key behavioural nudges: first, make a plan; automatic phasing of annuitisation; capital protection in the form of 'money-back' annuities; the slogan 'spend more today safely' to reinforce that 'buying an annuity is a smart thing to do'.

6. How networks can help

It is now beginning to be recognised that nudging is more effective in networks. There are a variety of possible networks:

- **Employment-based networks** are most effective for: encouraging pension savings and helping to pay-off debt (e.g., student loans) via pay-roll deduction with the deductions used to create positive savings once debts have been paid off.

- **Social networks**, such as family, friends and neighbours, can be effective in promoting a 'people like us' herding effect.

- **Internet-based networks** can be used to show the effectiveness of savings strategies. An example is 'Daily Dollar', a daily budgeting Facebook app (facebook.com/LiveSolid) which 'brings to life the notion that small lifestyle changes can add up to big savings'. You can publish the results on your Facebook profile.

- **Age-based networks** - see Table 1.

- **Networks based on personality types** - see Table 2.

TABLE 1

AGE-BASED NETWORKS

Age range	Description
Baby Boomers (1946 – 64)	Gilt Edge Lifestyles Mid Life Affluence Modest Mid Years Advancing Status Ageing Workers
Generation X (1965 – 81)	Successful Starts Happy Housemates Surviving Singles On The Breadline Flourishing Families
Generation Y (1982 – 95)	Happy Housemates Surviving Singles On the Breadline

Source: www.experian.co.uk.

TABLE 2

NETWORKS BASED ON PERSONALITY TYPES

Personality type in retirement	Description
Empowered Reinventors (19%)	Can easily adapt to change – welcome adventure and new challenges
Carefree Contents (19%)	Optimistic about coping with change – but do not seek adventure or new challenges
Uncertain Searchers (22%)	Recognise change could be fulfilling and satisfying, but still trying to make sense of change
Worried Strugglers (40%)	Worried, bored or saddened after the change. Lack of planning and preparation play a role here

Source: *The New Retirement Mindscape* (Ameriprise Financial, January 2006).

7. How to implement: A life cycle fund plus corporate platform

In this section, we look at one way of implementing our strategy: using a life cycle fund and a corporate platform.

A life-cycle fund manages savings and loans around key life events: paying off student loans and future debt management; tax-efficient short/medium term savings vehicles (such as Individual Savings Accounts in the UK) and share incentive plans; house purchase; marriage; children and school fees; holidays; retirement; inheritance and tax planning; long-term care.

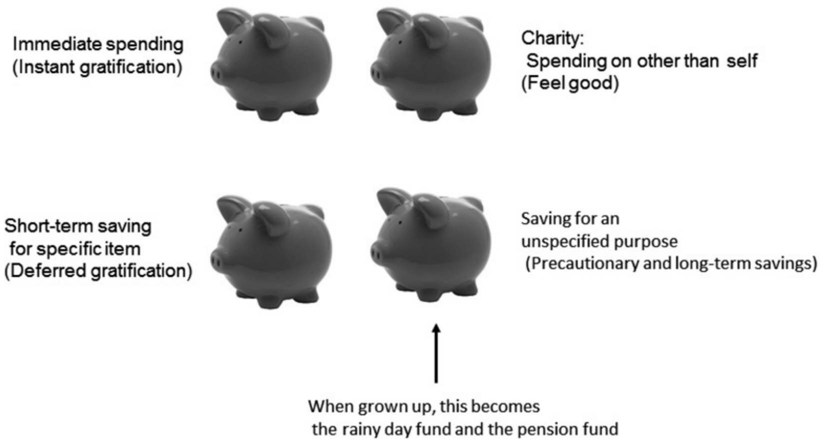
The plan can be implemented using a (corporate) wealth management platform (or wrap) with the employer as facilitator, thereby exploiting one of the most effective networks listed in section 6.

An important question to address is how much choice and flexibility should be offered. Econs like lots of choice and flexibility. Many people, especially the young, claim to like choice and flexibility, especially the flexibility to delay starting a long-term pension savings programme! This suggests the platform should provide lots of self-selection. But is this really suitable? *Humans* do not really like that much choice and flexibility. Rather they like well-designed defaults. This suggests that they should be offered suitably segmented information and products, selected on the basis of effective client profiling (such as that based on the personality types listed in Table 2).

Finally, we need to recognise that savings is a habit that needs to be engendered from a very early age: first, get ‘em young! One simple way of doing this is to have four boxes for pocket money as shown in Figure 5. The first box (labelled ‘instant gratification’) is for savings that are available for immediate spending. The second box (labelled ’feel good’) is the charity box, savings to be used for spending on someone other than oneself, such as buying a present for Mum. The third box (labelled ‘deferred gratification’) is short-term saving for a specific purpose such as a toy: when sufficient money has been saved to buy the toy, it is purchased. The fourth box (labelled ‘precautionary or long-term savings’) is savings for an unspecified purpose. When grown up, this turns into the life-cycle fund.

FIGURE 5

FOUR BOXES FOR POCKET MONEY



SOURCE: PREPARED BY THE AUTHOR.

8. Conclusions

Behavioural economics teaches us that we should assume nothing or at least very little when it comes to improving the life-cycle consumption-savings balance for most people. Products and marketing strategies should be designed with the abilities of less sophisticated, less experienced population in mind: this will involve guiding choices, choice-editing etc. Wherever possible, we should work with human biases – not against.

Nudging will help if the product design is good. Another critical lesson is that the default features of the pension plan should be well designed. These are the default contribution rate, the default investment strategy during the accumulation phase (including the de-risking glide path leading up to retirement) and the default income withdrawal strategy in decumulation (which must involve the purchase of a lifetime annuity at some stage). There is absolutely no point in nudging people towards a poorly designed pension plan. **Networks** can help support and reinforce good individual behaviour.

Well-designed pension plans recognise the need to help both *Human Spenders* and *Human Hoarders*. People need reassurance that it pays to save. Pension death benefits need to be as generous for annuities as they are for income drawdown. Phasing into annuitisation may be more acceptable. Annuity products with equity linking might be valuable for those who are sufficiently risk tolerant.

An important lesson of behavioural economics is that better communication and education alone will not work. There is an overriding need for a well-designed default option. As David Laibson of Harvard University has said: 'Education is no substitute for a good default'[4]. This is because the vast majority of individuals will not be able to design their own retirement income programme. Who wants to go into a car show room and be offered a choice of car kits to self assemble? All the heavy lifting has to be in the design of the default.

References

Blake, D. and Boardman, T. (2012) Spend More Today Safely: Using Behavioural Economics to Improve Retirement Expenditure Decisions, Pension Institute Working Paper, www.pensions-institute.org/workingpapers/wp1014.pdf

Mitchell, O, and Utkus, S. (2004) Pension Design and Structure: New Lessons from Behavioral Finance, Oxford University Press, Oxford.

Thaler, R, and Benartzi, S (2004) Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving, Journal of Political Economy, 112, S164-S187.

Thaler, R, and Sunstein, C (2008) Nudge: Improving Decisions about Health, Wealth & Happiness, Yale University Press, New Haven & London.

4 *Pioneer Investment's European Colloquia 2007.*

PART I

INDIVIDUALLY-FUNDED PENSION SYSTEMS AND CORPORATE GOVERNANCE

THE RESPONSIBILITIES AND RIGHTS OF ADMINISTRATORS IN THE COMPANIES WHERE THEY INVEST THE PENSION FUNDS AND THEIR CONTRIBUTION TO THE IMPROVEMENT OF CORPORATE GOVERNANCE: CURRENT INTERNATIONAL EXPERIENCE

ALEJANDRO FERREIRO[1]

1 *Alejandro Ferreiro graduated as a lawyer from the University of Chile and is a Master of Arts of the University of Notre Dame, U.S.A. He was Minister of Economy in Chile from July 2006 to January 2008 and has served in other important positions in the Chilean government, such as Superintendent of ISAPREs (1996-2000), Superintendent of Electricity and Fuels (2000), Superintendent of Pension Fund Administrators (2000-2003), President of the Risk-Rating Commission (2000-2003); member of the Anti-Monopolies Commission (2003-2004); Superintendent of Securities and Insurance (2003-2006). He has been a member of the Executive Committee of the International Association of Insurance Regulators (2204-2005) and president of the International Association of Pension Supervisors (2002-2003). During the year 2006 he was a member of the Presidential Advisory Commission for Pension Reform (Marcel Commission).*

The aim of this present article is to reflect on the responsibility and the rights of Pension Fund Administrators (AFPs), with regard to improving the corporate governances (CG) of the companies in which they invest the pension resources, either by means of securities that represent capital (shares in companies or funds) or through debt instruments.

The first chapter will give a brief description of what is meant by CG: explaining the current relevance of this issue and why we can say that pension funds must inevitably give some thought to it; identifying the components of a good CG that are worth promoting or encouraging and stating how the agenda of relevant issues in CG matters is fundamentally defined by the nature of the conflicts of interests in each company. The nature of conflict of interests depends fundamentally on ownership structure, and the probable risks and breakdowns in the functioning of CG follow on from there. We shall see that it is not possible to import recipes from the Anglo-Saxon world without due thought, because that world is characterized by highly diversified company ownership compared with the Latin American, Asian or Eastern European world, where in the prevalent ownership structure there is generally a relatively identifiable controller in almost all the companies quoted on the stock exchange, either directly or through an agreement.

As a second chapter, in the context of a world that is turning social accountability into an imperative, there is a reflection on the AFPs' responsibility to promote improvements in an active and efficient manner in the CG practices of the companies where they invest the pension resources. There we shall review the reasons that motivate us to consider this as an important proposition. Finally, there are conclusions.

I. Corporate Governance or Government

I.1 Concept and fundamental trends

The concept of CG is the set of processes, mechanisms and ground-rules agreed between the owners, board and management for directing the company, reaching the set targets, generating sustainable value over time for shareholders and responding to the legitimate demands of other stakeholders. These targets should be to generate sustainable value over time for all shareholders and respond to the legitimate interests of other stakeholders who are, in the end, those who guarantee the sustainability of the creation of value over time.

The generation of value is a principal target that cannot be avoided. Companies must earn money because otherwise they will be unable to reach any target at all. But that created value must be fairly distributed, among all the shareholders in the first instance. Fairness between shareholders justifies the concern about the rights of minority shareholders who, when there is a concentration of share ownership, may find themselves adversely affected by some kind of expropriation of value by the controller, such as related operations at unfair prices, sales of control in the company with a bonus that is not shared with other shareholders, advantage taken by the controller of the company's trading opportunities, etc.

In the case of companies where ownership is very fragmented, it is assumed that the distribution of value will guarantee that the flows generated will actually reach the shareholders and not remain entangled in excessive wages or benefits for the management. Here the conflict of interest and risk of failure corresponds to the classic agency problem, in which the agent (the management) may be inclined to neglect the interests of the owner in favour of his own objectives.

What is the new context emerging today in the thinking about CG? What are boards of directors being asked increasingly to provide in companies today? Markets and, strictly speaking, legislations also, seem to be increasing demands on directors. It is no longer enough to have "remote governance", where the board simply meets once a month, defines a certain strategy and contents itself with choosing, or believing it has chosen, a good Managing Director. The new standard assumes the acceptance of a more demanding and direct role and, although care is taken not to invade the field of action specific to the management, it demands greater knowledge of what goes on in the companies, because otherwise risk control, which is a function of the board, becomes impossible. Nobody can exercise risk management from a position on the board without being familiar with the essential risk matrix of the company, and that requires a level of involvement which is no longer merely superficial or skin-deep. Directors can no longer get away with meeting once a month for a couple of hours. They must work on committees, gain access to information and understand it, because we are moving from indirect government to an increased involvement, which is also consistent with the legal responsibilities that company directors are increasingly having to face.

What is being asked of the board? That it should be capable of setting its sights on the long term, define strategies and offset the administration's tendency to look at the next quarter, the next financial statement, the next variable bond based on the financial result, to set its sights a little further off. It is the board's job to impose the logic of long-term sustainability and that is yet another function that calls for a much greater degree of involvement and understanding of the fringe variables of the business. It is also the board's job to understand what is happening in the context.

It is difficult for the management to be perfectly au fait with the impacts that the company may have with regard to all the stakeholders.

A board is expected to be able to put the regulatory impacts and the reputational, legal and political risks on the table, in order to include the external or contextual view in the strategic and risk-management analysis.

As a result of the financial scandals and the regulatory reaction of the past few years, companies and their directors are, paradoxically, dedicating much more time to "compliance", to seeing how to comply with the regulations and leave a formal written record of having done so, than to the fundamental management of strategy and risks. Regulation consumes increasing amounts of urgencies and time in the "post-Enron" and "post Dodd Frank" era in the United States, or the "post La Polar" in Chile. It should come as no surprise that the time that used to be dedicated to the board is no longer enough. The regulatory demands, added to the need to understand and manage risks and encourage the creation of sustainable value, call for more than a monthly meeting or a merely superficial involvement.

So, the current trends in CG matters are, to summarise: i) greater legal responsibilities; ii) increasing professionalization of directors; iii) evaluation of directors; iv) setting up of training or gap-closing programs so that directors and the board improve their performance; v) professional recruitment of directors, especially on the part of institutional investors like the AFPs. If the institutional investors have political rights that allow them to elect directors, it is not only reasonable, but demandable that those directors should meet the standards that this new context requires.

I.2 Relevance

Corporate Governance: a hot issue

Why is Corporate Governance a hot issue, an unavoidable issue?

First, because of the significant financial scandals that have occurred recently, to which, predictably, the regulatory reaction has not been slow in coming. When value is destroyed, in the way that value is destroyed with the financial scandals that we have become familiar with in the case of La Polar in Chile, a scandal of a retail company that falsified its financial statements by overestimating its assets as receivables, which were in the end impossible to collect: a destruction of value equivalent to 0.5% of the gross domestic product. To put this in context, the fall of Enron in the United States meant 0.55% of the GDP of the United States and Parmalat, 0.48% of the Italian GDP. And so you will find examples in other countries where, obviously, the economic significance and impact on the pension funds generated great debate and public concern, even though the rules for diversifying investments minimise the real impact on pension savers. There is low political and social tolerance for these scandals and the politician and the regulator are therefore expected to adopt measures to prevent such cases occurring. With retrospective logic, we try to correct what we understand to have been the cause of the fault that allowed the scandal to occur, and regulations increase. Some of these regulations are cost-effective, but others, the majority, tend not to be.

The second factor is explicable because in periods of "hyper" transparency, when everything is known, companies cannot allow themselves to have significant faults in their CG. The destruction of the value of the trademark, the destruction of reputation, destroys value to a very significant extent that is difficult to restore. In the era of Facebook and Twitter, in which nothing can be hidden, bad news spreads unstoppably and the cost of the fault may therefore be lethally high for companies. As a result, if everything that we do in a company is known, it behoves us to look good and do things well, because the cost of doing things badly is becoming, increasingly, impossible to pay.

A third element lies in the importance of good corporate governance as a competitive factor in the capital markets. Given what has been said above, it is evident that for a capital market regulator, a Minister of Economy or Minister at the Treasury, for all those who want to encourage the capital markets to operate well, it is absolutely essential to correct CG issues in order to foster investors' confidence, reduce funding costs and so have a positive influence on the cycle of saving and investment. The matter is obvious: if the perception is that corporate governments do not work, how do you raise capital? How do you place a bond? How can you manage to achieve reasonable interest rates? It is definitely of the essence of a smoothly running capital market that CGs should function properly, so that the risk premium can be reduced and finance can flow efficiently.

Furthermore, in those countries in which there is political debate on extending investment alternatives to corporate instruments (bonds or shares), it is much easier to defend this option when the functioning of the issuers is reliable. Consequently, from the point of view of the grounds for expanding the investment portfolio to include corporate instruments, safeguarding a good CG is also essential.

As a fourth element, companies are realising increasingly that having a high-quality board of directors is a competitive factor, insofar as it contributes towards defining long-term strategy, managing risks and incorporating complementary views into the strategy that help to make the business sustainable. Furthermore, there is clear evidence that a good CG is recognised and rewarded by investors and creditors with lower costs for capital. As a result, the companies begin to realise that they should not allow the board to consist of the owner's friends, because doing so has a high price, and that it is better to make up the board with professional directors, even when they ask uncomfortable questions, challenge inertias and impose demands that are unknown in traditional ways of management.

Finally, as the fifth element, we must consider the political hyper-sensitivity of the damage that certain scandals may cause in the pension funds. It is true that diversification mitigates the risk, but every time there is problem that affects the value of the pension funds, there is a very strong political/regulatory reaction, so it is unreasonable to expect pension funds not to adopt measures to mitigate or prevent the recurrence of cases such as those that have rocked the market. It will not be possible for them to avoid them, but it is possible to adopt strategies designed to reduce the probability of these cases occurring.

And this has clearly occurred at worldwide level. The activism of the institutional investors, especially the large-volume pension funds such as those in the United States and Canada, has turned them into the great promoters of good CG practices. So there is a certain example, though in a different context and with different targets and agenda, in that the pension funds of the Anglo-Saxon world have taken up the active promotion of best practices in this matter as an essential function.

There are some correlations that should be borne in mind. Certainly, if an AFP is a shareholder, it has more at stake in the company than if it is merely a bond-holder and if it is neither a shareholder nor a bondholder, the pension funds cannot be expected to have a role in this area. In other words, the involvement and relevance of the role of the pension funds in this area is directly proportional to the possible investment space for corporate instruments.

A second factor to be borne in mind has to do with regulatory effectiveness. As a matter of fact, the greater the ability of state regulation and supervision to prevent CG failures, the less the market premium will be for those issuers with good individual conduct and, consequently, the less the challenge of the institutional investors. On the other hand, if it is perceived that regulation does not work and that supervision is ineffective, then the willingness to pay for those companies that counteract the weaknesses of the regulatory environment is much greater. I therefore believe that in Latin America, where the expectation of regulatory effectiveness probably tends to be lower, the premium for management perceived to be good in CG is as high as the contribution that the pension fund administrators can make on promoting it.

I.3 Risk as an opportunity for mitigating action by the administrators

Figure Nº 1 shows a map of risk, in which the premium for doing things well will depend on regulatory quality and effectiveness and the depth and liquidity of the local market. For a pension fund, being able to buy a share is not the same as being able to sell it quickly, and that occurs in deep, liquid markets, than being obliged to do a “buy and hold". In other words, once an investor has entered a company, he is almost condemned to stay there for a long time, because of the lack of depth and liquidity of the market. In that situation, where one cannot “vote with one’s feet”, where it is impossible to penalise an issuer by withdrawing investment because it very expensive or costly to do so, the correlative responsibility is to have as much influence as possible on the good CG of the company in which one has invested.

FIGURE Nº 1
QUALITY AND EFFECTIVENESS OF REGULATION

SOURCE: THE AUTHOR.

I.4 Pension Funds and CG: comparing records between the Anglo-Saxon world and Latin America

In the Anglo-Saxon world, there is over 40 years' experience of "activism" on the part of institutional investors, mainly the large pension funds. For example, the Calper's pension fund of public employees in California; the TIIA-CREF of teachers in the United States or the teachers' Pension Fund of Ontario, Canada, are investors recognised for their efforts to promote good CG practices.

What were their great conflicts, their great battle standards in the 70s and 80s? To avoid the company managers' practice of preventing "hostile" takeovers. Let us remember that when there is fragmented ownership, either the owner is virtually non-existent, or there are so many, with so many coordination problems, that the real owner is the manager. One way of producing discipline in companies' management is through taking over the control of companies with poor performance. So a bad manager ran the risk of being displaced by new owners desirous of changing course. In the face of the risk of "hostile" takeovers, many managers – and directors – thought out defensive mechanisms known as "poison pills", those poisonous pills that put impediments of all types in the way of company takeovers.

In the 90s and the 2000s, the burning issues were trade-offs: how to achieve specialisation of directors, and how to find ways of measuring their performance and that of the boards. Election systems were also an issue. Many of us would be surprised to discover that the boards of directors, the councils of administration in the most important North American companies, are self-generated on the basis of proposals made by the management itself. The owners have very few political rights to enable them to change the directors. This is part of the challenge that is mooted as a work agenda for the pension funds of the Anglo-Saxon world.

In the case of the AFPs in Latin America, the issue is different; the root of the dilemma is in the possible conflict of interest between the controllers and the minority shareholders. The regulatory emphasis has therefore been placed above all on defending the interests of minority shareholders through regulations such as operations between related parties - so that such operations are carried out at market prices-, regulations that deal with taking control of companies, etc.

Recent examples of pension fund "activism" in the Anglo-Saxon world

On 12th February 2012, the Calpers Fund of public employees in California led a coalition of institutional investors at worldwide level which proposed a set of top-priority reforms for capital markets to protect the rights of shareholders and reinforce investors' confidence. There were 14 pension funds, managing funds totalling USD 1.6 billion, taking part in the initiative to urge Mary Shapiro, director of the Securities and Exchange Commission (SEC) to "complete the work" of reform promised after the financial crisis and speed up the application of the post Lehman Brothers regulations.

Another illustrative case, this time from the Calpers Fund, consists in what is known as the "focus list". This is a list of companies which they believe comply with best CG practices. Belonging to this list produces what is known as the "Calpers effect" in the North American capital markets, in other words, the increase in the value of the share as a result of this form of tacit certification of good corporate governance practices.

There is something similar in the CG policy definition of the most important pension fund in the United States, the TIIA-CREF. This fund establishes a set of good CG practices, and it expects the companies in which it invests to comply with them.

As a result, there is relevant activism of the pension funds in the Anglo-Saxon world, associated with the predominant type of conflict of interest, which is the risk of the senior management using its powers against the shareholders by generating excessive trade-offs or even protecting inefficiencies by placing barriers to control takeovers on the part of other companies or investors.

I.5 Components of a good Corporate Governance

The emphasis of the various components of a good CG will depend on the "risk map", which in turn is a result of the ownership structure and the effectiveness of state regulation and supervision.

The first component to be mentioned is the generation of value, and it is necessary to have strategy, long-term vision and innovation to achieve that.

A second element is to be found in the "correct or just" distribution of the value created, between the various shareholders and also between the different shareholders and other stakeholders.

A third element consists of sustainability. On the one hand, risk management, supervision and control are important to prevent frauds. On the other, the current context is transforming Social Business Accountability (SBA) into something that is no longer merely a recommendable option, but a core element in long-term sustainability policies.

Finally, a fourth component has to do with the corporate institutional framework. The present situation forces us to think of companies' institutional framework, of clarity in roles, procedures and internal controls, of the existence of specialised committees, of alignment of discourse and incentives and also of evaluation, complementation and training (gap-closing) inside the board. If it is decided, for example, that risk control is important, but all the variable bonds of the executives leave out risk control considerations, what is the company's real discourse? What is stated in the ethics handbook or the way in which the variable trade-offs are constructed?

Company ownership, risks and challenges about corporate governance

TABLE Nº 1

Diversified ownership: companies "without an owner"	**Concentrated ownership: controllers and minority shareholders**
• General rule in the Anglo-Saxon world and especially in the USA. • Agency problem: managers pursue their own interests at the owner's expense.	• General rule in Latin America and Asia. • Effective control on the part of the majority shareholder is assumed, reducing the likelihood of the Anglo-Saxon agency problem. • The risk has to do with the possible extraction of value by the controller (and senior management) to the detriment of the minority shareholders.
• **Risks or threats:** - Trade-offs and retirement plans - Restrictions on buy-outs and mergers (poison pills) - Stock options and incentives for creative accounting - Confusion of roles: the CEO often chairs the board - Conflict of interest exacerbated in choice of external auditors and risk rating firms.	• **Risks or threats:** - Operations between related parties with low trading prices. - Transfers of control with a premium that is not fairly distributed between all the shareholders. - Excessive fees for directors. - Appropriation of trading opportunities on the part of the controller.

SOURCE: THE AUTHOR.

In Table Nº 1 a comparison is made between the characteristics of the types of ownership in the Anglo-Saxon world and those in the Latin American and Asian world, with their respective risks and threats. In diversified or "ownerless" ownership styles, such as the North American, there is a type of risk and a type of "remedy" that seeks to guarantee that the management is really conducted for the owner's benefit. Meanwhile, in concentrated ownership styles, we have another type of risk: that the owner who controls the management may possibly expropriate part of the value of the minority shareholders. There are risks in both cases and there is a space that may reasonably and sensibly be occupied by a certain activism, in the best sense of the word, on the part of institutional investors, to guarantee that best CG practices prevail.

II. Towards effective AFP leadership in the promotion of good Corporate Governance practices

II.1 Grounds

There are at least three grounds or reasons why it is positive for the AFPs to promote good CG practices in the companies where they invest the pension resources.

First, good CG practices coincide with the fund's best interest, because they improve the risk/return prospects of the investments in private issuers. Furthermore, these practices correspond to the level of diligence to be expected of large investors which have a fiduciary role defined by law and which, in many cases of markets with little liquidity and depth, are in no position to penalise bad CG simply by "voting with their feet", withdrawing their investment and choosing another type of investor. It is certain that as investment frontiers open up and it becomes possible to invest abroad, as has already happened in a fair proportion of Individually-Funded Systems, this "voting with one's feet" becomes a possibility, but restrictions tend to subsist that keep the funds "captive" to a certain extent, in terms of local issuers being the investment destination.

Second, good CG practices contribute towards reinforcing a good reputation for active performance of the fiduciary role proper to institutional investors. If one asks the North American pension funds that operate according to these practices, they will undoubtedly acknowledge the positive reputational value of management styles that help to align the conduct of the fund with its participants' expectations.

Third, as we have already said, good CG practices help to produce a favourable political/regulatory climate for diversifying investments and expanding limits in private issuers. If one works on mitigating the risks of CG failure, it is much easier to justify the argument of diversifying investments to the corporate world as well.

In brief, an active encouragement of good corporate governance practices helps to prevent future scandals. But even in cases where such scandals occur anyway, it will allow the pension funds to argue that such failures have occurred despite their best efforts and not as a result of their passive behaviour or laziness.

The premium that investors are prepared to pay for good corporate governance

In Table Nº 2 we show a list that reveals the premium that investors would be prepared to pay if companies had good CG. The evidence is that there is a premium for companies in doing things well, and correlatively, a premium for investors if this occurs. The premium is greater in countries where the perceived risk is also greater. Later studies that have been carried out confirm the trend. The average premium in emerging countries is 25%.

TABLE Nº 2

PREMIUM FOR GOOD CORPORATE GOVERNANCE

Germany	20.2%
Argentina	21.2%
Belgium	19.6%
Brazil	22.9%
Chile	20.8%
Colombia	27.2%
Korea	24.2%
Spain	19.2%
USA	18.3%
France	19.8%
Netherlands	18.5%
Indonesia	27.1%
Italy	22.0%
Japan	20.2%
Malaysia	24.9%
Mexico	21.5%
United Kingdom	17.9%
Sweden	18.2%
Switzerland	18.0%
Thailand	25.7%
Taiwan	20.2%
Venezuela	27.6%

SOURCE: MCKINSEY, INVESTOR OPINION SURVEY, JUNE 2002.

II.2 Possible components of a strategy

First, it seems to me that an explicit leadership position can and must be taken up in the public debate on these matters. This has happened, but there is always room to be even more active.

Second, it is necessary to encourage the promotion of solid measures:

(i) To choose directors in a professional manner.

(ii) To favour professional risk management, including measures to detect corporate fraud.

(iii) To produce guidelines and recommendations concerning the fulfilment of duties of loyalty and care on the part of directors.

(iv) To promote and disseminate guidelines with regard to the evaluation of boards and directors, to improve their internal dynamics and close gaps in skills and knowledge among directors.

(v) To support debates and specialised courses for directors.

(vi) To favour the explicit and significant consideration of essential CG factors on the part of risk-rating agencies.

(vii) To make an explicit correlation between investment decisions and the perceived quality of the issuer's CG.

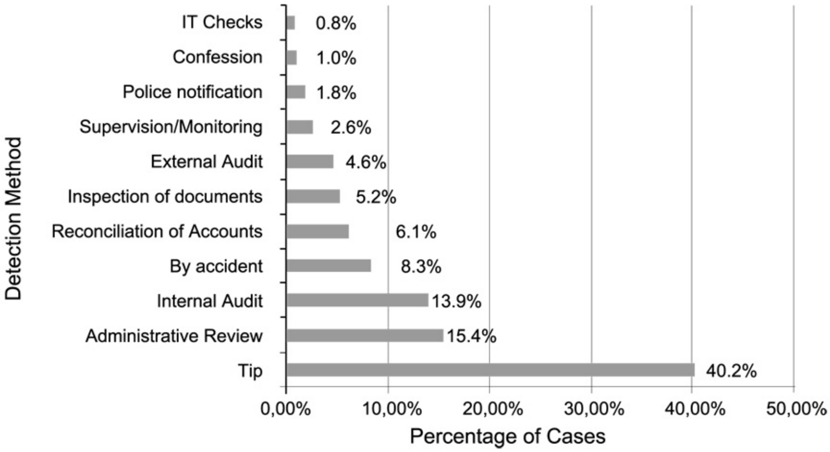
(viii) To establish Codes of Good Corporate Practices.

A documented case of good practice: to encourage confidential channels for complaints

The evidence of recent years is that the great scandals and destructions of value at corporate level have to do with frauds. In the face of that evidence, it is imperative that we concern ourselves with fraud prevention and its early detection. In that context, it is interesting to analyse the available studies on forms of corporate fraud detection around the world. Figure Nº 2 is based on a study of 1,900 documented fraud cases, arranged according to the way in which they were detected. It is really remarkable to see the enormous relative importance of the tip, especially when supplied by the company's own employees through anonymous complaints channels. That is how 44% of detected frauds are brought to light. Frauds detected by external and internal audits occur far less frequently.

So, when one is aware of fraud's potential for destroying value and one knows how to achieve early detection, the unavoidable conclusion is that the installation of confidential complaints channels within companies is a mechanism that must be promoted by any corporate government that claims to be diligent in risk management. As in the case of complaints lines, it is possible to identify many other good practices to improve the way in which sustainable value can be created in companies and which they can and must adopt in their management.

FIGURE Nº 2
INITIAL DETECTION OF PROFESSIONAL FRAUDS



SOURCE: 2010, GLOBAL FRAUD STUDY ASSOCIATION OF CERTIFIED FRAUD EXAMINERS.

III. Conclusion

I want to make the following points, by way of conclusion:

(i) Good CG has a positive influence on higher expected returns and lower investment risk.

(ii) Favouring good corporate governance practices is a component of the fiduciary accountability of long-term investors.

(iii) The emphases and priorities will depend on the type of risk or threat. There is no place for importing "Anglo-Saxon remedies" without due thought.

(iv) The residual risk for institutional investors as a result of bad CG practices will depend essentially on the typology of the conflict of interest, the effectiveness of regulation, the depth of the local markets and the flexibility for structuring investment portfolios.

(v) The explicit, active adoption of a strategy to promote good practices offers: (a) a positive effect on the long-term yield of the assets; (b) reinforcement of the Administrators' reputation as active custodians of their funds' interests; and (c) improved political prospects for extending investments to local corporate issuers.

(vi) Although every reality offers a variety of risks and challenges, there is abundant evidence of good CG practices and their potential impact. The issue is not merely ethical and neither is it ambiguous. "What ought to be" is acquiring profiles that are increasingly clear and demanding, but also achievable.

CORPORATE GOVERNANCE AND THE PRIVATE PENSION SYSTEM IN PERU

LUIS VALDIVIESO[1]

1 *Luis M. Valdivieso has a Doctorate and Master's in Economics from the University of Boston, USA and a Bachelor's Degree in Economics from the Catholic University of Peru. He has over 35 years' experience in the design and implementation of economic and financial policy at local and international level, in financial planning, project funding, and economic and academic research. He has been Minister of the Economy and Finance and Peru's Ambassador to the USA and occupied a high position in the IMF for 28 years. In February 2012 he was appointed President of the Association of Private Pension Fund Administrators (AAFP) and Vice-president of the International Federation of Pension Fund Administrators (FIAP).*

This article illustrates some aspects of how the AFPs in Peru are trying to encourage corporate governance, not only at the internal level but also in the companies where they invest the workers' pension resources.

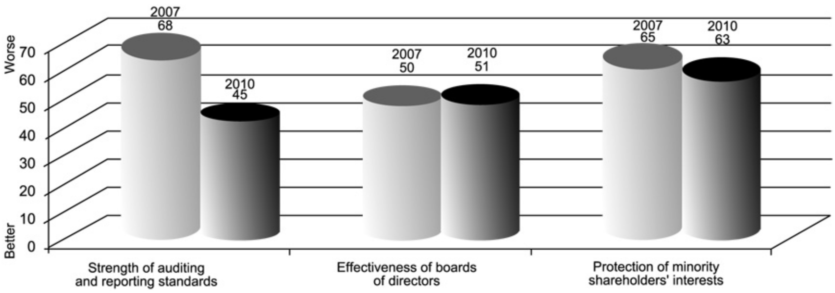
It deals with the following topics: (i) Peru's competitiveness in Good Corporate Governance; (ii) limits to the AFPs' exercise of due diligence in investing the pension resources; (iii) quality of the information delivered to the market concerning the securities that make up the pension funds; and (iv) institutional regulation and design to prevent frauds.

I. Competitiveness of Peru in Good Corporate Governance

The competitiveness ranking produced by **The Global Competitiveness Report** (see Graph Nº 1), indicates that there has been considerable progress in Peru in terms of the strength of its auditing and reporting standards, while there has been a slight deterioration in the effectiveness of boards of directors and a slight improvement in the protection of the interests of minority shareholders.

GRAPH Nº 1

PERU: COMPETITIVENESS RANKING 2007-2010

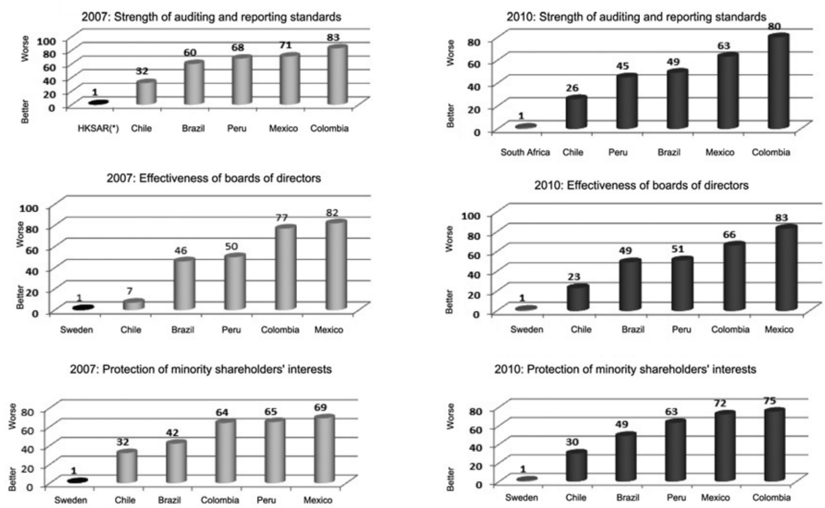


SOURCE: WEF – THE GLOBAL COMPETITIVENESS REPORT 2008 – 2009; WEF - THE GLOBAL COMPETITIVENESS REPORT 2011-2012.

By comparison with the Latin American countries that have investment grade (see Figure Nº 1) it is possible to see a generalised improvement in 2010 in the strength of auditing and reporting standards, with Peru advancing slightly more quickly and almost catching up with Brazil. By contrast, the effectiveness of the boards of directors has been poorer in almost all countries except Colombia. With regard to the protection of the interests of minority shareholders, a slight improvement may be seen in Peru's case, but a substantive decline in Colombia, Mexico, Chile and Brazil. Shown for reference are the countries that occupy the first places in these rankings: Hong Kong and South Africa in terms of the strength of their auditing standards and Sweden in terms of the effectiveness of boards of directors and the protection of minority shareholders' interests.

FIGURE Nº 1

COMPETITIVENESS RANKING OF GOOD CORPORATE GOVERNANCE



SOURCE: WEF – THE GLOBAL COMPETITIVENESS REPORT 2008 – 2009; WEF - THE GLOBAL COMPETITIVENESS REPORT 2011-2012.
(*) HKSAR=HONG KONG SPECIAL ADMINISTRATIVE REGION.

It is important to have these general indicators for reference, because they make it possible to find out how institutional legal arrangements are developing within each country.

II. Limits to the AFPs' exercise of due diligence in investing the pension resources

The AFPs should be an example or model of Good Corporate Governance. The Supreme Decree of the Peruvian Government Nº 004-98-EF (Art. 60) stipulates that each AFP must adopt the principles of good corporate governance and improve practices applicable to its administrative management and to the investment process of each fund that it manages, taking for reference the best standards available in the matter. The Superintendence of Banking, Insurance and AFPs (SBS) and the Superintendence of the Stock Market (SMV) ensure that these principles and practices are adequately observed.

The AFPs must likewise be proactive in disseminating Good Corporate Governance by their practices and through their representatives at shareholders' meetings and boards of directors. The second paragraph of article 94 of the regulation of the Single Ordered Text (TUO) of the Private Pension System (SPP) of Peru states that the representatives elected "… to exercise the rights and obligations derived from the investments made with the Fund's resources… shall ensure the defence of the rights corresponding to the Fund, independently of the interests of the AFPs, shall adhere to the practices of good corporate governance and shall encourage the adoption of these in the governing bodies in which they exercise their responsibility…" [2]

Taken as a group, the AFPs currently have 29 members in their own boards of directors and 31 independent directors in companies that make up part of the pension funds' net worth.

In the words of Article 2 of SBS Resolution Nº 3282-2010, an independent director is one who is chosen for his/her professional prestige and who is not linked with the company's management, with its economic group or with the company's main shareholders. The "link" is defined in the special Rules on links and economic groups, approved through SBS Resolution Nº 445-2000. The independent director of a company may be an independent director of other companies in its economic group.

In order to meet these strict criteria, the AFPs have professionalized the selection of independent directors who represent them as minority shareholders of the companies where they invest. The AFP Association has hired "head hunters" in order to eliminate any suspicion with regard to the electing of "friends". What happens today is that the head hunter is asked to talk with the companies, to analyse the composition, strengths and weaknesses of the board of directors and the professional balance required, in order to be able not only to guarantee the dissemination of good corporate governance, but also guarantee that the management of the company will follow the lines put forward by a board of directors that is fairly balanced in terms of its abilities and, undoubtedly, honest.

Most of the share participation of the AFPs in companies is minority in nature. In order to appoint directors, the AFPs have to make a pool, by joining the shares that each one holds, and that allows them to appoint one, two or three directors, depending on the size of the combined share participation of the AFPs.

Risk rating of the investments eligible for the AFPs stimulates Good Corporate Governance in companies. The SPP has been the deciding factor in introducing

2 *According to the modification to article 2 of D 182-2003-EF dated 12/XII/2003.*

the concept of risk management in the financial market. Article 26 of the TUO of the SPP stipulated that the securities and financial instruments in which the AFPs are allowed to invest the Pension Funds must have risk ratings granted by firms authorized for the purpose, in accordance with the Stock Market Law, and under rating systems aligned with internationally accepted methods.

The Superintendence regulates and authorises the different types of investments. Consequently, the private companies that wish to access the capitals held by the AFPs must not only meet the requirements demanded by the Stock Exchange or Superintendence of the Stock Market, but must also have good corporate governance practices. At this point in time, the criterion of corporate accountability evaluation is being created in Peru, and this will have to be observed by companies desirous of selling their securities to the AFPs.

III. Quality of the information delivered to the market on the securities that make up the pension funds

The investments of the SPP Pension Funds are rated by the SBS. In Peru the range of investments is quite highly-regulated and limited and an attempt is being made to relax some of the criteria in the reform that is being debated at this very moment. Thus investments are subject to prudential limits, including global limits, meaning that the debts of the Government and Central Bank put together may not reach more than 40% of the fund and neither may foreign assets exceed 30% of the fund. (A limit of 50% has been approved but not yet implemented). Very liquid assets, such as cash, may reach up to 40% of the fund at a given moment. However, there are specific limits by asset class, whether fixed income, derivatives or equities; by issuer, both local and foreign; and negotiation limits by currency, forwards and float.

The fact is that there are over 100 limits in operation today. The AFPs have to inform the SBS about their investments every day and these are reported publicly by the regulator on a weekly basis and published on its website with a certain delay.

The AFPs also provide their members with information through the four-monthly account statements.

Press conferences are held systematically via the AFP Association on the results achieved by the SPP in its various investments and on the factors affecting the funds' yield prospects. This has been well-received by the press and the public.

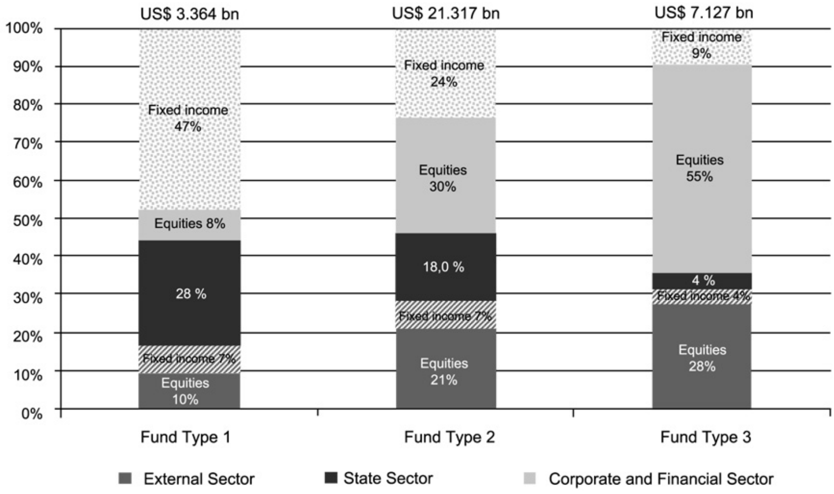
The AFPs' investment portfolio

Graph Nº 2 shows the summary of the AFPs' investment portfolio by type of fund.

Fund Type 1, the most conservative, is considerably slanted towards fixed income, with a large share in the state sector, though this is below the 40% limit established by law. Why is it not up to that limit? Because, in the first place, an attempt is being made to develop public infrastructure in Peru through the so-called public-private associations, which issue securities that the AFPs are allowed to buy. Consequently there is a certain public factor behind the purchase of these private securities, which are private as long as the concession lasts. The infrastructure eventually reverts to the public sector, but it is an indirect way of financing public infrastructure. The government therefore needs to issue treasury bonds to finance activities of this type. In the second place, the State has a surplus, and as it is not assuming responsibility for that investment, but rather deferring the acquisition of that infrastructure, this makes the positioning of the AFPs in the various funds somewhat easier.

GRAPH Nº 2

PERU: AFPS' INVESTMENT PORTFOLIO BY TYPE OF FUND (MARCH 2012)



SOURCE: SUPERINTENDENCE OF BANKING, INSURANCE AND AFPS (SBS),PERU.

The composition is progressively slanted towards equities as one enters the Type 3 Fund, which is the fund with highest risk, where most younger people are to be found, though the majority of members are in Fund 2 (with average risk).

IV. Regulation and institutional design to prevent frauds

State policies and the legal and regulatory framework

The State, through its policies and the legal and regulatory framework, constitutes the deciding factor affecting corporate governance practices. Particularly important are those measures that affect the investment climate (economic aspects of state governance). The economic instability produced by irresponsible economic policies, high protectionism and a populist policy of subsidies and waivers, creates a scenario that lends itself to corruption and fraud. Fortunately, the policy that has been pursued in Peru in recent decades has helped to create a climate appropriate for the adoption of good corporate governance practices.

Equally important are the standards that regulate governance in the corporate sphere: the lower the requirements in terms of transparency, responsible accounting and competence in the administration and the boards of directors, the greater the possibilities of corruption and fraud. Furthermore, for those companies with fiduciary responsibility such as the AFPs, the requirements must be stricter, because the contributors are obliged to hand over their savings to be managed. These two aspects have been amply treated and incorporated in the Peruvian regulatory framework.

Corporate level

Companies have to comply with the regulatory framework, but also have the ability to reinforce their good corporate governance practices by internal measures and processes, and so avoid misappropriation and fraud at corporate level.

The role of the various committees (administration, auditing, operations, investment and corporate governance), of the external auditors, the board of directors and the general shareholders' meeting is of key importance. In the case of the AFPs, the election of independent directors in the companies in which they invest is also critical, to ensure that those companies observe the relevant regulations and maintain Good Corporate Governance.

It is also important to refer to Alejandro Ferreiro's[3] article on the evaluation of directors. In Chile, for example, there is a register of directors which states all the

3 *"The responsibilities and rights of Administrators in the companies where they invest the pension funds and their contribution to the improvement of corporate governance: current international experience": Article produced by Alejandro Ferreiro, FIAP Book "Opportunities and Challenges for Individually-Funded Systems in a Globalised World", May 2012, Mexico.*

payments that they receive. In Peru the AFPs are asking for directors' fees to be limited, as part of good corporate governance. This is because in Peru there is a rule that allows 6% of the profits to be distributed in fees for the board. For example, in the case of a mining concern that has USD 14,000 million in profits, this would mean a fee of USD 1 million for the directors, which cannot seem correct, even though it is legal. Adopting rules for paying boards of directors is an important responsibility, because the money distributed for the boards does not come out of dividends, and therefore never reaches the members' accounts. This is what has to be defended in the final analysis.

The areas in which it is possible to go beyond the regulations include (i) developing detailed documentation of transactions open to error or fraud; (ii) clearly defining employees' responsibilities and obligations, and the penalties for non-compliance at the level of each process; and (iii) giving broader and more frequent information to stakeholders about the performance and management of the company. In the case of the AFPs, this means expanding the content and increasing the frequency of reports on the results of their management of members' funds.

CORPORATE GOVERNANCE AND PENSION FUNDS IN POLAND

ANDRZEJ NARTOWSKI[1]

1 *Andrzej Nartowski is a lawyer with considerable experience in boardrooms. He is an expert in corporate law. Currently he is the President of the Polish Institute of Directors (PID), an independent non-governmental organization focused on corporate governance. Also, he is Publisher & Editor-in-chief of "Review on Corporate Governance", a quarterly publication of the PID. He is author of the manual "Best Practices of Companies listed at Warsaw Stock Exchange"; Arbiter at the Court of Arbitration of the Financial Services Authority; and columnist, laureate of prestigious prizes in international and economic journalism.*

The Polish capital market is a fresh phenomenon, since the transformation of the Polish economy started at the very beginning of the last decade of the 20th century. This process has been successful and noticeable progress has been accomplished. However, disputes as to whether the capital market in Poland is still "emerging" or has already "emerged" have not yet been resolved. Until the Polish market reaches maturity, it is still in the transition phase.

Corporate governance is all about trust. In the era of trust-based economy, the pension fund system should be a place where money and trust meet: money to be invested and trust to be created. Pension funds are expected to guarantee the well-being of future generations by implanting corporate governance into companies in their portfolios, thus transforming money into trust at the best rate of exchange.

With the passing of time, corporate governance has been gaining significance in Poland. So the pension funds, which are important participants in the Polish capital market, have also gained significance. Yet it should be admitted that neither of the essential components of the market, corporate governance and pension funds, has advanced enough. Corporate governance is not a prevailing feature of pension funds and pension funds are not making sufficient efforts to promote and implement corporate governance.

The Polish system of corporate governance may be called "transitional". In its core it is a product of the economic transformation from a centrally-planned to a free-market economy: a genuine local product, since Poland has not imported a set of ready-made corporate governance principles from more developed markets. The first Polish corporate governance code, Best Practices of Public Companies 2002, was adapted to urgent local needs. Following the internationalization of the economy and the internationalization of the Warsaw Stock Exchange in particular, subsequent codes have been less and less local in character.

As corporate governance is located somewhere between the market and the law, Poland faces a hard dilemma: a conflict between corporate governance and the legal system. Company law is deeply rooted in the mid-XIXth century German tradition while corporate governance in its present shape follows a modern Anglo-Saxon model. Company law permits only a two-tier system in the company's organisation: instead of a single board of directors in one-tier system, here the supervisory board (often purely ornamental) and the management board (operational) are strictly separated from each other, and independent directors, board committees (auditing and remuneration) or a supervisory board member's personal responsibility for the company's financial statements are still novelties.

Another novelty is the supervisory board's involvement in risk management. It is, of course, the domain of the management board, so the supervisory board is not directly responsible for managing risk, but it is responsible for the evaluation of the company's system of risk management as well as for the evaluation of the company's system of internal control (if indeed such systems operate in the company). Anyway, numerous supervisory boards do not fulfill their mandate. They hold meetings once in a blue moon and their members feel themselves representatives of particular shareholders' interests (often conflicting among themselves) rather than of a common interest.

In general, companies are overregulated, especially in the field of reporting duties. Recent research from the Polish branch of Mazars, an auditing and consultancy firm, has shown that Polish companies are obliged to report too much, far more than companies in Great Britain, France or Germany. Yet the capital market is underinformed.

Polish companies, particularly those listed on the stock exchange, are under strong pressure from the European Union. Brussels (the EU headquarters) produces a lot of new directives, far more than Poland is able (or, to be sincere, is willing) to implement. They aim at introducing more reliable financial reporting, to increase market confidence in companies. In consequence, Polish supervisory boards sometimes – above the letter of Polish law – invade the restricted domain of the management boards and make direct contact with the subordinates of management, namely the financial services, risk managers, internal auditors, or compliance officers. Sometimes attempts may be observed to establish a double subordination of internal audit both to management and supervisory boards.

There is a pressure to apply some Anglo-Saxon solutions which have proved to be much more efficient, because the Anglo-Saxon board of directors is plugged into the company, while our supervisory boards are unplugged, and separated from the current activities of the company. On the other side, expansion of corporate governance is encouraged both by the significant inflow of foreign capital and by the growing shareholder activism.

Since the beginning of Polish transformation in the early 1990s, an aggressive invasion of politics into economics can be observed. The State's ownership domain is still of considerable size, and the State tends to play a dominant role even in privatized companies already listed on the stock exchange where it holds only a minority stake. As a result, managers of companies under the State's (too) strong influence face the "revolving door trauma": they often enter the company only to be forced soon to leave. Pension funds, as well as other institutional investors, take a passive stand and do not confront the State as an over-active shareholder.

The Polish economy is strong. We are on the sunny side of the street nowadays, as never before in our recent history. GNP is rising, society is highly entrepreneurial, growth is promising, privatization is in progress, and the stock exchange is gaining capitalization. Against the spirit of crisis prevailing in Europe, Poland's prospects seem bright. But there is a dark cloud expected to appear over Poland shortly and it is a demographic one. Society is getting older, more affluent and childless. A considerable number of the most promising young people, the very best and brightest, emigrate, mainly to the British Isles, and they are much more fertile there than in Poland. It means that the demographical situation is collapsing and we are facing an alarmingly growing pension gap.

This is the moment when the pension funds entered in 1999, bringing hope and comfort to the economy. There are fourteen of them with 15.5 million members; it seems that economy is too small to have fourteen pension funds. Some of them are of considerable size: one has 3 million members, a further two approach that number and two have over one million members. The middle ones, and in particular the small ones are unable to influence the market. Pension funds have collected, earned (and sometimes lost, due to falls in the capital market) a considerable wealth: approximately US$ 75 billion. Among the finance industries, the banking sector is the biggest, but the pension fund industry is the second, ahead of insurance and mutual funds.

In a turbulent market under dynamic transformation, the pension fund industry is heavily regulated. There is also strict daily supervision of funds' activities; perhaps "surveillance" would be more proper term than "supervision". Pension funds have not questioned the need for overwhelming regulation or the particular requirements put upon their activities. Most of the industry has gone even further by voluntarily subscribing to the self-regulatory Code of Best Practices for Institutional Investors, drawn up in 2006 with mutual funds.

The biggest pension funds volunteered to adopt also their own additional corporate governance obligations: the standards of behavior at general meetings of shareholders of companies in which they hold a considerable stake. They publish reports on their activities and the stands taken in voting on a particular resolution. However, their example has not been followed among middle and small funds. The reason is simple: only the few of pension funds (they may be called The Magnificent Few) attend the general meetings of numerous companies, the remaining funds prefer not to bother.

Pension funds are transparent and efficiently organized. Their corporate governance has been challenged only once, when the government intervened by demanding disclosure of fund-managers' individual salaries. There were some cases of window-dressing of funds' investment results, and these were severely punished by the Polish Financial Services Authority (KNF). From time to time the media draw public attention to the fact that the funds' owners always make money while the members' accounts depend on the market's performance.

There is a constant dispute in Poland, and perhaps in Europe and the world, about the balance that should be worked out between shareholders (those who brought capital to the company) and so called stakeholders (those whose vital interests are at stake). Corporate governance is generally oriented towards shareholders. Corporate social responsibility, a concept that is now a very fashionable one, is oriented toward stakeholders or, in some cases, mistake-holders. Pension funds are in a very specific situation. They have to fulfill the interests and expectations both of shareholders – the funds' owners, and of true stakeholders – the funds' members. The stake is enormous: it is the well-being and prosperity of generations, present and future. While the expectations of members are met only while the market performs well, owners have profits anyway.

In 2011, instead of introducing the second stage of pension reform, the government decided to cut the contribution to the private pension funds dramatically from 7% to its present level of 2.3%. (According to law it will subsequently increase to 3.5% in 2017). In spite of protests of the part of the financial community, parliament adopted the proposal. The reason was simple: funds buy large amounts of treasury bonds causing growth of public debt. The pension funds' shareholders lost immediately, stakeholders may suffer losses for decades. Opposition against "The Great Funds' Robbery of 2011" was mild. Protesters were loud but they were not numerous. They were ignored by the government. In my opinion, the future of private pension funds in Poland is now in serious danger.

The reduction of contribution to the funds was accompanied by the lifting of the limit on investment in shares and similar instruments. Provided with less money, pension funds are thus going to be exposed to much higher risk. At present the limit on foreign investments is 5% of resources (it will rise to 30% in 2021) but at the end of 2011 it was fulfilled up to only 0.48%, as funds are taking the growing foreign exchange risk into consideration. Therefore it may be observed that pension funds behave more cautiously and responsibly than the regulators advise them.

In the Polish market there is no official corporate governance watchdog. The Warsaw Stock Exchange requires reports from listed companies on their respect for, and observance of, its Code of Best Practices, based upon comply-or-explain principle. The Polish Institute of Directors promotes corporate governance standards and the Association of Individual Investors (SII) intervenes in cases of corporate governance failures. Due to its size and resources, the pension fund industry is able to exercise a vast influence on the capital market. Yet only the biggest pension funds feel responsibility for corporate governance in the companies in their portfolios.

There is a theory, supported by some surveys, which claims that investors are ready to pay more for shares of companies with good corporate governance, provided that some fundamental conditions are met, such as: majority of Non-Executive Directors (NEDs) free of ties with the company, members of the board owning shares of the company and company using formal assessment criteria of board's performance. It should be observed that there are no such companies on the Warsaw Stock Exchange.

All pension funds invest in listed companies. At present some of them do not invest up to the limits allowed. Yet only some of the funds, called above "The Magnificent Few", represent the spirit of ownership and feel themselves responsible for the prosperity of companies in which they put the money. They attend hundreds of general shareholders' meetings each year (annual meetings and some more important extraordinary meetings; the last ones are extremely popular, to the detriment of shareholders, as they consume a lot of time and money). They contact the management at least twice a year to get the true picture of the company.

When the general meeting of shareholders is held in Warsaw, capital of Poland, where all the pension funds are based, bigger pension funds take part, represented by competent employees, investment directors or lawyers. When meetings are held outside the capital, bigger funds may participate, represented by the employees of local branches of brokerage houses. The cost of the preparations to attend the meetings and of attendance itself, are considerable, because companies are in habit of adjourning meetings already in progress and there are numerous breaks. This may explain why medium and small funds do not attend.

Polish law allows companies to hold "electronic" general meetings with shareholders attending, discussing and voting by Internet, and the Code of Best Practices encourages them to do so. Yet only two companies out of the four hundred listed on the main floor of the stock exchange apply this solution (transmission to the non-voting public has already become popular). Pension funds do not push companies for electronic general meetings. Perhaps they do not trust new technological appliances or their own ability to use them properly.

Pension funds are interested in having their representatives on the supervisory boards of companies in which they have invested, but they are cautious of consulting with other investors about their candidates to the boards, or organizing coalitions, because such steps may be considered by the Financial Services Authority as concerted action, which is not permitted by the law. Therefore funds publish the names of their candidates to the boards well ahead of general meetings.

Usually pension funds do not propose their employees for directorships on the boards. Although the Polish Institute of Directors runs a list of highly professional candidates for boardrooms: experts representing experience, competence and the confidence of the market, pension funds prefer to exploit lists of their own candidates, some of them being former and unsuccessful fund managers. If elected to the board by the general shareholders' meeting, they do not sit as formal delegates of the particular fund; they are not bound by instructions on how to vote on particular resolutions; nor are they expected to report on their activities on the board to the fund to which they owe their election to the boardroom. They are expected to work hard in the interests of the company.

In the Polish market there are an above-average number of listed companies with strong majority investors, often foreign ones. In principle, majority investors respect the rights of institutional investors to representation on the supervisory board. However, there are some cases of conflict between institutional investors and the majority ("strategic") investor on the ground of alleged transfer pricing, dividends, managers' remuneration or related-party transactions. When other means of dispute resolution fail, institutional investors sometimes take the matter to court. Their position is weak compared with the State; sometimes the State holds only the minority of votes but it uses the voting cap formula to prevent institutional shareholders from using their power in the company.

Other minority shareholders, including individual investors, usually consider pension funds as allies. They expect pension funds to take a firm stand against corporate shenanigans (as irregularities of corporate governance are called) and to use all legal means at their disposal to support shareholders' activism. They vote for pension funds' candidates to the supervisory boards. In case of conflict with the majority shareholder, or a company's poor performance, minority shareholders expect institutional investors, especially pension funds which have a long investment horizon, not to sell their shares and leave the company but to stay – and fight.

Among the hundreds of companies listed on the stock exchange's main floor, there is a handful of "Investors' Edens": companies with no significant non-institutional shareholder, no stake held by the State, and ruled jointly by institutional investors. Pension and mutual funds own the vast majority of their shares and freely decide on the composition of the supervisory board. There is no employee representation in the boardroom. Corporate governance in such companies is considered to be correct.

In such companies, medium and small pension funds which are absent or inactive elsewhere, demonstrate their activism. They attend the general meetings, propose motions to be resolved by the meetings and propose their own candidates to the board. For them it is easy to be active there because the environment is friendly for minority investors on a free ride. Yet only the biggest institutional investors, including the Magnificent Few pension funds, make real efforts to further the performance of such companies and, in fact, pay the bill for their efforts.

Pension funds are particularly interested in the sustainable growth of companies they invest in and their long-term strategy. They are sensitive about mergers and acquisitions, financial statements, division of profits and dividends. They do care about management remuneration, salaries and options. They are cautious about the conditions of proposed increases of share capital, especially when the shares are not to be covered by shareholders' pre-emptive rights. They are interested in the composition of supervisory boards, including the number of independent (non-executive, outside) directors. They pay special attention to proposed amendments to the companies' statutes.

Special attention is paid by pension funds to the activities of audit committees. According to law, an audit committee within the supervisory board is obligatory in public interest entities only when the board is composed of more than five members (minimum number). This is why pension funds oppose attempts to limit the number of members of supervisory boards in order to avoid setting up an audit committee, and encourage all listed companies in their portfolios to form an audit committee. The candidates they propose for the board are often people qualified to work on audit committees. Yearly reports of audit committees are evaluated by the pension funds and brought to the attention of the public at general meetings.

Another hot problem for pension funds is the remuneration of audit committees. Neither the law nor the stock exchange's Code of Best Practices pay any attention to the remuneration of members of audit committees. Usually members of audit committees are remunerated at the same level as other board members, although they have much more work and, in fact, they do work much harder. In Poland, only the Best Practices of Audit Committees advocate additional salary for them. It is, however, a document of lesser significance, drafted by the Polish chapter of the Association of Chartered Certified Accountants (ACCA) and the Polish Institute of

Directors, not yet endorsed by the stock exchange and not based on the comply-or-explain principle. It is worth noting that some pension funds have already made efforts to promote adequate additional remuneration for the chairperson and members of audit committee.

The extremely important feature of pension funds in Poland is the high appreciation of their presence and activities by foreign capital. Investors and investment banks often declare: "We are pushing money into Poland because there are pension funds here, and we trust them, and that is official. If you, government, try to destroy the system, we will pull our money out of Poland". They consider the pension fund industry to be a main factor behind privatization and the recent successes of economic transformation. In their opinion, companies in which pension funds have invested are more trustworthy.

Will pension funds survive in Poland despite the hostility now shown towards them by the government? Poland can not afford the long-term minimalizing of the pension funds' contribution to the development of the economy. She aspires to create a Central European financial centre. In the early 2000s the Ministry of Finance produced "Agenda Warsaw City 2010" aimed at the privatization of the Warsaw Stock Exchange and the development of the capital and financial markets. That Agenda had been fulfilled successfully and the pension fund industry played an important role in reaching its goals. Now in 2012 preliminary steps are being taken to formulate "Agenda Warsaw City 2020". It should define the pension funds' place in the market and the means to accomplish their mission.

CORPORATE GOVERNANCE AND PENSION FUNDS IN MEXICO

VICENTE CORTA[1]

1 *Vicente Corta is a lawyer who qualified at the Universidad Iberoamericana (UIA) in Mexico and has a Master's in legal aspects of international business from the University of Warwick, England. He was President of the National Commission of the Savings for Retirement System (CONSAR) and is currently a partner in the firm White & Case.*

The issue treated in this brief article is corporate governance and its relationship with the pension funds in Mexico. It refers to the function of the pension funds as investors and shareholders of the companies in which they invest; the institutional arrangement that exists; the administrators' ability to become really involved in these matters; the associated costs and a few conclusions.

I. Preliminary Considerations

The first point to be emphasised is that the Retirement Fund Administrators (AFORE) have to define their investment and asset allocation policies, while thinking of the costs involved in monitoring the investments that they make. In other words, this is an issue that must be considered ex ante. When I took part in an AFORE, each time a new asset appeared on the market, it was very important to define what the administrator's policy was going to be on the investment of those assets before actually starting to invest. The fact of investing in shares involves many preparatory steps; a lot of foresight is required before investing and a series of monitoring issues exists, as with any other investment. In Mexico's case, investment at the beginning was basically in short-term government bonds. Due to the infrastructure of the administrators, such bonds are clearly insufficient for many of these investments, and there has had to be a gradual adaptation and modernisation in order to be able to invest with efficiency.

Of course, defining what to invest in, and how much, is a fundamental issue. This has to do with diversification, yield and risk.

However, there is also a series of costs related with administration, people, infrastructure and possible future responsibilities in the investments that take place. It is important to bear in mind that investments in Private Equity or in the stock market entail adjustments in the structure and management procedures of the AFORE, and this has already been seen in the case of Mexico with the famous Capital Development Certificates (CKDs)[2] .

With the CKDs we saw how enormous pressure to invest in these instruments was generated from one day to the next, and the AFOREs had no idea how to go about it. They had no methods, no procedures, and no professionals capable of making these investments. First of all, an attempt was made to find a scheme that sought to diversify these investments and have small quantities of them. Shortly afterwards, those who had already made such investments realized that monitoring them required the dedication of personnel, with the respective associated costs. It seemed more logical, in those cases where there was a desire to be involved in these projects, to have a more significant participation that would justify the administrative cost associated with the investments, rather than making very small investments which they would have difficulty in monitoring later.

II. ¿What is the function of the AFOREs as investors and shareholders of the companies in which they invest?

There is a significant debate about how active or passive the funds should be. At one end of the scale, it is pointed out that funds could have controlling shares in the companies and become "entrepreneurial funds" that would direct the destinies of the companies into the future. At the other end, there is the view that the funds should be able to invest in the stock market through Exchange Traded Funds (ETF). This has proved to be a very practical and easy-to-manage investment, but does not involve a more intensive involvement in the administration of the companies. Perhaps the most efficient approach is for administrators, when preparing to invest in these criteria, to have criteria for selecting companies.

Which are the corporate governance criteria that companies should meet so that the retirement funds invest in their capital? What quality of information do these companies have? Do they deliver this information punctually? Have there been any sanctions, from the stock exchange for example, such as suspension of operations due to inadequacy of information?

Who are the people that check the companies' financial statements? What notes has it been possible to check? Are there variances in the practices for revealing adequate information?

2 *The Capital Development Certificate (CKD) is an instrument designed by the financial and regulatory authorities in Mexico to allow the Retirement Fund Administrators (AFORES) to invest in funds and productive projects using private capital.*

Probably one of the most important issues has to do with the board of directors and how it is made up. In public companies, if the management is really operating in an appropriate manner, it must be seen to have the balances required for investments of this type. It is also important to know which committees exist in the company and how they are made up. The AFOREs, in order to be able to carry out their fiduciary duties with the workers who entrust the money to them, must know they are investing not only in a good business, but in a well-managed one. On this issue, therefore, the timely delivery of information is essential.

III. What is the institutional layout that the AFORE must have, in order to be able to check these criteria?

It must be decided whether it is the job of the people who are making the investments every day to define this, or the Investment Committee, or whether there should be interaction with some other stakeholder, such as the trade union associations, for example. It would seem that the most effective procedure is for the Investment Committee to set the criteria on the basis of a proposal from the management, and that it should be the latter that carries out the investments on a day-to-day basis.

There was an interesting experience of setting criteria in Mexico, which was carried out through the Mexican Association of Retirement Fund Administrators (AMAFORE), using Covenants[3]. This was a good initiative, but it was not stated in the most appropriate way. The fact that the union realised what its minimum rights ought to be as issuance creditors was good practice. However, I believe this is more than a union issue. The unions may set policies or better practices, but it is the Investment Committee of each AFORE that must define how these better practices are applied. Something similar may be analysed on the matter of corporate governance of companies.

Another point of view that may be very passive and seems, in my opinion, to be inappropriate, maintains that the AFOREs do not have a fiduciary responsibility to fulfil because public companies have already been authorized by the National Banking and Securities Commission, are listed in the market and fulfil all the requisites that the law stipulates for them. We have seen many cases in which this

3 *A Covenant is a set of commitments which the borrower accepts with the lender in a loan contract and which are quite usual in syndicated loans. Covenants describe specific actions that a company has to carry out during the life of the loan that has been granted, which may be positive commitments (actions that must be carried out by the company, such as auditing its accounts and delivering them to the bank) or negative (actions that it must not do, such as giving dividends to its shareholders) or to achieve specific financial ratios.*

has not been enough, and it is important that the administrator, and especially the Investment Committee, does take responsibility for checking these points.

IV. Do the Administrators have the ability to follow the companies' management accurately?

How can the administrators monitor the companies' management accurately? Which mechanisms can they use, and with regard to which investments?

If there is an investment that may be of very marginal importance for the administrator, is it worth diverting administrative resources in order to oversee that investment or should the administrator simply act as a passive investor? How can one define the use of independent advisors, in the CKDs in some cases, or even in the possibility that administrators might appoint advisors? In companies, as from certain percentages, there is also the possibility of doing so. If there is a company in which a pension fund has a significant percentage, the appointment of a professional advisor would probably also be the best way of being able to fulfil this fiduciary responsibility.

Obviously, we all have access to financial information. Often the analysis of the different sectors is not easy, and probably the majority of administrators, who do not have the ability within the institution itself, should trust in specialized financial advisors to help them detect possible problems in these companies before they occur, and also help to detect possible shortcomings in corporate governance that may perhaps oblige the administrators to abandon particular investments.

V. What are the costs associated with these functions and how do they affect the investments?

What are the risks for the administrators in carrying out these functions? The risk, and the temptation, is to become an entrepreneur. I think the pension funds should avoid the temptation of being involved directly in the management of the companies in which they invest, given that this could generate more liabilities for that fund than the benefits for the investors who have entrusted their money to it.

Are there any liabilities for exercising these rights? In principle, the law does not establish any generic liabilities, but there may be issues in which an excessive involvement in the management of a company may lead to trouble for the administrator. The question depends on the volumes invested on each project. This, for example, was an important issue in the CKDs. The costs associated with becoming involved in the management of the company are not insignificant;

they require and distract the attention of the Board of Directors, the Investment Committee and the Risk Committee, and they should be properly weighed up when these investments are made.

There are also cases where the normal rhythm of a company requires very little participation from the shareholders, but there will still be arguing among them, so an effort will be required to enable appropriate decisions to be taken in following up investors' interests.

VI. Conclusions

Investment on the stock market is not an option but a necessity. Because of this, diversification is required through ETFs and probably also through those companies that may be in a leadership position.

The definition of how investments are made in such companies is ex-ante. If the right decision is not made at the beginning, the consequences will probably have to be suffered in the future. In this ex-ante definition there are several considerations that need to be taken into account to find out whether the decision is the right one.

Diversification, as was already pointed out, is very important. There are probably some projects, through an ETF or a very small share in a company, for example, where the administrator's approach should probably be not to intervene in the management of that company.

The investment criteria that we have already mentioned are also very important.

Monitoring the investments is also a key factor. If you invest in a government bond, for example, the long curve of those bonds should be monitored to see how they are moving. In the case of shares, the process is different and more complex in several aspects.

Attention must also be given to the associated costs, and this is very important.

By doing all that has been mentioned, it is possible in the end to achieve the aim of the administrators' fiduciary obligation, to the benefit of the investment portfolio.

PART II

ADVANCING TOWARDS BETTER PENSION LEVELS

ARE CONTRIBUTION RATES AND RETIRING AGES SUFFICIENT TO GUARANTEE GOOD PENSIONS?

CARMEN PAGÉS-SERRA[1]

1 *Carmen Pagés-Serra is head of the Labour Markets and Social Security Unit of the Inter-American Development Bank (IDB). She has a PhD in Economics from the University of Boston. Her speciality areas include employment, labour market, social security and productivity.*

The purpose of this article is to inquire into whether the contribution rates and retiring ages existing in the pension systems of the various countries are sufficient, particularly in the Latin American region. To do this, it first checks on the replacement rates that are being achieved, assuming a contribution density of 100% of the time worked. The analysis then concentrates on showing the effect of contribution density on pension level. Thirdly it identifies the various options to enable replacement rates to be improved, emphasising a proposal that is being developed on this issue by the Inter-American Development Bank. The article ends with some relevant conclusions for consideration.

I. What replacement rates does the system achieve when contribution density is 100% of the time worked?

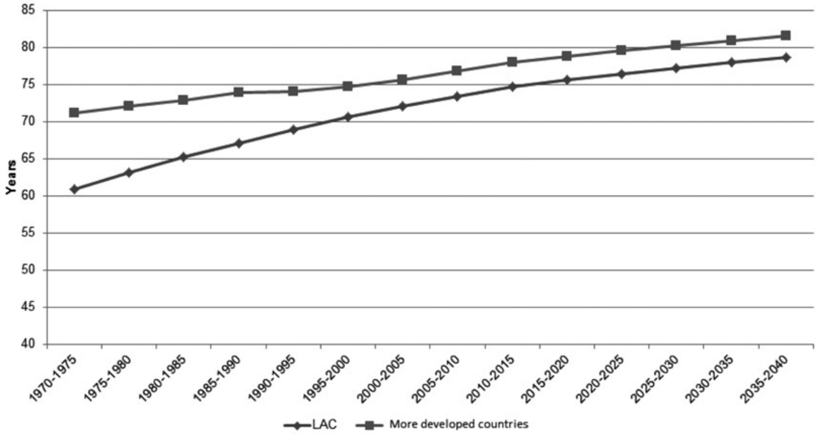
Life expectancy has grown rapidly in Latin America and the Caribbean

Life expectancy in Latin America has grown enormously. If an analysis is made of how that life expectancy has evolved (see Graph Nº 1), one finds that a person born in 1970 had a life expectancy at that moment of 60 years, while a person born in 2010 has a life expectancy of 75 years. In other words, life expectancy has risen 15 years in 40 years, which is a huge amount. By contrast, the growth in life expectancy in that same period in the developed countries is only about 7 years. It is therefore possible to see that life expectancy in Latin American countries is starting to converge towards that of the industrialised nations; today the difference in life expectancy at birth between this group of countries and those of Latin America is only about 3 years. Being translated, this means that when one analyses the number of years during which the social security system will have to finance pensions, the present reality indicates that considerable periods are involved.

In most countries, pension systems today have to finance an average of over 15 years' retirement in the case of men (see Graph Nº 2) and over 20 years in the case of women (see Graph Nº 3).

GRAPH Nº 1

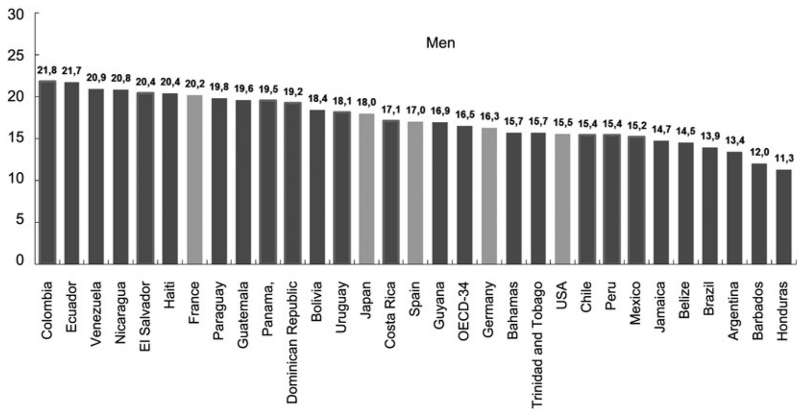
LIFE EXPECTANCY AT BIRTH



SOURCE: WORLD POPULATION PROSPECTS, UN.

GRAPH Nº 2

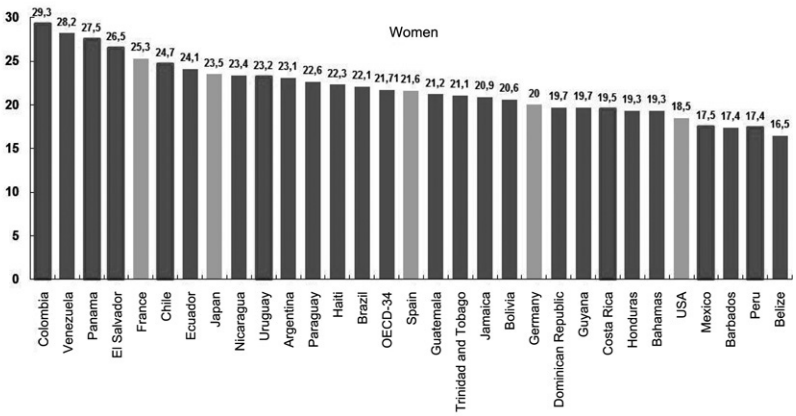
EXPECTED YEARS OF RETIREMENT = LIFE EXPECTANCY AT 60 - OFFICIAL RETIRING AGE



SOURCE: SOCIAL SECURITY THROUGHOUT THE WORLD, 2011 US SOCIAL SECURITY; OECD STATS AND WORLD POPULATION PROSPECTS, 2010 UN.

GRAPH Nº 3

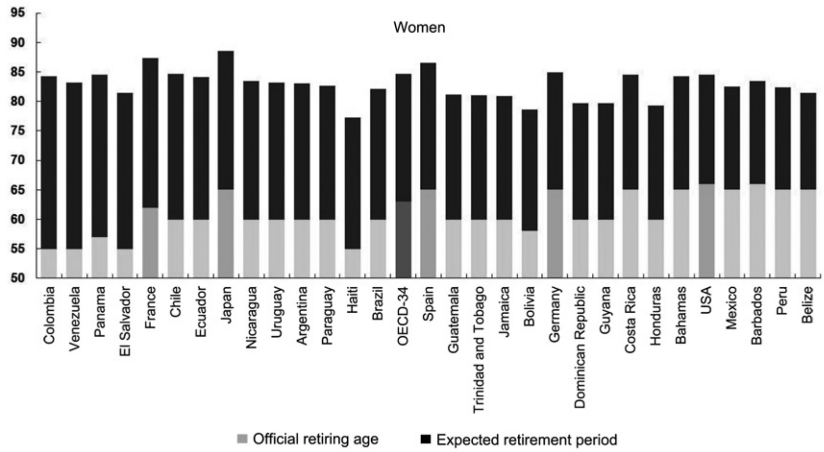
EXPECTED YEARS OF RETIREMENT = LIFE EXPECTANCY AT 60 – OFFICIAL RETIRING AGE



SOURCE: SOCIAL SECURITY THROUGHOUT THE WORLD, 2011 US SOCIAL SECURITY; OECD STATS AND WORLD POPULATION PROSPECTS, 2010 UN.

The high average periods listed, during which pension will have to be financed, are due basically to the fact that retiring ages are low in most of the countries. There are still many countries in Latin America where women retire at age 55, whereas in countries such as Germany, Costa Rica, Spain, Japan, Mexico and Peru, women are retiring at age 65, which is the age established almost as standard in the developed countries (see Graph Nº 4). In other words, most countries in the region still have to align with this standard retiring age.

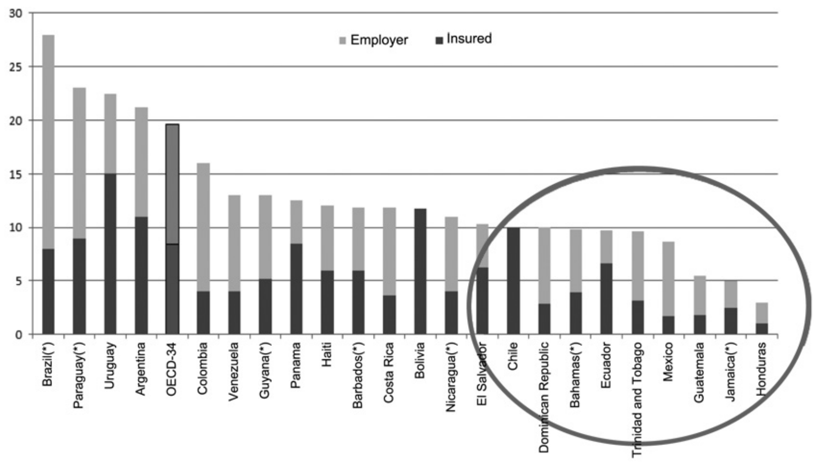
GRAPH Nº 4



SOURCE: SOCIAL SECURITY THROUGHOUT THE WORLD, 2011 US SOCIAL SECURITY; OECD STATS AND WORLD POPULATION PROSPECTS, 2010 UN.

When a comparison is made between Latin America and the industrialised countries of the OECD, it may be seen that, on average, the difference in the average official retiring age is approximately 2 years in the case of men and 3 years in the case of women. Therefore retirement periods in Latin America are longer than those expected in the OECD. And these retirement periods are going to have to be financed with contribution rates that are lower than the average of the OECD (see Graph Nº 5). A considerable proportion of countries in the region have contribution rates of below 10%, lower than the OECD average, which is almost 20%. This produces the dilemma of increasing longevity accompanied by low contributions. For example, countries like Honduras have a contribution rate of 3.5%, which makes it difficult to see how reasonable pensions can possibly be generated.

GRAPH Nº 5



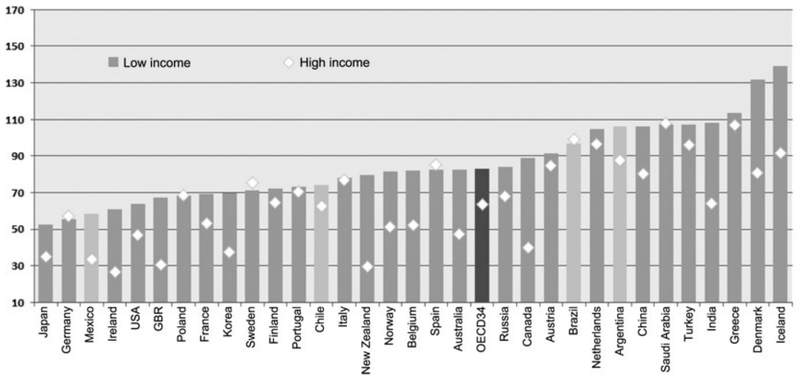
SOURCE: SOCIAL SECURITY THROUGHOUT THE WORLD, 2011.
(*) COUNTRIES IN WHICH IT WAS NOT POSSIBLE TO SEPARATE THE PENSION CONTRIBUTION FROM CONTRIBUTIONS TO OTHER PROGRAMS.

Replacement rates: calculation hypothesis

Calculating the replacement rate is not easy, since it is not a piece of information produced by the system but one that has to be calculated, and like every calculation, it is subject to a series of hypotheses. In this case, the calculations are not made by the IDB directly, but by the OECD. In its publication *"Pensions at a Glance 2011"*, which includes for the first time 4 countries from Latin America, the replacement rates are calculated by taking into account the national rules and parameters of the year 2008, assuming that people contribute throughout their working lives (from age 20 to the official retiring age) and including all pensions (public and private, in force in 2008). The calculations also assume common parameters for all the countries: (i) a real yield, net of commissions, of 3.5%; (ii) benefits paid in the form of a life annuity; (iii) no changes in contributions or other parameters in the future; (iv)a calculation based on the average income throughout people's lives.

GRAPH Nº 6

NET REPLACEMENT RATES ASSUMING COMPLETE CONTRIBUTION DENSITIES – MEN



SOURCE: PENSIONS AT A GLANCE 2011, OECD.
LOW INCOME: 0.5 OF THE MEAN; HIGH INCOME: 1.5 TIMES THE MEAN.

What we see is that, in Latin America at least, there is an important divergence between countries that have defined-contribution systems and those that have defined-benefit systems (see Graph Nº 6).

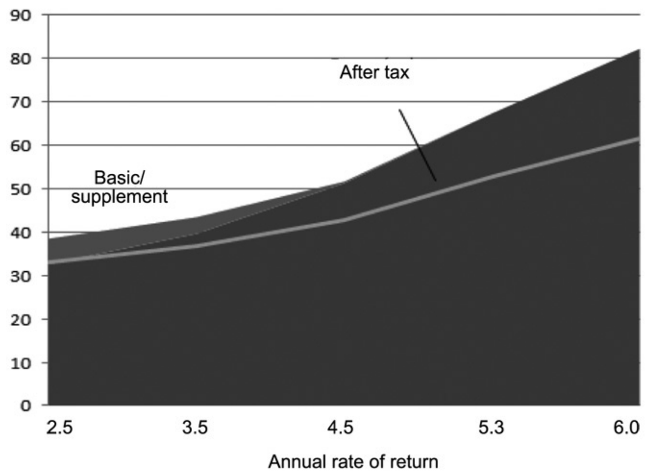
Argentina and Brazil, countries that have pay-as-you-go systems, appear with very high replacement rates. In fact those countries present theoretical replacement rates that are approaching 100%, while the defined-contribution countries are appearing with relatively low rates. This makes one think that there are probably sustainability problems in the countries with pay-as-you-go systems. Now it also true that if one looks at the contribution rates, Argentina and Brazil have levels higher than the average of the OECD. In other words, those countries are funding expensive pensions, but are paying contributions of over twenty per cent into the system.

However, it is important to bear in mind that in defined-contribution systems, the replacement rate is particularly sensitive to the rate of yield. As has already been stated, the replacement rates shown above are calculated on a real rate of yield (net of commissions) of 3.5%. Obviously, with higher rates of yield, higher replacement rates will occur (see Graphs Nº 7 and Nº 8). From this, the fact emerges that the replacement rate, in a system of individual funding, is actually an estimate.

To summarise, what we see is that there are long periods of life to be expected, with relatively low contributions, and replacement rates that obviously reflect the fact, especially in the case of the individual contribution systems.

GRAPH Nº 7

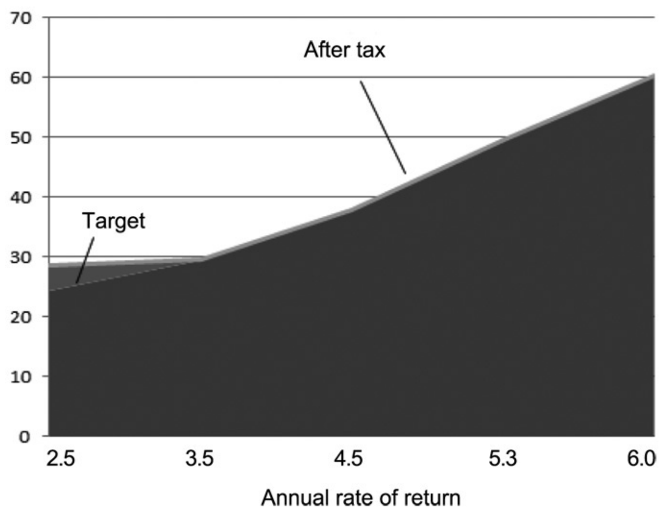
CHILE:REPLACEMENT RATES (% OF GROSS INCOME)



SOURCE: PENSIONS AT A GLANCE 2011, OECD.

GRAPH Nº 8

MEXICO: REPLACEMENT RATES (% OF GROSS INCOME)



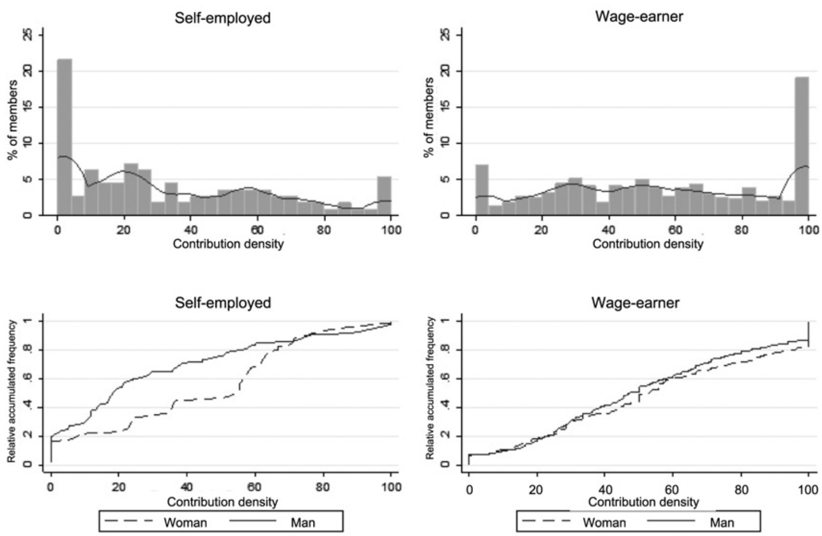
SOURCE: PENSIONS AT A GLANCE 2011, OECD.

II. Contribution density and its effect on pensions

One of the problems facing pension systems is that the contribution density is far from being 100%. Figures Nº 1 and Nº 2 show the results of a survey carried out by the IDB, based on Chile's Social Protection Survey (EPS). An attempt was made there to estimate the density of contributions in Mexico's Distrito Federal (DF) and Metropolitan Lima. What we see is that only 19% of wage-earners in the DF, and 14% in Lima pay contributions throughout their lives; that there is a massive scatter in the percentage of members whose contribution densities are between 20% and 80% of the time worked; and finally there is a group of around 5% of workers who contribute nothing (zero contribution density). Obviously, there is a very marked difference between wage-earners and self-employed workers. In the case of self-employed workers, only 5% of members contribute throughout their working lives, while over 20% of them never contribute in the DF.

FIGURE Nº 1

MEXICO DF: CONTRIBUTION DENSITY, POPULATION AGED 25-55

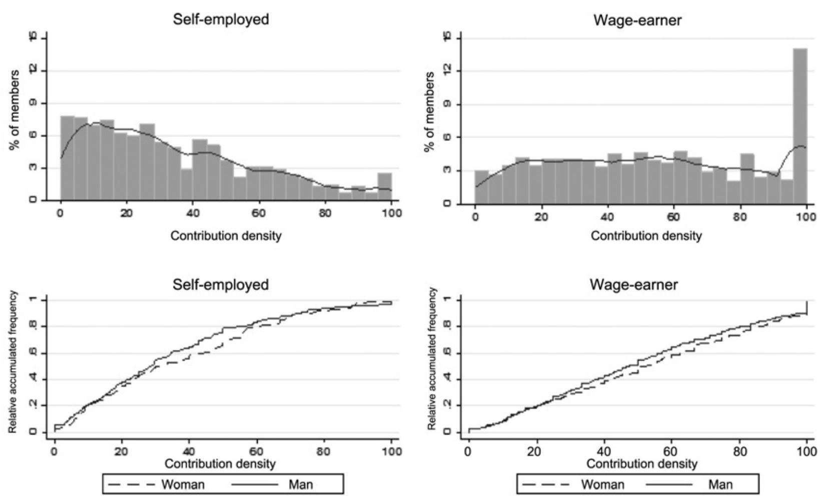


SOURCE: IDB SOCIAL PROTECTION SURVEY 2008.

The same can be seen, though more exaggeratedly, in the case of Metropolitan Lima (see Figure Nº 2)

FIGURE Nº 2

METROPOLITAN LIMA: CONTRIBUTION DENSITY, POPULATION AGED 25-55

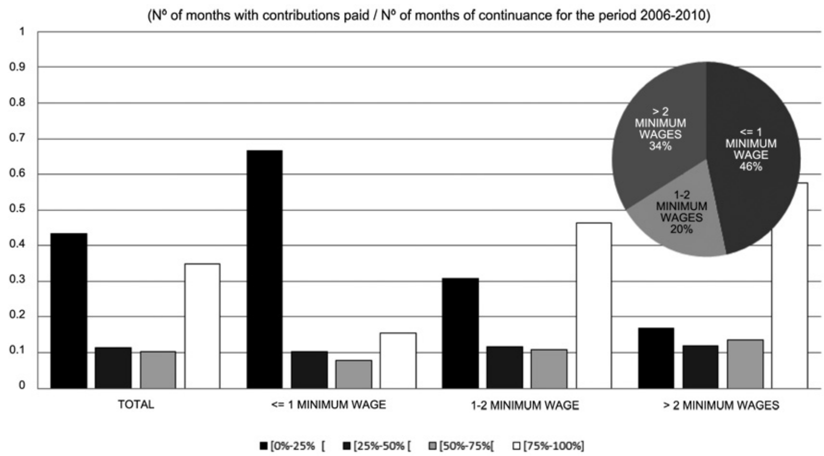


SOURCE: IDB SOCIAL PROTECTION SURVEY 2008.

Another important phenomenon to be pointed out lies in the fact that there is a very important positive correlation between contribution density and the worker's income level (see Graph Nº 9). In fact, in the case of Peru we can see that, in the group of workers who earn up to one minimum wage, slightly over 15% have contributed between 75% and 100% of the time worked, whereas almost 67% have not contributed at all or have done so for up to 25% of the period worked. However, in the case of workers who earn over twice the minimum wage, those who have contributed between 75% and 100% of the period worked represent almost 58% of members, while those who never contribute, or do so up to 25% of the period worked, represent only about 17%. In other words: the higher the income level, the greater the probability that the worker has really paid contributions throughout his/her working life.

GRAPH Nº 9

PERU: DENSITY OF CONTRIBUTIONS TO THE PRIVATE PENSION SYSTEM BY TAXABLE INCOME LEVEL – MEN



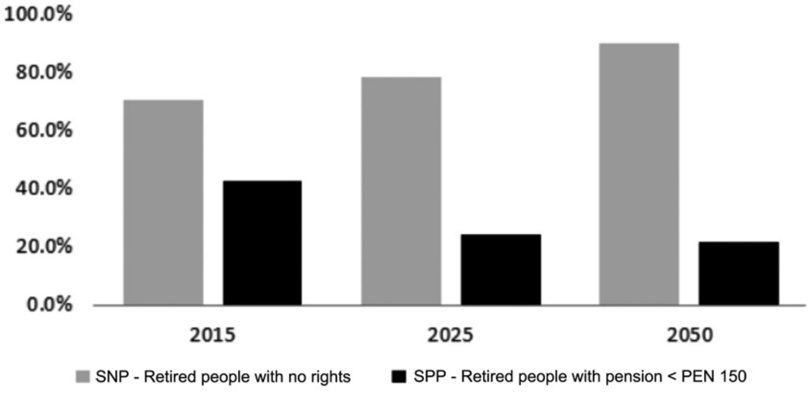
SOURCE: SUPERINTENDENCE OF BANKS, INSURANCE AND AFPS (SBS), PERU.

For all these reasons, there is a very strong correlation between low incomes and low pensions, resulting not only from low contribution rates but also from low contribution density.

Due to this fact, even people who are apparently covered will face serious risks of poverty in old age. This is what can be seen in Graph Nº 10, which shows a IDB forecast of the percentage of pensioners that the National Pension System (SNP, public pay-as-you-go system) and the Private Pension System (SPP, the individually-funded system) will have in Peru.

In the case of the SNP, the exercise was carried out by looking at how many people are going to retire with at least the minimum pension established by the system. What may be observed is that, in 2015, 70% of members will not have managed to contribute for the minimum period required by the law to qualify for a minimum pension, meaning that they will have a replacement rate equal to zero. And this percentage will continue growing (in the exercise, until 2050) because the SNP is in fact attracting people with lower incomes and lower contribution densities. This is obviously ironic, because what happens is that there is an internal redistribution which means that people with low incomes in the SNP pay contributions but never manage to receive any benefit, and those contributions are used to pay pensions to high-income workers who do meet the contribution time requirement. This makes the SNP grossly unfair.

GRAPH Nº 10
PERU: % OF TOTAL PENSIONERS IN EACH PENSION SYSTEM



SOURCE: IDB, 2012

III. Options for improving the replacement rate

On the one hand, due to low contributions and somewhat irregular payments and to lack of continuity in participation in the labour market, the result will be that many of those who are contributing to the pay-as-you-go system will not manage to complete the number of years required to receive a pension, and will therefore be unable to retire. On the other hand, in the individually-funded systems, many have not contributed sufficiently to have a reasonable pension. Unless rates of return remain high, the defined-contribution systems are going to produce relatively low replacement rates. The pension system therefore presents a great challenge: for the time being it is not going to satisfy many people. If the expectation is to have a replacement rate approaching 100%, because that is what enables consumption to be smoothed during people's lives, many are going to find out that they are nowhere near that position.

What can be done then to improve replacement rates? What options are there? That is the big question. The options would point basically in the following directions:

In the financial market:

- Ensure higher yield on the investments;
- Reduce commissions;
- Make life annuities cheaper.

In the labour market:

- Raise the contribution rate;
- Raise retiring age;
- Increase contribution density.

And finally, in terms of increasing saving capacity, take measures designed to increase incentives to make voluntary contributions for retirement.

Below we take a further look at some of the options mentioned above.

Raise the contribution rate?

Everything seems to indicate that the contribution rate is at a relatively low level in many countries. In general, it is said that the default level of this rate should be 15%, and many countries are below that standard. However, the problem is that in the Latin American labour market an increase in contribution rate does not always result in a higher pension because, given the informality phenomenon and the fact that there is a kind of capillary action between the formal and informal markets, as contributions increase, many people may stop contributing or contribute even less often than before, and the replacement rate may end up being lower.

It is therefore essential that a careful study be made of the effect of a potential increase in rates. Incredibly, there are very few studies that show how formal employment might react to the contribution rate (the elasticity of the formalization rate to contributions) and what that might signify in terms of the final replacement rate. That elasticity is a key parameter. It is necessary to carry out the prior technical studies, precisely because of this elasticity whose prior estimations are unknown.

Raise retiring age?

Raising retiring age is an option that has political restrictions, but apparently has few costs from the economic point of view. For example, in Latin America there are many people who work after the official retiring age in the informal sector.

Many people go on working, partly because they do not have a reasonable pension.

On the other hand, there is the idea that women are entitled to retire earlier. This turns out in the end to be a very mixed blessing, particularly in individually-funded systems. They retire before men, contribute less than men and live longer. All this is reflected in a much lower replacement rate for women. In countries with defined-benefit systems this is less true, because the risk is borne by the State, but once again it leads to problems of sustainability, which must be covered sooner or later.

So, although raising retiring ages may be difficult, it is a battle that may be worth fighting.

Another interesting subject that some countries are suggesting is the automatic indexing of retiring age to life expectancy.

Increase density with incentives to save voluntarily?

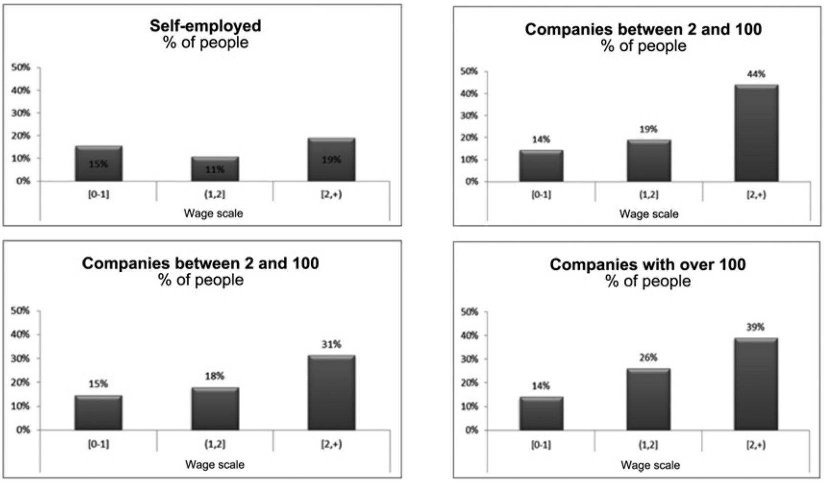
In order to solve the problem of low contribution density, there are proposals that suggest that incentives should be provided to encourage voluntary saving. Another proposal often made is called "matching contributions", a joint effort in which the state contributes something and the individual also contributes on his/her own behalf.

One of the realities that need wrestling with is the fact that people with low incomes really have an extremely limited saving capacity. Figure Nº 3 shows the percentage of people who manage to save at the end of the month in Metropolitan Lima (data from 2008). Results show that only 15% of people who earn up to one minimum wage say that they manage to save at the end of the month. This figure is practically independent of where the person works (whether self-employed or a worker in a company with a large number of employees). In the case of workers who earn between 1 and 2 minimum wages, most of those who say that they save at the end of the month are working in companies with over 100 workers (26%). Finally, in the group of those who earn more than twice the minimum wage, 44% of those who work in companies with up to 100 workers claim that they save at the end of the month.

All this shows the limitations of incentives to save voluntarily, since it is very likely that people with low incomes have very little ability to make use of such incentives, and those who benefit are probably workers with higher incomes, who already have higher densities in any case. If the desire is to reach the most difficult sectors, with lower densities, it may be that incentives to save voluntarily are not a realistic solution.

FIGURE Nº 3

% OF PEOPLE WHO SAVE AT THE END OF THE MONTH, METROPOLITAN LIMA 2008 (*)
(WAGE SCALE MEASURED IN MULTIPLES OF THE MINIMUM WAGE)



SOURCE: IDB, SOCIAL PROTECTION SURVEY 2008.
(*) PEOPLE WHO ANSWERED THAT THEY DO NOT MANAGE TO SAVE IN THEIR CURRENT SITUATION.

The low saving capacity of many people may be due to the fact that there is fierce competition between the present and the future, largely because it is impossible to meet the minimum needs of the present. This is the problem of the pension systems in Latin America. Generally speaking, wherever there is a large mass of population with low income it will be a challenge to attract savings, whether by way of contributions on work, or incentives for people who have little ability to save.

It is therefore not surprising that such people are not in the system. A low ability to save is a low ability to contribute, and this means that for the vast majority of workers, the contribution is seen as a tax. The contribution is also a tax for the employer, and that makes the hiring and formal employment of people with low incomes much more difficult.

So then, social security seems theoretically to be forcing saving on people who in practice cannot afford even to meet the basic needs of the present. In practice, these people, or their employers, evade that obligation. What can be done then about all this population that has very little ability to save? To do nothing, though this is what often happens, is unrealistic and is not a zero-cost solution. The region is moving towards non-contributory pensions, most of which are not well-designed and represent a response to political commitments made in election campaigns, without fiscal or sustainability analysis. They also represent, by their design, an incentive to informality, because they are paid if the person does not pay contributions. In other words, they produce informality.

These incentives to informality fade only when the design is well-studied and seeks to give a better pension to those who contribute than to those who do not.

So, what can be done? How can one attract those who are not contributing at all or are contributing very little? The IDB proposal on this matter consists in producing a route sheet leading towards a system that is better suited to the characteristics of the Latin American labour market and the fact that a large number of people receive incomes very close to the poverty threshold. If countries are moving in any case towards programs of non-contributory pensions, in other words, if there is a State contribution that is going to come sooner or later, why not design contributions in such as way that they cause least distortion and are as cost-effective as possible? The proposal therefore consists in exempting the poorest people from paying social security contributions. Instead, the State would pay contributions, either into an individual account in the case of countries with defined-contribution schemes, or directly into an account for financing pensions, in the case of defined-benefit systems. That eases the cost of hiring people with low incomes and should encourage their being offered formal employment. For those who are not so poor (middle class) the proposal is to subsidise the contribution but to reduce the subsidy progressively. As from a pre-defined threshold, it is assumed that people can self-fund their pensions, at which point the system would remain as it is today. The initiative is complemented by a proposal to create a fund to preserve state contributions from economic or political upheavals, imposing clear conditions of economic and fiscal sustainability.

The advantage of this system is that it would not encourage informality, but would encourage the creation of formal wage-earning employment for less-skilled workers. It is very important to emphasise the idea of a route sheet, because it undoubtedly implies a fiscal cost. It is necessary to have a transition, as in every reform, and it is necessary to seek a way to fund it and ensure that the funds are there, in a sustainable manner.

IV. Conclusions

If nothing is done, it is highly likely that the pensions produced by the region's pension systems will be inadequate. We are experiencing an unprecedented expansion in life expectancy, which is great news. The challenge, however, is to know how to finance the longer retirement periods to be expected. With a system in which little is contributed, the result is either unsustainability in pay-as-you-go systems, or low replacement rates for the vast majority of the population.

From the public policy point of view, it is certainly necessary to increase retiring age progressively to at least 65 years for men and women, and then index-link it to the increase in life expectancy. It is also necessary to make benefits more proportionate to years of contribution in the pay-as-you-go systems. On the other hand, it is also vital to evaluate the effect of increasing the contribution rate with great care. The solution may be to increase the general rate, while providing subsidies for people with lower incomes.

Finally, it is necessary to solve the problem of low coverage and contribution density in a sustainable way, by drawing up a route sheet leading towards higher coverage. The proposal is that the State should pay contributions during workers' active lives in the case of people with lower incomes, rather than doing so with an ex-post non-contributory pension. The benefits of this proposal lie in the fact that it is progressive (it provides most help for the people who have least), it generates more formal employment and avoids poverty in old age for a large majority of the population.

THE SAVINGS FOR RETIREMENT SYSTEM IN MEXICO[1]

PEDRO ORDORICA[2]

1 *Comments on the presentation by Carmen Pagés.*

2 *Pedro Ordorica is a Licentiate in Law, having graduated from the Escuela Libre de Derecho, Mexico. He is currently President of the National Commission of the Savings for Retirement System (CONSAR). In the practice of his profession, he has occupied various positions within CONSAR itself and in the Bank of Mexico. He has also worked as an independent consultant. In the academic field, he is involved in various activities in the Escuela Libre de Derecho, the Universidad Panamericana, the Universidad Anáhuac and the Latin American Monetary Research Centre (CEMLA).*

People tend to forget why we arrived at defined-contribution systems. Alejandra Cox[3] stated it very strongly: pay-as-you-go systems are unsustainable and are taking many countries to the brink of ruin. Going back that way is not a solution.

In Mexico today we are "celebrating" 15 years of the existence of the Savings for Retirement System (SAR) because, although defined-contribution systems are not a panacea, when they are applied consistently and over a long time, they will begin to bear fruit. The problem is that these systems tend to be evaluated in the very short term and often with an unfair approach. These systems are not here to solve the problems of the formal labour market, nor to solve the problems of wage levels, but to provide pensions that are fiscally sustainable and aligned with what people have worked for and contributed. From that point of view, Mexico has much to celebrate.

With reference to the presentation given by Carmen Pagés, I must say that I agree with each and every one of her diagnoses and I shall be making just a few comments that seem to me to be very interesting.

There are countries that insist on introducing parametric reforms, in other words, increasing retiring age or the minimum number of years for obtaining a full pension. Carmen Pagés was saying, though perhaps less crudely, that if people in countries like Spain are being asked to work for 33 or 35 years in order to qualify for a pension, then basically it is being denied. In a country which today has 50% unemployment in the under 35 age-group, it is highly likely that people will have no way of qualifying for any pension at all. In other countries, such as France, reforms have been brought in that require people to contribute for 38 years (and in others up to 40) in order to be entitled to a pension, with brutal penalties on the amount for each year that is lacking.

So these reforms, which apparently continue to give life to the defined-benefit systems, are actually leaving a large number of people without any pension at all. I agree therefore with Alejandra Cox, that the only viable system is the defined-contribution one which, though not a panacea, does solve many problems.

3 *Alejandra Cox. Labour market trends and their interdependence whith the Individually-funded Pension Systems. FIAP Seminar 2012, Mexico.*

The following pages show the main characteristics and diagnoses in the SAR's performance, 15 years after its inception, and also the proposals for improving it.

I. Background

In 1995, according to figures from the independent consultant actuaries of the Mexican Social Insurance Institute (IMSS), the actuarial deficit of the old IMSS pension system already represented 61.4% of the 2004 GDP. For the system, as it was then, to be capable of paying pensions, it would have had to increase contributions to 23.3% of the Base Contribution Wage (SBC) in 2020, with the consequent impact that this would have had on the effect of formal employment.

In other words, if the reform of the IMSS had not taken place, its financial deficit would have reached 141.5% of the 1994 GDP on a 74-year horizon.

The actuarial deficit of the State Workers' Social Security and Services Institute (ISSSTE) already represented 46% of GDP in 2002. By 2007 it was no longer just an actuarial deficit, but a financial or cash deficit that was absorbing budget resources to the tune of some MXN 42 thousand million each year to cover the pensions then being paid.

So both systems, the IMSS and the ISSSTE, were unsustainable, making it necessary to carry out a structural reform to give them long-term financial viability. The new system of individual accounts, the SAR, has several attributes that are worth highlighting.

First, in this system there is no loss of rights: in other words, there is a proprietary right to the contributions that is always maintained at all times. The worker always receives the benefit of his/her savings, even if he/she does not reach a minimum number of contribution years or has contributed in different systems.

Second, the system offers mobility and greater fairness. The worker may work in several sectors without losing his/her contributions, and the system rewards permanence in work with a better pension.

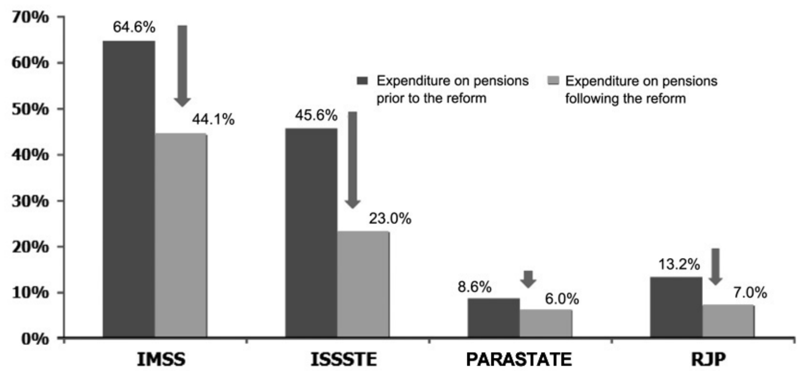
Third, in Mexico solidarity was retained by establishing a commitment on the part of the government to set up a guaranteed minimum pension, which is financed with the taxes paid by society as a whole and not just the workers. Furthermore, with the so-called "Social Contribution" paid by the government, the workers with lowest wages receive more benefit.

Fourth, the SAR takes the financial system to the workers, who would otherwise not participate in it.

And finally, in the SAR the worker has full proprietary rights over his/her individual account which, once created, never expires, and the resources may in fact be inherited.

It is also very important to underline the fact that, in addition to the IMSS and the ISSSTE, reforms were also carried out in the systems of the Federal Electricity Commission (CFE) and the Pensions and Retirement Benefits Scheme of the IMSS (RJP), producing savings of around 52% of GDP (see Graph Nº 1). Certainly, with these reforms the platform for a fiscally sustainable pension system was put in place.

GRAPH Nº 1
SAVINGS THROUGH PENSION SYSTEM REFORMS (% OF GDP)



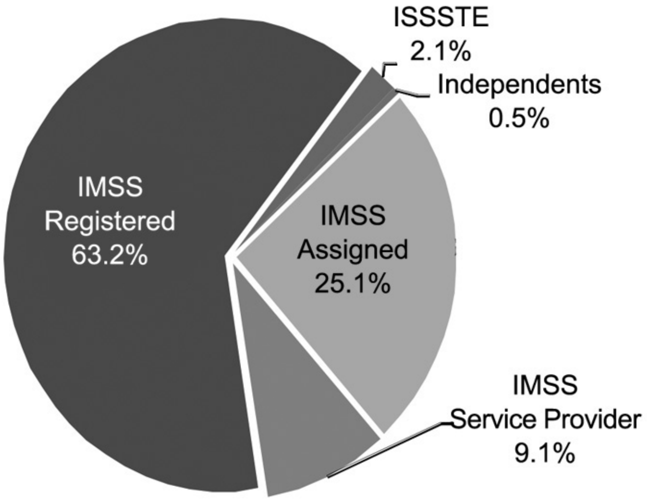
SOURCE: CONSAR, MEXICO

II. Coverage of the SAR

At the end of March 2012, according to data from the National Institute of Statistics and Geography (INEGI), there were already 46.8 million individual accounts in the SAR, representing 94% of the Economically Active Population (EAP). In other words, practically the whole EAP of Mexico has an individual account. Graph Nº 2 shows the segmentation of the existing individual accounts per type of worker, while Graph Nº 3 shows the distribution of the individual accounts by Retirement Fund Administrator (AFORE).

GRAPH Nº 2

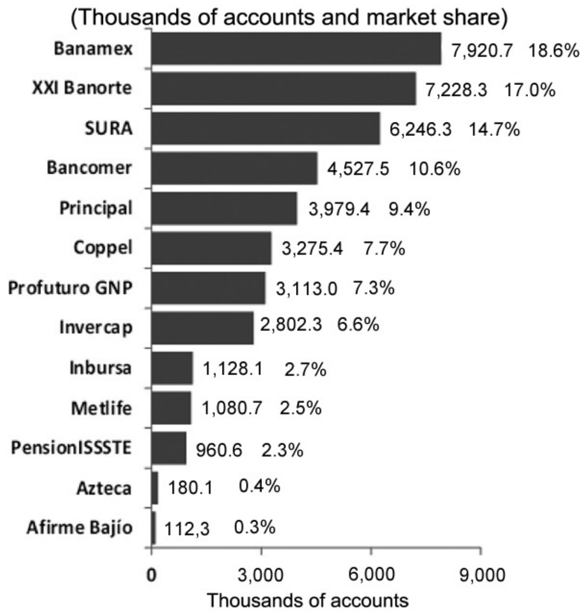
SAR: INDIVIDUAL ACCOUNTS



SOURCE: INDICATORS OF OCCUPATION AND EMPLOYMENT AS OF FIRST QUARTER OF 2012, INEGI. FIGURES CORRESPOND TO END OF MARCH 2012. IN THE CASE OF ISSSTE, THE ONLY ACCOUNTS INCLUDED ARE THOSE OF WORKERS UNDER THE INDIVIDUAL ACCOUNTS SCHEME.

GRAPH Nº 3

INDIVIDUAL ACCOUNTS WITH RESOURCES IN SIEFORES



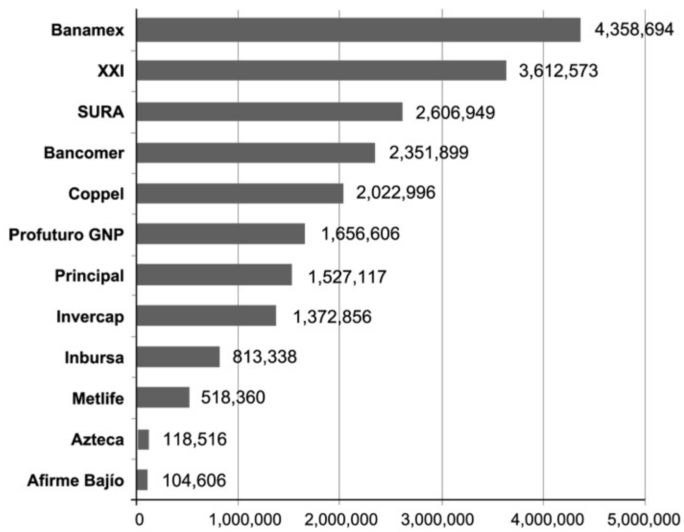
SOURCE: CONSAR, MEXICO.
NOTE: SIEFORES = INVESTMENT COMPANIES SPECIALISING IN RETIREMENT FUNDS.

When we talk about the formal and informal sector, we are not speaking of segments that never cut across one another. Quite the reverse: Carmen Pagés has already pointed out that there is a lot of capillary action in Latin American labour markets, so the question is: since we already have a system that has opened an account for everybody, how can we take advantage of it to increase pension coverage.

Contribution density is a decisive factor for SAR coverage. According to the information published by CONSAR, at the end of April 2012 there were 21.1 million accounts belonging to workers enrolled in the IMSS that had received at least one contribution in the past 36 months. In other words, of the 46 million accounts, there are approximately 15 million contributors enrolled in the IMSS today in a regular manner, but if the accounts are followed up every 36 months, at least 21 million accounts are receiving some contribution (see Graph Nº 4).

Therefore, the number of active accounts that receive at least one contribution in each bi-monthly period is relatively few. If these people are contributing, the challenge is how to enable them actually to achieve a pension.

GRAPH Nº 4
SAR: INDIVIDUAL ACCOUNTS WITH AT LEAST ONE CONTRIBUTION IN THE PAST 36 MONTHS



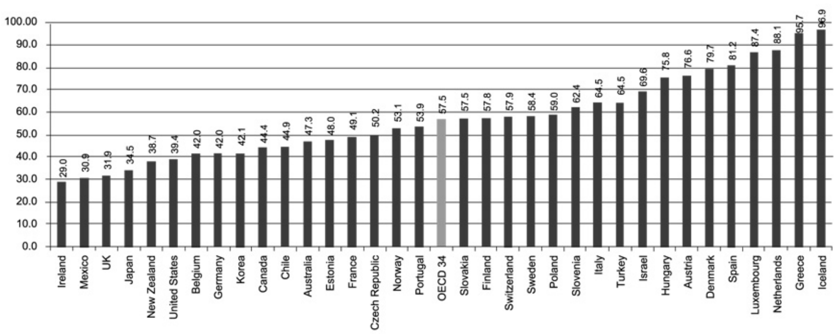
SOURCE: CONSAR, MEXICO.
FIGURES AT END OF APRIL 2012.

III. SAR replacement rates

The other problem that exists is the pension's replacement level. Graph Nº 5 shows the gross replacement rates (before tax) of the OECD countries. It is possible to see that the country that gives the highest replacement rate is Iceland, followed by Greece, a country that we all know is doing very badly in financial terms. Then comes the Netherlands, a country that does have large reserves and then, for example, after Luxembourg comes Spain, a country that has tremendous fiscal problems today, like Italy which is lower down on the same graph. Within 5 years, this graph will most probably be quite unlike the one we are looking at today.

GRAPH Nº 5

GROSS REPLACEMENT RATES OF OECD COUNTRIES

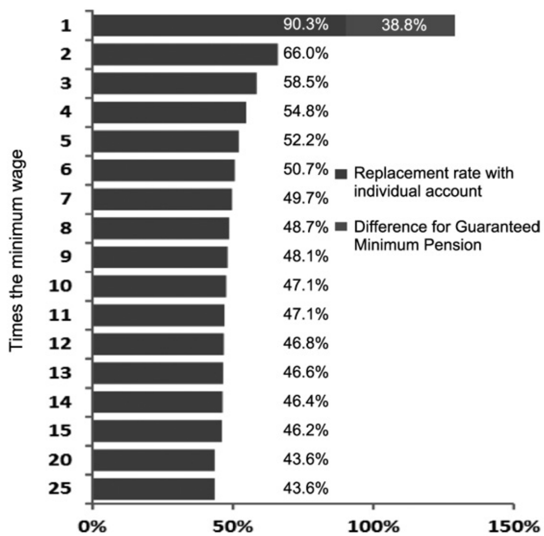


NOTE: GRAPH Nº 5 SHOWS GROSS REPLACEMENT RATES (BEFORE TAX). THE CALCULATIONS SHOW THE BENEFITS OF A WORKER WHO ENTERS THE SYSTEM TODAY AND RETIRES AFTER A COMPLETE WORKING LIFE OF 40-45 YEARS. THE PARAMETERS REFLECT THE SITUATION IN 2008 AND INCLUDE THE RECENT REFORMS (THE PARAMETERS OF THOSE REFORMS WERE CALCULATED FOR 2008).
SOURCE: PENSIONS AT A GLANCE 2011, OECD.

In fact it is also possible to see in Graph Nº 5 that Mexico, like Great Britain, Japan and the United States, has an issue with a relatively low gross replacement rate. But what is understood by "real replacement rate"? If we look at contribution densities, in Mexico the replacement rates of the IMSS may vary from 43% to 129% (see Graph Nº 6).

GRAPH Nº 6

REPLACEMENT RATE OF IMSS WORKERS
(PENSION AS % OF FINAL WAGE)

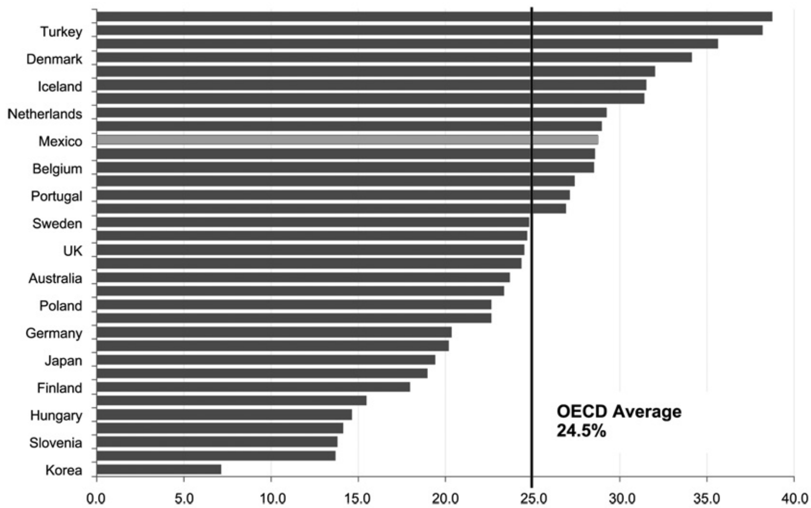


SOURCE: CONSAR, MEXICO. THE ASSUMPTIONS ARE A FLAT WAGE RECORD, A REAL NET YIELD OF 4.9%, A CONTRIBUTION DENSITY OF 100% AND A WORKING LIFE OF 40 YEARS.

It is very interesting to note that, according to data from the OECD, the minimum pension is above the average as a percentage of the wage in Mexico (see Graph Nº 7).

GRAPH Nº 7

MINIMUM OR BASIC PENSION AS A PERCENTAGE OF THE AVERAGE WAGE IN THE ECONOMY



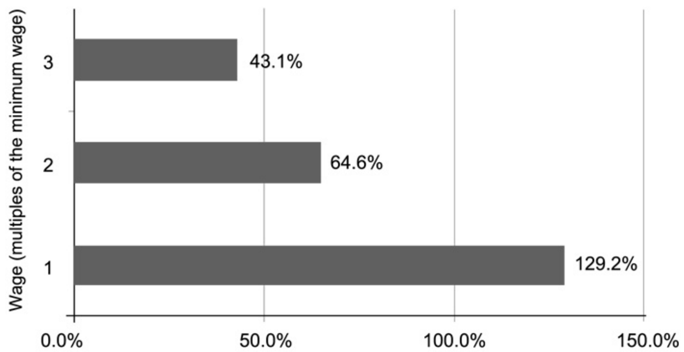
SOURCE: PENSIONS AT A GLANCE 2011, OECD.

So, the guaranteed minimum pension in Mexico is very high compared with the average wage of the economy, meaning that it provides effective protection from the social point of view.

This leads to another reflection. Graph Nº 8 shows the workers who contribute in the IMSS and who earn between one and three minimum wages (SM). These workers represent 73% of the contributors to social insurance and they will not actually manage to achieve a pension above the minimum either because of their contribution density or because of their accumulated balances. This will make them eligible for the guaranteed minimum pension.

The guaranteed minimum pension in Mexico is more than the SM, so, for a worker on one SM in Mexico, receiving the guaranteed minimum pension gives him/her a replacement rate of over 129%; for a worker receiving 2 minimum wages, the minimum pension is equivalent to 65% of his income, which means that we are practically at the international standard of 70%. Those two groups of workers represent in themselves over 50% of contributors, and this is a fact that tends not to be picked up normally in the press.

GRAPH Nº 8
GUARANTEED MINIMUM IMSS PENSION AS % OF WORKER'S WAGE

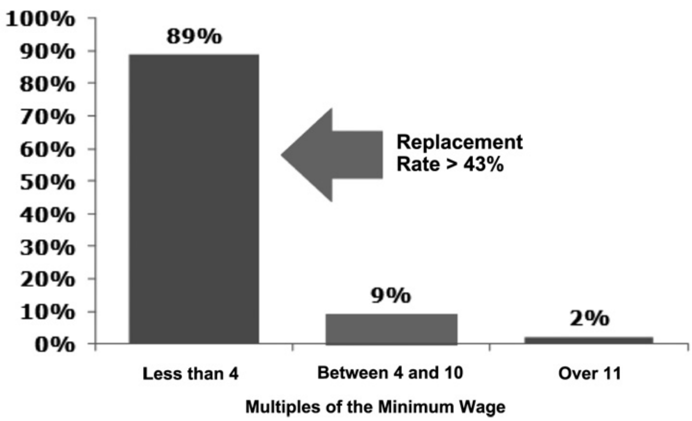


SOURCE: CONSAR, MEXICO.

The challenge lies in seeking to improve the replacement rate of workers who are between 4 and 10 SM and who represent 9% of the workers enrolled in the IMSS. Graph Nº 9 shows that 89% of workers enrolled in the IMSS have a wage lower than 4 times the SM and will obtain, with the guaranteed minimum pension, a replacement rate of between 43% and 129%, as has been stated already. Meanwhile, workers who earn more than 11 SM, who represent only 2% of the workers in the IMSS, have additional old-age protection by way of private pension plans.

GRAPH Nº 9

WAGE DISTRIBUTION OF WORKERS ENROLLED IN THE IMSS OF THE AFORE GENERATION



SOURCE: CONSAR, MEXICO.

IV. Proposals

In order to improve replacement rates, at least two reforms in the Mexican Pension System would have to be implemented:

1. **The Guaranteed Minimum Pension (PMG) should be paid to workers with over 750 weeks of contribution (the minimum today is 1,250 weeks).**

   Together with the above, a guarantee should be granted equivalent to a percentage of the PMG, proportional to the weeks contributed.

   This policy, de facto, would expand the coverage of the Social Insurance Law (LSS) to a considerable extent. It would cover 850,000 workers, mainly with incomes of less than 4 minimum wages.

   According to the calculations that have been made, the present value of the fiscal cost of this proposal is estimated at MXN 161,878 million (1.2% of GDP). How would this reform be funded? Well, in CONSAR we have calculated what would happen if the pension age were raised by 2 years from 65, as it is at present, to 67. The results indicate that the replacement rate would increase on average from 39.5% to 49.4% with this change. Furthermore, if, from that reform onwards, the age of retirement were indexed to the increases in observed longevity, this change would make it viable to finance that proposed PMG, because it would produce savings of over 7 percentage points of the GDP on what is today called the "transition generation". The proposed PMG would cost us 1.2% of GDP, so we would have more than enough savings to fund this reform.

2. Mechanisms should be sought to increase contributions without increasing the cost of labour

In order to do this it would be necessary to make the contributions of the IMSS equal to those of the ISSSTE. At present, in a working life of 40 years, workers' contributions to the IMSS in the subaccount of Retirement, Severance and Old-age (RCV)[4], without including the Social Contribution, are equivalent to the 2.6 years' wages (the boss 2.1 years, the worker 164 days and the Government 33 days).

4 *The tripartite contributions and payments are deposited in this sub-account: in other words, those paid by the boss, the federal government and the worker. The contributions are paid proportionally, as follows: Employer: for Retirement, 2% of the base contribution wage and for Severance at an advanced age or Old Age, 3.15% of the base contribution wage. Contributions are paid bi-monthly; State: 0.225% of the worker's base contribution wage for Severance at an advanced age and Old Age (bi-monthly) and an amount equivalent to 5.5% of the general minimum wage for the D.F. for each day contributed, as social contribution; Worker: 1.125% of base contribution wage, bi-monthly. The total resources paid into this sub-account are equivalent to 6.5% of the worker's base contribution wage. The base contribution wage is that which the employer reports to the IMSS for paying the corresponding instalments, and includes all the cash payments that a worker receives under the heading of daily payment (wage), bonuses, receipts, meals, lodging, premiums, commissions, loans in kind and any amount or benefit given to the worker.*

EVOLUTION OF PRIVATE VOLUNTARY SAVINGS PLANS IN THE U.S.

STEPHEN UTKUS[1]

1 *Stephen Utkus is chief and director of the Vanguard Center for Retirement Research. The Center conducts and sponsors research on retirement savings in the United States, with an emphasis on private defined-contribution retirement plans. Its work is designed to assist employers, consultants, policymakers, and the media in understanding developments in the U.S. retirement system. Utkus's research interests also include behavioral finance and the role of psychology in household financial decisions. He is a member of the advisory council of the Wharton Pension Research Council and a member of the board of trustees of the Employee Benefit Research Institute.*

The goal of this brief article is to describe the 401(k) retirement plans in the U.S. and see if there are any lessons that Latin American mandatory pension systems might consider in encouraging private supplemental contributions to their systems.

Early history of U.S. occupational pensions

I am going to begin from the late 19th century. The first occupational pension system in the US was established by a company called American Express. It was not the credit card company you know today; it was a shipping company.

In keeping with pension systems of the time, the American Express pension was a pay-as-you-go defined-benefit plan. Pension payments to retirees came directly from current corporate revenues. Similar pension programs evolved in the late 19th century and the early 20th century in such industries as railroads and utilities. Given these developments in the private sector, it was not surprising that in 1935, when the government sought to establish an old-age mandatory state pension known as Social Security, during the Great Depression, it adopted the same model that corporate American Express used—a defined-benefit pay-as-you-go system.

These supplemental occupational defined-benefit plans became quite popular after WWII, particularly in unionized industries—including automobiles, steel, paper, rubber, oil, and utilities. During the same period, there was a secondary growth of defined-contribution plans. Under the "profit-sharing" movement, corporate profits were shared with workers through profit-sharing contributions to a defined-contribution plan. In the "employee ownership" movement, workers would come to own the corporate stock of their employers through an employee stock-ownership plan. But these early defined-contribution plans were always less prominent than traditional defined-benefit plans.

ERISA and the regulation of Defined Benefit (DB) pensions

In 1963, the traditional defined-benefit system was thrown into disarray when a famous auto company, Studebaker, went bankrupt. Because its DB pension was unfunded, most active workers, including those with long job tenure, received nothing in the way of pension. It took more than a decade, but Congress responded in 1974 with the passing of the well-known pension law, the Employee-Retirement Income Security Act (ERISA). Among ERISA's features were the legal principle that vested and accrued benefits should be fully funded in advance by employers, and the creation of an insurance fund, managed by the federal government, known as the Pension Benefit Guarantee Corp., which would serve as a backstop for defined-benefit plans in the event of corporate bankruptcy. ERISA is also well-known for its fiduciary and plan governance standards.

In 1974, at the time of the passing of ERISA, about half of the private sector workforce was involved in occupational pension systems. Of that half, more than 80% of the group was in defined-benefit plans, and less than 20% were in profit-sharing or other defined-contribution plans. Of the defined-contribution plans that existed, funding was solely from employer contributions and employers were responsible for all investment decisions. Workers had really no say in these traditional defined-contribution programs.

The rise of 401(k)s

How, then, did 401(k)s evolve and become the dominant type of occupational pension plan in the U.S? In 1978, Congress decided to offer additional tax benefits to encourage private saving as part of its annual budgeting process. It did not necessarily set out to encourage retirement or old-age saving or create a new type of pension system. Rather, it was more interested in encouraging saving in general through the tax code. At the time, certain large companies had established some corporate savings plans, and Congress granted these plans a specific tax benefit: employee contributions to these savings plans (up to a certain limit) would be tax-deductible. This tax benefit was added to section 401 of the U.S. tax code – and the new section was labeled section (k). Hence 401(k)s were born in 1978.

By 1981, the government issued new regulations for 401(k) plans—and the 401(k) era began. Starting in the early 1980s, emerging companies that had previously never offered a pension began adopting 401(k) plans as their first and only pension plan. Think of newer American companies like Microsoft or Dell or Walmart: they never offered traditional pensions and, as they grew, they introduced 401(k) savings plans instead. (Vanguard, coincidentally, was established in 1974 and grew rapidly over this period. We too offer only a defined-contribution plan).

At the same time, over the decades that followed, established companies— including Bank of America or IBM or General Motors—gradually began to switch from defined-benefit to defined-contribution plans. Often the transition to 401(k)s is inaccurately described as U.S. companies switching from one pension type to another. But in reality, both trends were at work, with high-growth companies adopting 401(k)s as their first and only pension, and more established companies making the switch over time.

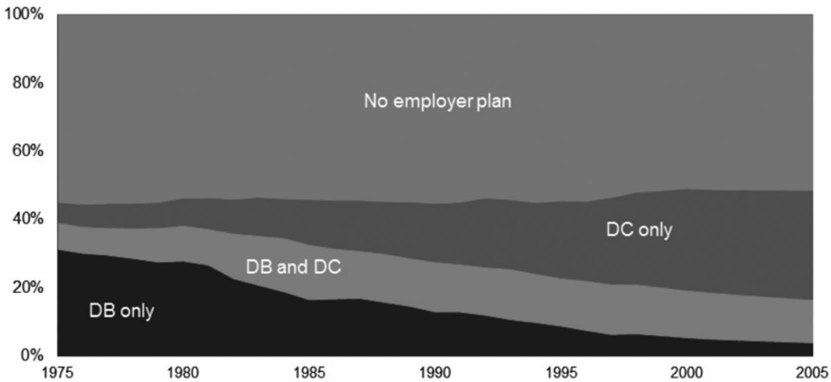
Under 401(k) plans, most of the contributions came from employee wages, with secondary contributions by the employer. Because employee wages were the prominent type of contribution, employers decided over the course of time that employees should control the investment decision-making. Whereas traditional defined-contribution profit-sharing plans were under the control of the employer, and usually invested in a single balanced account, in 401(k) plans the control gradually shifted to the participant or worker. And 401(k) plans offered a range of investment options to workers, who could then choose from among them.

This was how the transition to 401(k) plans occurred. Today, about 30 years after the initial 401(k) regulations were issued, and more than 35 years after the passage of ERISA, about half the U.S. private sector workforce is still covered by occupational pensions. However, over 80% are now covered by defined-contribution 401(k) plans, and less than 20% are covered by traditional defined-benefit programs—a complete reversal of the proportions in 1974.

Snapshot of changing coverage

Graph Nº1 captures these developments. Traditionally, in the US about half the workforce has had no occupational pension plan, since the plans are voluntary at the employer level. This has not changed, but there has been a major shift in the composition from defined-benefit to definedcontribution. By the way, this data is given up to 2005, and the defined-benefit line continues to fall quite dramatically.

GRAPH Nº 1
PRIVATE WORKER PLAN COVERAGE (1975-2005)



SOURCE: DEPARTMENT OF LABOR, VANGUARD.

Keep in mind that all employees and employers in the U.S. contribute to the state Social Security system. Over 95% of workers receive some minimum state pension from Social Security. So the U.S. coverage issue is somewhat different from yours. We have near universal coverage with the state Social Security system. But the system is not designed to provide an adequate income on its own. Our coverage challenge is one of encouraging small businesses to adopt occupational plans, whereas in your countries, the problem is one of the informal labor market and of individuals avoiding contributions to the mandatory pension system.

The role of the employer

One of the themes that I think may be relevant to Latin American pension systems is the role of the employer. In the U.S. 401(k) system, the employer plays a prominent role. Much of the discussion we have had today about supplemental contributions has focused solely on encouraging individuals to contribute. But I think an important question to consider is to what extent Latin American systems can enlist the employer to encourage supplemental contributions. (I know some private employers offer their own pension plans; but here I am thinking instead of enlisting private employers to encourage supplemental contributions to the mandatory system, including contributions by employers.)

Summary of U.S. system

Let me summarize, then, the characteristics of the retirement system for the typical private-sector worker. First, dating from the 1930s, with changes over time, there is Social Security—a pay-as-you-go defined-benefit system. It is a World Bank Pillar 1. Social Security is compulsory, pay-as-you-go, and funded by tax revenue. Over 90% of workers are covered. Benefits from Social Security are paid as an inflation-adjusted annuity. Importantly, Social Security has a progressive benefit structure: if you are low wage, your replacement rate is 60-65% and if you are high wage, it is 10-20%. As noted by an earlier speaker, 35% to 40% is the wage replacement rate for the median worker.

Second is the U.S. occupational system, which is increasingly dominated by 401(k) plans. It is a World Bank Pillar 3 (there is no World Bank Pillar 2, which is a mandatory occupational system). The U.S. occupational system is not compulsory; it is voluntary for the employer, and voluntary for the employee. Within 401(k) plans, employee contributions are the main funding source. The most common form of payment is lump sum distributions. Assets in the 401(k) system total US$3.1 trillion today, with about 80 to 85 million accounts.

Third, let me mention the IRA system. I know in Mexico you also have an IRA system. In the U.S., the IRA system is a World Bank Pillar 3 program offering tax-advantaged savings at the individual level. However, most of the assets in IRAs come from the 401(k) system through "rollovers." When you change jobs, a worker in the U.S. gains control over all the assets in the 401(k) account and can move those assets to an IRA at any financial institution in the country—a process known as a "rollover" from a 401(k) to an IRA. In effect, through this process, occupational pension assets become assets under individual control. IRAs have about US$ 4 trillion, but much of that has originated earlier in the 401(k) system. So think of 401(k)s and IRAs as an integrated system. They can't really be thought of independently.

Key characteristics

Let us walk through certain characteristics of the U.S. 401(k) system and think about how certain features could be used to encourage voluntary savings in Latin American systems.

As I noted earlier, one of the key characteristics is the role of the employer, and that is one of the elements that I believe we need to think about philosophically for Latin America. What role does the employer play in promoting voluntary savings? In the U.S., an occupational plan is voluntary, but once offered, it obviously has to comply with complex tax and fiduciary law. Yet the idea of occupational pension systems is that it is better to collect contributions at the workplace—before workers have a chance to spend their income—and to enlist the employer in encouraging these contributions. I would ask the question: Is there a larger role for employers to play in encouraging supplemental contributions to Latin American systems?

A second characteristic of U.S. 401(k) plans is that there are quite substantial tax subsidies. This is often a criticism of the U.S. system, but it remains an essential element. The tax subsidies are what are known as PPT—contributions are pre-tax, earnings are pre-tax, and then distributions (withdrawals from the accounts) are taxed in retirement, when presumably the account owner is at a lower tax rate. The tax limits today are generous: a worker (under the age of 50) can contribute up to US$ 17,000 of his or her own money (the limit is higher for age 50 and older). Employers can contribute more, so the total amount contributed can reach nearly US$ 50,000 a year if the employer chooses to make contributions. The tax subsidies for retirement are the second largest tax subsidy in the U.S. tax code. In times of fiscal stress, such as that currently being faced by the U.S., one of the debates is whether the tax subsidies are too large.

A third feature of the U.S. is a comprehensive regulatory system, including tax, fiduciary and securities law regulators. One observation I would make is that there is a lot of shared regulation between this IRA system and the 401(k) system—in effect, a blurring between the employment system and the individual saving system, which does not exist in the Latin American systems in the same way.

One U.S. feature I would encourage you to avoid is creating different types of tax-advantaged savings plans for different segments of the population. I have spoken today about 401(k) plans. But in reality, I mean 401(k), 403(b), 457, profit-sharing, KSOP, ESOP, SEP, SIMPLE and other types of defined-contribution plans. In effect, they are all very similar but have different rules and regulations. Here's one simple lesson from an American: don't repeat this mistake. A common proposal in the U.S. is to streamline all of these plan types into a single, simplified system.

Contribution behavior

In the U.S., about 2/3 of eligible participants contribute to a 401(k) plan when offered. As a result, we are continually working on how to promote voluntary contributions – although this focus on voluntary contributions is changing, as I'll discuss in a moment. The median contribution by the employee today is 6% of pay. The employer typically offers a matching contribution of 3%. By the way, this is a unique feature of the U.S. system—a large part of the employer contributions are not made automatically, but are used as incentives for employees to contribute. Should Latin American systems find a way to encourage employer matching contributions for employee voluntary contributions?

In terms of contributions, in the U.S. there is wide variation in the level of contributions around the median 9%. There are some workers contributing 1% or 2% with no employer contributions, and then there are some plans where the employer and the employee are generating 18% to 20% of pay. At Vanguard, where I work, the contribution rate is 18% of pay—4% from the employee, 4% employer matching contribution, and a 10% automatic employer contribution for all.

Investment characteristics

Investment offerings are another compelling feature of the U.S. system. As with your mandatory pension systems, 401(k) plans offer diversified investment offerings and daily valuation of accounts. I suspect there is probably a greater degree of transparency in terms of strategies and holdings in the U.S., given the disclosure regime, and this is certainly something every pension system can work on.

The investments in a typical 401(k) plan today are structured as a two-tiered menu. In Tier 1, a participant or worker can choose between a series of target-date funds, which are similar to the age-based strategies in your pension systems. For example, I might pick the 2025 Fund because I expect to retire around the year 2025. As I become older, the fund's allocation becomes more conservative.

Tier 2 consists of a range of individual investment options. This is one feature that is unique and appealing about 401(k) plans—the availability of very detailed and discreet investment strategies. Plans will offer 10, 15 or 20 additional options—large cap, mid cap, and small U.S. stocks, developed versus emerging stocks, various types of bond funds, conservative short-term investments, inflation-protected bonds, real estate investment trusts and so forth. Participants have a real ability to personalize their investment allocation. This is something to consider as you think about promoting voluntary savings. Off-the-shelf, life-strategy or life-cycle funds are great. But to appeal to those who want to contribute more, more investment flexibility may be necessary.

In the U.S., just a side note, some large employers have used employer stock in their investment menus. You may have heard of Enron, where the 401(k) plan was concentrated in Enron stock and went bankrupt. But this risk – of having too much of your retirement savings in your employer stock – is falling over time, due to regulatory changes.

Another feature of investment menus is a growing focus on low-cost investing, and plans are increasingly using indexing strategies to lower the costs of investing. The mandatory systems in Latin America might follow this same path – offering more investment choice, and ensuring that many of the options are low-cost index funds, offering better value for investors than what they might be able to purchase in the retail marketplace on their own.

The behavioral finance revolution

Perhaps the biggest change in 401(k) plans over the past decade is a revolution driven by behavioral finance. Behavioral finance has provided two lessons to policymakers and plan sponsors. First, many workers are poor planners and so do not save enough for the future. And second, many workers have poor portfolio construction skills.

To respond to concerns about lack of saving, 401(k) plans are increasingly introducing automatic enrollment. Under automatic enrollment, workers do not voluntarily choose to make contributions, but they are instead automatically enrolled in the plan, with a right to opt out. What we know about auto-enrollment is this: if you look at traditional low savers— people with low wages, the young and, in the U.S., ethnic minorities—auto-enrollment nearly triples their participation rates in 401(k) plans. This is quite a powerful and appealing idea to policy makers.

One concern with automatic enrollment is a contribution rate that is too low. In a typical plan, the worker is given the following notice: "Next week you will begin to make contributions at 3% of pay, but you have a right to opt out." But 3% of pay is too low to guarantee a reasonable retirement income for most workers (even after including the state pension, Social Security). Thus, the best practice in the U.S. is to use an automatic escalation feature. In year 1, the worker contributes 3% of pay; in year 2, the contribution increases by 1% to 4% of pay; in year 3, to 5% of pay; and so on to a cap, such as 10% of pay. Many large U.S. employers have introduced these designs in the past few years.

The auto enrollment / auto escalation feature is another interesting idea to consider in the context of Latin America. What role could automatic enrollment in voluntary contributions play? What about an automatic escalation feature?

The second lesson from behavioral finance is on the investment side. For more than a quarter century, the 401(k) model was that all workers should manage their own money. "Take charge of your savings." "Every worker should be a money manager." Research from behavioral finance and from the field of financial literacy has taught us that this is an undesirable or indeed unachievable goal. Instead, the U.S. system is moving workers toward automatic investment features—namely, target-date funds, which are age-based lifecycle funds, and managed account advice programs, which are basically third-party advice services that are technology based and that manage your portfolio in a customized way. We anticipate that more than half of all workers will be investing their contributions in a single target-date fund within 5 years—and in effect, will be delegating investment decisions back to the fund manager. Part of this is because employers are automatically enrolling workers in target-date funds. But another reason is that workers with low levels of investor literacy find it easy to invest in target-date strategies, given the simplified method of choosing the fund based on an expected year of retirement.

In other words, in the U.S. we are moving more towards a model in which more workers are invested in default or professionally-managed strategies. But as you think about encouraging voluntary contributions, you will probably want to think about exactly the opposite: what additional investment flexibility do you need to offer besides the standardized lifecycle options that exist in the mandatory pension system? Many of those workers making supplemental contributions would probably be better off just choosing the standard lifecycle options. However, they may never be willing to make voluntary contributions unless they have other choices.

Education and communications

Another distinctive feature of 401(k) plans – which is also, of course, somewhat characteristic of Latin American pension systems – is a promotional and communication element. We call it the member or the *participant experience*. 401(k) plans are associated with extensive education and communication programs. The main difference in the US is that the educational messages are lifecycle-based and are mostly about saving and retirement planning. Promotion is not centered on investment performance as in many Latin American systems; it is not about moving your money from one AFP to another. This kind of fundamental refocusing of communications is an important idea you should think about. You won't encourage voluntary contributions, which are more of a retirement planning or savings adequacy issue, if you are spending your time promoting short-term investment performance.

An emerging feature of the participant experience is advice. Increasingly, workers are looking for professional advice. This can come in the form of a managed account, as I mentioned earlier, which is a type of customized portfolio. Or it can come in the form of pre-retirement financial planning or counseling.

I'd also like to highlight the participant service model. Today, 80% of the transactions in 401(k) plans are on the Internet. That is, of course, a function of our relative national income, but it is also a function of the fact that 401(k) plans have to compete with retail financial institutions. The fastest growing adopted technology at Vanguard today is now the smartphone. It is growing at compound rates of 30% per month. We can imagine a world in which, for example, your smartphone would ring and remind you that you need to save more for retirement.

Ongoing issues and concerns

Let me summarize some of the current issues in the retirement debate in the U.S.

Perhaps the biggest policy debate concerns adequacy. There is some worry about those who have occupational pensions and whether they are contributing enough. But the main challenge is that half of the workforce does not have access to an occupational pension system. There are various proposals to expand the system to cover these workers, of whom a very large proportion works in small companies. As I said, our coverage issue is not an informal labor market problem; it is a small-firm problem. More broadly, the issue of raising private pension contributions is obviously a worldwide concern. In the U.S., particularly among low-wage workers, automatic enrollment is the preferred mechanism for addressing this concern, at least among those workers at firms with 401(k) plans. In the U.S. our approach is not to mandate such policy changes but to encourage them gradually. Thus we see automatic enrollment and automatic escalation disseminating gradually through the 401(k) system. Some would argue that, in order to increase contributions faster, such features should be a mandatory feature of the system.

A related issue which is unique to the U.S. is the pre-retirement access that workers have to their saving. Workers gain access to their 401(k) accounts when they change jobs. There are tax penalties that discourage individuals from spending their savings—but they can spend them if they want to. This problem is known as the "leakage" problem in the U.S.

A second issue in the U.S. today is fees. I spoke about the importance of low fees earlier; let me come back to the issue again. A major regulatory undertaking beginning in August 2012 is the new fee disclosure regime for the employer—and for the employee. We expect greater competition regarding fees and fee reductions across the system. An important question to think about for mandatory pension systems is how they can reduce fees (for example, with indexing) and then promote themselves as a low-cost place to invest; not just for mandatory contributions, but also for voluntary savings.

Finally, another topical issue in the U.S. concerns the fact that 401(k) plans typically pay benefits as a lump sum. Policymakers would like to encourage greater annuitization of 401(k) assets, even though U.S. workers already receive a lifetime annuity from the state Social Security system. The lesson for Latin American systems is, I think, the opposite. Today you obviously mandate annuities or structured payouts because of the social insurance nature of the pension systems. But as you seek to encourage voluntary savings, you will need to consider how to provide lump sum access to the voluntary portion of savings in retirement. This flexibility will make voluntary savings more attractive.

A brief recap

Let me recap with a short list of things to think about in promoting voluntary savings. Number one is this promotional idea: promoting education about adequacy and contributions, rather than investment performance. Number two, tax incentives – should they play a role? Number three, the employer – what role can the employer play? Again I am not referring here to formal employer pensions, but how the employer can be enlisted to encourage voluntary contributions to the mandatory system.

Number four is this idea of investment flexibility and choice: people are more willing to put money where they have more choice of tailoring their portfolios, and related to this are the ideas of advice and the notion of low-cost investing. If you can drive down costs in the system and make it more attractive, it becomes a destination of savings. As for number five, the automatic enrollment, auto-escalation idea, I'm not sure about how to adapt the idea to Latin American systems, but I do think that it is the most important behavioral finance idea to consider.

PART III

DEVELOPING PENSION SYSTEMS FOR A MORE DEMANDING CUSTOMER

CITIZEN PARTICIPATION IN THE FORMULATION OF STRUCTURAL REFORMS: THE 2008 PENSION REFORM IN CHILE

MARIO MARCEL[1]

1 *Mario Marcel has a degree in Economic Sciences from the University of Cambridge, United Kingdom. He is currently Deputy Director of the Division of Public Governance and Territorial Development of the Organisation for Economic Co-operation and Development (OECD). He offers his leadership on issues such as public sector reform, the struggle against corruption, regulatory policy, public budget and expenditure and territorial development. He led the Commission for Pension Reform in Chile in the year 2008.*

I. Motivation

President Michelle Bachelet took office as head of state in 2006 with two major promises: Citizen Government and Pension Reform. While the former was aimed at developing a style of government that would take the needs, opinions and sensibilities of the country's citizens into account, the Pension Reform was intended to transform a central component of social policy, when the individually-funded scheme was introduced in Chile.

One of the points of contact between these two promises was the Presidential Advisory Council for Pension Reform (CAPRP). This Council was set up with the mandate of generating reform proposals for the pension system, bearing in mind the opinions of the citizens and the stakeholders related with the sector. To carry out this assignment, the Council called on 15 experts with a variety of political and professional sensibilities, drew up a work program that included an intensive stage of public hearings, commissioned studies and opinion polls, and produced a set of mutually agreed proposals which were delivered to the President after 100 days of work. The Council's Report provided the bases of the reform bill which the Executive subsequently presented to the Congress. This became law in January 2008, a record in terms of the time taken for processing pension reforms in democracy.

The CAPRP counts therefore as a specific, effective expression of the concept of Citizen Government and as the basis of the main social reform to be introduced during President Bachelet's administration. These facts make CAPRP one of the most interesting recent experiences of public policy making in Chile to describe, evaluate and project.

This paper looks at the CAPRP experience as a participative process of public policy formulation in Chile. To do this, there is first an account of the central elements that defined how the CAPRP worked, both in terms of context, structure and operation and of its link with the later process of preparing, discussing, approving and implementing the legislation on pension reform. Then the paper evaluates the results of the CAPRP in terms of its contribution to Pension Reform and to citizen participation in the formulation of public policies in Chile. In order to carry out this evaluation, the paper compares the performance of the Council with the work of other advisory commissions and councils set up by the government of President Bachelet, and also with previous experiences of reform in pension issues. In the final section the paper makes a deeper analysis of the CAPRP experience as a mechanism for framing public policies, looks at the problems of its relationship with the institutions of representative democracy in Chile and draws some lessons on the potentialities, limits and requirements of advisory councils.

II. The Advisory Council in the process of shaping the Pension Reform

II.1 Frame of reference

Process for shaping public policies in Chile

Chile has a well-deserved reputation as a consistent innovator in matters of public policy. The Organisation for Economic Co-operation and Development (OECD) described the country as a regional referent for structural reforms[2] in 2003, while the Inter-American Development Bank (IDB) in 2005 placed Chile first in Latin America on the basis of a public policy quality index[3], with high grades in all the aspects analysed (stability, adaptability, effective implementation and application, coordination and consistency, orientation to public interests and efficiency).

The BID study quoted above contains a good description of the public policy formulation process in Chile. Policy initiatives generally arise from a strong Executive, with competent technical teams, to be followed by a process of negotiation and agreement in various stages[4]. In this process the key protagonists are the political parties, Congress and a collection of political and social stakeholders who have power of veto resulting from their own strength, their networks or the inheritance of authoritarian enclaves. Chilean Presidential Government is upheld especially by the prerogatives granted to the Executive by the Constitution in budgeting matters, which extend to the permanent legislation in issues concerning taxation, public employment and pensions[5].

2 *OECD (2003) Economic Surveys: Chile.*

3 *Inter-American Development Bank (IDB) (2005) La Política de las Políticas Públicas. Progreso Económico y Social en América Latina. Report 2006, chapter 6.*

4 *BID (2005) op.cit. pp. 170-171.*

5 *Marcel (1997) "Los Caminos de la Gobernabilidad Fiscal en América Latina" Revista Internacional de Presupuesto Público Year XXV, Nº 37, Buenos Aires, 1998.*

All the above shows Chile as a country with a high degree of institutionalisation in the formulation of public policies and a strongly presidential political regime, which has been capable of generating good policies by virtue of its governors' sense of state, a competent technocracy and an honest, efficient civil service, all of which, however, has been unable to avoid the influence of power groups protected by the tremendous inequalities that exist in the country.

At the same time, Chile is a country with limited experience in the use of participative mechanisms of formulation, execution and evaluation of public policies. In general there are no obvious signs of great efforts to consult the citizens when formulating policies and programs and, with few exceptions, the beneficiaries tend to be seen as passive recipients of public policies[6] and participative evaluation of public programs is used very rarely. There is marked centralism in the state and private sector, and the practices of participative planning and budgeting have been relegated to a few municipal councils with mayors who are particularly committed to developing a new local culture. In contrast, Chilean civil society seems to have discovered more space for development in community, sport and religious[7] organisations, while the largest spaces of sociability tend to be concentrated in the family environment, as revealed in the 2007 ECosociAL survey[8].

So, there is another side of the coin to the effectiveness of the hierarchical process of public policy formulation, namely the predominance of technocratic, authoritarian values in the running of the state and a strong elitism in the exercise of power.

Judging by what is shown in opinion studies and the attitudes of the electorate, this is not a sustainable state of affairs. In the past few years it has become increasingly evident, not only that Chileans' electoral participation is low, but also that there is growing dissatisfaction with life and great distrust of those who exercise power in its various forms. Thus a IDB study in 2009 identifies Chile as the country with the most negative "cultural bias" in the whole of Latin America and the Caribbean, this being defined as the gap between people's appreciations and the "objective" indicators of economic and social development[9].

6 *Among the main exceptions to this tradition are some of the social programs implemented in the past decade, such as Chile Barrio and Chile Solidario.*

7 *UNDP (2000) Informe de Desarrollo Humano en Chile 2000. Mas Sociedad para Gobernar el Futuro, UNDP, Santiago – Chile.*

8 *E. Valenzuela et al. (2008) Vínculos, Creencias e Ilusiones. La Cohesión Social de los Latinoamericanos. Uqbar Editores.*

9 *IDB (2009), Calidad de Vida más allá de los Hechos. Desarrollo en las Américas. Inter-American Development Bank. Economic Culture Fund, chapter 2.*

Pension Reform

This area is marked by the inheritance of the 1981 Pension Reform, considered to be the greatest social reform brought in by the military regime.

The 1981 Pension Reform replaced a segmented system of defined-benefit schemes administered by the state with a single system structured on a privately-managed defined-contribution scheme (with individual funding). The 1981 Pension Reform was both daring and creative. The pension system that it produced quickly became a world referent and a model that has been replicated – with variations – by over 30 countries all around the world.

The radical nature of the 1981 reform and its influence on pension systems in other parts of the world did not, however, save it from problems in Chile. Even in the 1980s, certain studies queried the promises of the reform[10]. For most of the population, it was also branded by having been implemented right in the middle of the dictatorship.

Nevertheless, this situation began to change at the beginning of the 2000s. The administration of President Lagos made an effort to produce more information about how the system works, including the records, perceptions and possibilities of the system's members. A fundamental step in this direction was the design and application of the first Social Protection Survey (EPS) in 2002, which compiled information on workers' perceptions, knowledge and expectations of the AFP system and on their working careers[11]. Combining this information with the administrative information of the pension funds for the first time provided a basis to enable a projection to be made of the pensions that members would receive on retirement.

The 2002 EPS and its following applications in 2004 and 2006 made it possible to recognise a real situation that was substantially different from the one advertised by the defenders of the AFP system. The survey revealed high degrees of ignorance about basic facts of the system, and without those facts it was difficult to uphold the hypothesis of rational and informed behaviour on the part of members. Studies carried out by the technical team of the Superintendence of AFPs with information from the EPS were particularly revealing in terms of the delicate position of self-

10 *See for example, Arellano, J.P. (1985), "Políticas Sociales y Desarrollo", Chile 1924-1984 (Santiago, Cieplan).*

11 *Bravo, D. (2004) Análisis y Principales Resultados Primera Encuesta de Protección Social, Undersecretariat of Social Provision, Ministry of Labour and Social Provision, and Microdata Centre, Economics Department, University of Chile.*

employed workers and women[12]. It became possible for the first time to make a direct measurement of contribution density and it was forecast that not only would less than half the workers receive pensions above the minimum, but the vast majority of the remaining workers would not manage to meet the requirements to qualify for the minimum pension guaranteed by the State[13].

In the final stage of President Lagos's administration, proposals were drawn up to reform the pension system, but by then the political debate was already marked by electoral dynamics and these proposals never got as far as being presented to Congress. However, the issue of Pension Reform was taken up by Michelle Bachelet, the candidate of the centre-left coalition known as the "Concertación", who transformed it into a fundamental component of her election platform.

II.2 Origin of the CAPRP

The Pension Reform was one of the most surprising elements of Michelle Bachelet's campaign. Though this was not the first time that the electoral programs of Concertación candidates had promised to modify the functioning of the pension system, never before had a reform been proposed that would tackle all the dimensions of the pension system's operation. This surprised her opponents, because it not only broke a taboo that had lasted almost 25 years, but also reduced to insignificance the proposal of the opposing candidate, Sebastián Piñera, to bring in a pension for housewives.

The process by which the pension reform was included in the electoral program of the Concertación was not devoid of difficulties, however. While the candidate's more liberal advisors doubted the wisdom of a reform in this sector, others questioned its content. The candidate held a series of intense private meetings to familiarise herself directly with the diagnosis of the system's problems and the possible ways of solving them. At the end of this process, the candidate was not only inclined to favour the Reform, but also determined to give it a central place in her program of government and in the electoral campaign.

The inclusion of the Pension Reform in the electoral program challenged traditional schemes. Instead of detailed proposals, it simply stated the urgent need for a reform

12 *Berstein. S. and A. Tokman (2005): "Brechas de Ingreso entre Géneros: ¿Perpetuadas o exacerbadas en la vejez?" Working Paper Nº 8. Superintendence of AFPs. Berstein, S. G.Reyes and F. Pino (2006) "Trabajadores Independientes: ¿Incentivarlos u obligarlos a cotizar? Una Tercera Opción". Expansiva, in Foco Nº 66.*

13 *Bersein, S., G. Larraín and F.Pino (2006), "Chilean Pension Reform: Coverage Facts and Policy Alternatives".*

to the pension system, identified the objectives that this should seek to achieve and then referred its design to an Advisory Council which would have to consult the citizenry before issuing its proposals.

The program of government justified the need for a reform on the current system's inability to keep the promises with which it had begun. Furthermore, the Program made it quite clear that it was willing to challenge the corporate vetoes in the sector.

In this way, the proposal to set up an Advisory Council for Pension Reform appeared in the program of government as a firm response to the traditional play of corporate pressures in the framing of public policies, acknowledging that to achieve this, it would be necessary to use a method different from the technical-political sequence that had prevailed prior to that date.

Finally, the program listed a set of issues that were to be dealt with by the Council: (a) to increase contribution density and incorporate self-employed workers; (b) to eliminate discriminations against women and lower-paid workers; (c) to increase the performance of the workers' contributions; (d) to structure a solidarity pillar in the system and (e) to ensure the system's financial sustainability.

On the basis of these definitions, the President set up the Presidential Advisory Council for Pension Reform on 17th March 2006, just one week after taking office.

II.3 Basic definitions in the formation of the Council

Mandate

At the point of setting up the Council, the President clearly defined the institutional space that would be occupied by the Council. At the same time, the President stated clearly that the Council would be a forum of citizen participation that would extend much further than its members.

These same guidelines were reflected in the Decree which created the Council[14]. This also dictated the scope of the Council's analysis and proposals, circumscribing them to the pension scheme established by D.L. 3,500. This meant that issues related with the operation of the residual schemes dating from before the 1981 reform, and the pension system of the Armed Forces, were left expressly outside its scope.

Decree Nº 336 stated that the functions of the Council were: (i) to make a diagnosis

14 Supreme Decree Nº 336.

of the pension system´s operation; (ii) to request relevant information from the public organisms involved; (iii) to commission opinion studies; (iv) to invite a variety of actors from society and industry to hearings, as also experts in the field; (v) to recommend measures to meet the objectives behind the reform, and (vi) to ensure the financial sustainability of the measures proposed.

Finally the period for the Council's work was fixed at three months, after which a report was to be delivered to the President with its conclusions and proposals.

Membership

The CAPRP was made up of 15 members. Table 1 summarises the personal histories of each council member.

As may be seen in Table 1, the Council was made up of people with degrees in business administration and economics, lawyers, sociologists and one industrial civil engineer, with the first-named group having a clear majority, while in the performance area 8 council members came from the academic sector or from Non-Governmental Organizations (NGOs), 6 were working in the private sector (including consultancy) and one came from an international body. Finally, although no council member was a public employee, almost half had some prior experience in the State machine. All this indicates that the membership of the Council sought to ensure diversity in terms of both formation and professional experience. To this it must be added that, from the political point of view, a significant representation of sectors outside the governing coalition was guaranteed.

TABLE 1
COMPOSITION OF THE PRESIDENTIAL ADVISORY COUNCIL FOR PENSION REFORM

Member	Profession	Sector	Public Experience
Harald Beyer	Degree in Business Administration, Doctorate in Economics	Academic think tank	No
David Bravo	Degree in Business Administration, Master's in Economics	University academic	Ministerial advisor
Axel Christensen	Industrial Civil Engineer, MBA	Private sector, finance	No
Regina Clark	Lawyer	Consultancy	Public executive
Alvaro Clarke	Degree in Business Administration, Master's in Economics	Consultancy	Government authority
Rossana Costa	Degree in Business Administration	Academic think tank	No
Martín Costabal	Degree in Business Administration, MBA	Private sector, company director	Government authority
Margarita María Errázuriz	Sociologist	NGO	No
Alejandro Ferreiro	Lawyer, MA	Consultancy	Public executive
Augusto Iglesias	Degree in Business Administration, Master's in Economics	Consultancy	No
Mario Marcel (Chairman)	Degree in Business Administration, Master's in Economics	Academic think tank	Government authority
Alejandra Mizala	Degree in Business Administration, Doctorate in Economics	University academic	No
Andrea Repetto	Degree in Business Administration, Doctorate in Economics	University academic	No
Jaime Ruiz-Tagle	Sociologist, Doctorate in Sociology	University academic	Ministerial advisor
Andras Uthoff	Degree in Business Administration, Doctorate in Economics	International bodies	No

SOURCE: PREPARED BY THE AUTHOR ON THE BASIS OF INFORMATION IN WWW.CONSEJOREFORMAPREVISIONAL.CL

The diversity of the membership of the Council was not only a response to the need to complement points of views and have a multi-disciplinary approach. Above all, the selection of the members sought to ensure that they were well disposed to listen, dialogue and reach agreements. These qualities were considered to be indispensable in order to meet the commitment to listen to all sectors and increase the probability of a consensual proposal.

These criteria explain not only why the members of the Council were included, but also why other possible candidates were not. In particular, the inclusion in the Council of people who would (a) act as corporate representatives of a sector, or (b) act as defenders of a particular reform proposal was avoided. This enabled a dynamic of dialogue to be maintained, avoiding the rigidities typical of a negotiation or intellectual dispute. This did not mean, however, that trade union representatives or authors of reform proposals had no opportunity to take part in the process. On the contrary, they were all invited to take part in the process of hearings and to register their opinions and reform proposals formally[15].

The importance that the Pension Reform had acquired on the government's agenda and the guarantees offered by the composition of the group meant that all those invited agreed immediately and unconditionally to take part and dedicated a high proportion of their time to the activities of the Council during the following three months, despite receiving no payment for doing so.

Method of work

The basic rules for the functioning of the CAPRP were fixed to a large extent by President Bachelet's speech when she set up the Council and by the Decree which formally constituted it. In particular, these mechanisms fixed (i) the focus and thematic limits of the Council's analysis; (ii) the deadline for the work and the products to be delivered; (iii) the order of priority of the issues to be addressed; (iv) some components of the work agenda, particularly the hearings with civil society, and (v) the means of supporting the Council's work, including contributions from specialised public bodies, studies and surveys to be carried out, and an Executive Secretary's Office to be set up. These elements were transformed into the Council's terms of reference which were approved at its first work session.

On the basis of these terms of reference, the work of the Council was structured in three stages: (a) hearings; (b) analysis and deliberation, and (c) preparation of proposals. Each of these stages took approximately a month of work, including a progress report at the end of the second stage and a final report when the whole process was completed.

II.4 How the Council functioned

Hearings

The hearings stage took up the whole of the first month of the Council's work.

15 See section II.4 below.

During this period a total of 49 hearings were held, attended by 73 organizations and 242 individuals. In total, 74 hours of work were dedicated to the hearings, which were structured as continuous sessions during two days each week, for a total of five weeks[16]. In order to be able to cope with all the hearings, the Council divided itself into two groups which worked alternately, always with the presence of the Council Chairman.

In order to take the greatest possible advantage of the hearings, certain basic game-rules were laid down:

- The hearings were granted on the basis of invitations from the Council or applications received. By the end of the period, hearings had been granted to all the organizations that applied, except for one that did so outside the deadline.

- Each hearing had a maximum duration of one hour, except in cases where there was more than one person/organization attending. The time was divided between an initial exposé by those attending and a time dedicated to answering consultations from members of the Council.

- Those attending had to deliver a document of not more than 15 pages prior to the hearing, containing their respective position.

- In order to focus the presentations of those attending on the topics referred to the Council, it was requested that these concentrate on a pre-established set of topics, though if those invited wished to put forward other issues, these could be addressed, provided they were contained within the Council's mandate.

- In order to ensure that the ideas of those attending were adequately disseminated, they were also asked to provide an abstract of their presentation, on no more than one side of paper, ready to be handed to the press on the day of the hearing. The press points were coordinated by the Council's Executive Secretary's Office.

- The documents handed in were included on the Council's web page, so becoming available for public opinion.

This set of rules not only made it possible to fit a large number of hearings into a limited period of time, but also gave wide dissemination to the perceptions, opinions and proposals delivered by the individuals and organizations that attended them. The effort to acknowledge and value these contributions extended to the Council's

16 *Presidential Advisory Council for Pension Reform (2006), El Derecho a una Vida Digna en la Vejez. Hacia un Contrato Social con la Previsión en Chile. Volume II, Citizen Consultation Table 1.*

Final Report, which included all the documents received, and a synthesis of the debate in the hearings, in Volume II, dedicated to the whole citizen consultation process.

The hearings included a wide variety of economic and social groups. As may be seen in Table 2, trade union and social organizations - from the Central Unitaria de Trabajadores to the Sindicato de Trabajadoras de Casa Particular - played leading roles in almost 40% of the hearings, with 136 leaders representing 33 organizations taking part. Meanwhile, the employers, actors in the industry and financial system, were distributed among 13 hearings (27% of the total) with 61 representatives of 24 organizations. This sector was far from holding a monolithic position, due to the diversity of interests contained within it. The remaining third of the hearings corresponded to academics, experts and representatives of international bodies.

TABLE 2
CAPRP HEARINGS BY TYPE OF PARTICIPANT

Type of participant	Hearings	Organizations	Persons
Trade union and social organizations	19	33	136
Business organizations and actors from the industry	13	24	61
International bodies	6	6	17
Academics, experts, think tanks and others	11	10	28
Total	49	73	242

SOURCE_ CAPRP (2006), VOLUME II, TABLE 2.

As may be seen in Table 3, the hearings covered all the issues referred to the Council. The largest number of contributions in terms of diagnosis corresponded to testimonies about the real situation of members and pensioners: data about contribution density, coverage, pension gaps and default and the position of women, and analyses of administration costs, competition and information for members. The largest number of proposals, meanwhile, concentrated on incorporation of self-employed workers, reduction of pension gaps and default; reduction of costs and commissions; development of competition, the investment scheme and information to members, and structuring of the system's solidarity pillar.

TABLE 3

SYNTHESIS OF THE HEARINGS PROCESS BY TOPIC

TOPIC	DIAGNOSIS	PROPOSAL
1ST TOPIC: BENEFICIARIES OF THE PENSION SYSTEM		
Pensioners' Living Conditions	13	3
Expectations of Active Workers regarding their retirement	16	7
Relationship with Operation of the Labour market	22	2
Others		
Early Pensions	1	1
2nd TOPIC: CONTRIBUTIONS TO THE SYSTEM		
Contribution Density	30	10
Coverage: Incorporation of Self-employed Workers	36	35
Gaps in Workers' Pension Contributions, especially Women and Young People	14	16
Pension Default	18	14
Others		
Backlog Funds	5	7
Pension Damage	11	10
3rd TOPIC: MAGNITUDE, ORIGIN AND POSSIBLE DISCRIMINATION AGAINST PARTICULAR GROUPS OF WORKERS		
Women	30	30
Young People	9	4
Lower-paid Workers	13	8
Self-employed Workers	9	14
Seasonal Workers	9	13
4th TOPIC: COSTS OF THE PENSION SYSTEM		
Administration Costs and Level and Structure of Commissions	29	27
Costs of the Disability and Survivorship Insurance and Life Annuities	10	12
5th TOPIC: COMPETITION AND EFFICIENCY OF THE PENSION SYSTEM		
Yield of the Pension Funds	11	9
Investment Scheme, Risk and Yield of the Funds	7	23
Competition between Pension Funds, Entry of New Actors	21	30
Information to Members, Enrolment and Retirement Decisions	16	23
Operation of the Insurance and Life Annuity Market	11	12
Others		
Worker Participation/ Corporate Governance and Institutional Structure	2	18
6th TOPIC: SOLIDARITY PILLAR OF THE SYSTEM		
Concept of Solidarity Pillar	11	33
Non-contributory benefits (Guaranteed Minimum Pension (PMG), Welfare Pension)	7	28
State Participation in the Pension System	6	27
Fiscal Costs and Obligations	8	5
Institutional Framework to Sustain the Solidarity Pillar	-	14
Others:		
Contributory Scheme: 240 months requirement for PMG	-	4
7th TOPIC: FINANCIAL SUSTAINABILITY OF THE PENSION SYSTEM		
Guarantee of Fiscal Accountability	1	13
Effect of Pension Funds on Depth and Efficiency of the Capital Market	4	6
Others:		
Additional Contribution from Employer/State	-	17

SOURCE: CAPRP (2006), VOLUME II, TABLE 2

It is important to recognise that many presentations in the hearings process included questionings of the content of the pension system, and proposals ranged from minimal adjustments to the complete replacement of the individually-funded scheme. Nevertheless, even those who put forward more radical questionings and proposals valued the transparency and respect for their opinions that was revealed in the hearings process. This, as we shall see further on, contributed significantly to the success of the Pension Reform.

Inputs

In order to analyse the operation of the pension system and prepare reform proposals, the CAPRP had other important inputs, in addition to the hearings process.

In the first place, in accordance with the promise made when the Council was set up, the relevant public institutions, particularly the Superintendence of AFPs, the Budgets Department, the National Service for the Aged and the National Service for Women, contributed presentations, studies and estimates at the Council's request. Most of these contributions are included in the appendices of the Final Report. In order to fulfil this support function, the four public institutions took part in a considerable number of the work sessions held by the Council in its phase of analysing and considering alternatives.

In the second place, the evidence obtained in the hearings was complemented by information provided by the public through an opinion survey, studies from focus groups, electronic surveys and a consultations and suggestions box on the Council's web page. These details were systematised in volume II of the final report.

The qualitative studies were especially useful in capturing the population's sensitivity to key issues of the pension system's operation. The opinion poll revealed elements that were fundamental for understanding Chileans' relationship with the pension system[17]. In particular, it was concluded that this relationship was marked by: (i) high aspirations for welfare in the old-age stage; (ii) a polarization of views on the AFP system among young workers and elderly adults who had already retired or were about to do so, and (iii) an appreciation of individual saving as a means of solving the needs of old age.

The qualitative studies meanwhile revealed that people have great difficulty in dealing with the gap between their desires and the resources accumulated for coping with old age, and this is expressed in many cases by a denial of the issue or

17 *The survey was carried out by MORI, S.A., using the face-to-face method of a questionnaire with a sample of 1,000 interviewees.*

the dream of a lucky break to sort it out[18]. In these perceptions, the pension system does not figure as a reliable system to meet the desire for a dignified old age.

Finally, the Council held a seminar in May 2006 with the participation of about 20 well-known international experts in pension issues, which was sponsored by the Inter-American Development Bank (IDB), the World Bank, the Konrad Adenauer Foundation and the International Labour Organisation (ILO). This seminar was open to the public and dealt with issues of coverage, benefits, administration costs, competition in the industry and management of investment portfolios. The seminar was followed by a closed workshop with the council members to discuss specific reform proposals being studied in the CAPRP.

The special studies from the technical advisory bodies, the opinion studies and the seminar were defined at the beginning of the Council's work, which meant that their results were obtained in time to influence the group's work.

Process of discussion and generation of proposals

As was stated above, the call to the Council included a very clear definition of its sphere of responsibility, the issues that were excluded from it, and those on which the analysis and proposals should concentrate. This made it possible to target the group's agenda very quickly and avoid diverting the limited time available to the intricate – and to a large extent insoluble – problems of some hundred pension schemes belonging to the old pension funds ("cajas") or the pension system of the armed forces and police, for which the President herself had already produced reform proposals in her time at the Ministry of Defence. Having clarity about the agenda of the Council, its limits and priorities, was essential to enable the work to be completed within the time-limits given.

In the first stage, the Council's agenda served to guide the hearings program. Once the hearings were over, the agenda made it possible to sort out the internal debate on diagnosis and proposals. To do this, the group held a working retreat immediately after the conclusion of the hearings. At that retreat they reflected on the evidence and proposals received and on the main data and alternatives available on each of the topics. On the basis of this analysis, the Council divided into two working groups in order to advance more efficiently. The first group took the issues of coverage, fairness and the solidarity pillar, while the second took charge of the topics proper to the running of the individually-funded system (competition, costs and investment system). In order to avoid selection bias on the basis of the prior

18 *Two qualitative studies were carried out using the focus group technique. These were applied by the company Feedback and the National Service for the Aged, respectively.*

experience and political preferences of each council member, the conformation of each of these groups sought to maintain the plurality and multi-disciplinary nature of the Council as a whole.

As the working groups progressed in their discussions, presentations were made in plenary session with the aim of broadening the consensuses and coordinating the proposals. In this way, deep analysis and broad discussion combined in both the diagnosis and the set of proposals.

This method of distributing the work ensured that the whole group of council members identified itself with the output of the collective work, since each of them had the opportunity to produce specific proposals and at the same time give a timely opinion on the other proposals in preparation. The "appropriation" of the work continued in the stage of producing the Council's final report, where the wording of the drafts of the various chapters was distributed between the council members before being submitted for final editing. The draft of the complete report was reviewed in a two-day retreat of the whole Council.

Despite the efforts to produce consensus within the CAPRP, the possibility that there might not be full agreement was foreseen from the outset, so the possibility of recording minority votes in the final report was established. The condition for recording minority votes was to have exhausted all the efforts to reach agreement first, and then to word the minority vote at a length compatible with the format of the Report. In the end this contained 10 minority votes, generally on specific aspects of the Council's proposals. The greatest disagreements corresponded to the proposals to separate the AFP industry's functions and increase legal retiring age for women.

The possibility of minority votes helped to produce agreements far more than it hindered them, because it reduced council members' suspicion and demanded a degree of strictness in the disagreements equivalent to that of the proposals produced by agreements.

Communications

The management of communications occupied a central place in the CAPRP's work. Due to the high public profile that the pension reform occupied in the government's program, it was necessary for the communications surrounding the Council's work to fulfil three objectives: first, that they should demonstrate willingness to listen to the citizens' voices; second, that they should express transparency in the council's actions, and third, that they should fulfil a pedagogical function, guiding expectations about what the Council would, and would not be able to do. For this reason, the communications function in the CAPRP's work was deliberately bi-directional.

Meeting these objectives depended on certain strategic decisions. In participation matters, wide publicity was given to the hearings, including the management of press points with all the actors that attended them, backed up by brief communiqués. The Council's web page not only included these hearings, but also set up mechanisms so that citizens could participate directly through online surveys and a questions and suggestions box.

As regards transparency, it was stipulated that the whole relationship with stakeholders in the reform should be channelled through the hearings, avoiding the private meetings which many stakeholders had hastened to request. In the same way, the relationship with the institutions and authorities of the State was handled with prudence, leaving it clear that their role would be to provide the Council with technical support but that, in the final analysis, the decisions would be taken autonomously by the Council. This meant that several meetings were held without the presence of representatives of public institutions, including the workshops in which the agenda and proposals were defined and in which the final text of the Report was checked.

In order to reinforce the pedagogical function of the council's work and streamline its messages, progress reports, press points and interviews were used to explain in advance the values and criteria with which the work was being done. To do this it was essential to produce a single spokesperson and avoid leakages, a matter that was discussed and reinforced on several occasions. This pedagogical function was reinforced by the opinion studies commissioned by the Council, which helped to fine-tune the messages and the language of the Report. In order to strengthen these messages, the Final Report had an executive summary presented in a separate volume, which served as the basis for disseminating the main contents of the Report.

II.5. The Council's report

The Council's Final Report was finished at the beginning of July 2006. The Report consisted of three volumes: one volume with the Council's diagnosis and proposals, one containing the set of documents associated with the citizen consultation[19], and an executive summary.

In substance, the Council's Report rested on four central concepts: (a) raising awareness of ageing and the risk of losing income in old age as a social reality that

19 *Hearings, opinion studies and information contributed via the web page.*

had to be faced; (b) confirming that the individually-funded system imposed by the 1981 reform would not be capable of assuming the risks associated with the ageing of the population as a whole; (c) recognising that the limitations of the individually-funded scheme were not the responsibility of the AFPs, but of the way the pension system was designed; and (d) visualising the pension system as a social contract, through which people acquire obligations in exchange for rights which the system must be capable of honouring.

On the basis of this conceptual structure, the Report states that the central purpose of a reform must be to renew the social contract of social security through a universal, fair and efficient pension system, with the responsibility shared between the workers, the employers and the state. In order to achieve this purpose, the Report states that the pension system must meet three requirements: (i) prevent the risk of poverty in old age; (ii) increase the replacement rate; and (iii) minimise the differences in replacement rate between segments of the population, especially between men and women. This in turn meant a pension system supported on three pillars: a contributory pillar, a solidarity pillar and a voluntary pillar. Most of the Report's proposals aim to restructure or reinforce these pillars.

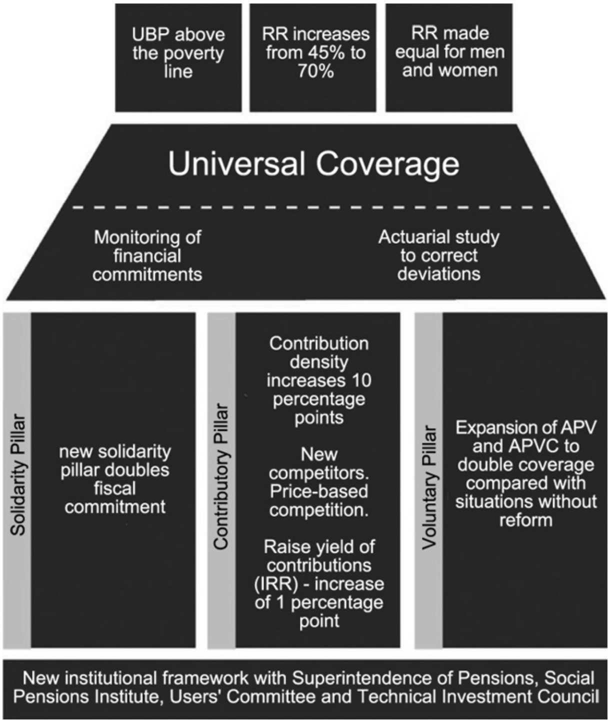
In total, the Council's Report included 81 reform proposals arranged in 11 areas: new solidarity pillar; coverage, contribution density and compliance with the contribution mandate; gender fairness; competition and organization in the AFP industry; competition and prices; investment of the pension funds; pensions in the contributory pillar; expansion of the voluntary pillar; education and information; institutional framework; and financial discipline.

The proposals of the CAPRP may be summarised with the help of the programmatic and institutional architecture proposed in the Report, as illustrated in Figure 1.

The proposals about the solidarity pillar were directed towards replacing the solidarity components of the system then in force (the guaranteed minimum pension and welfare pension) with a strong pillar, incorporated into the rest of the system and funded out of tax revenues. These proposals rested on the realisation that the system then in force had a coverage that was too limited, due to the contribution period required or to poverty, and that it distorted workers' incentives to contribute.

FIGURE 1

BASIC ARCHITECTURE OF THE PENSION SYSTEM ACCORDING TO THE CAPRP PROPOSAL



SOURCE: FINAL REPORT OF CAPRP.
NOTE: - UPB = UNIVERSAL BASIC PENSION.
- RR = REPLACEMENT RATE.
- IRR = INTERNAL RATE OF RETURN.
- APV = VOLUNTARY PENSION SAVINGS.
- APVC = COLLECTIVE VOLUNTARY PENSION SAVING.

For this reason, it was proposed that the solidarity pillar be structured as from a basic benefit (the Universal Basic Pension), which would be accessible to all those people who met the requirements in terms of age, residence and socioeconomic situation and had no accumulated pension fund. In order to avoid discontinuing the guaranteed minimum pension, it was proposed that this benefit be reduced gradually on the basis of the amount of pension self-funded by the worker. This reduction would take place at a rate such that the sum of the self-funded pension and the basic pension would always grow as the worker made a greater effort to save, until it was absorbed completely at a self-funded pension level called the Maximum Pension with Solidarity Contribution (PMAS). The scheme sought in this way to maintain the incentives to contribute, avoiding the discontinuity that was typical of the guaranteed minimum pension, and eliminated the contribution period requirements from the design of the system, thereby allowing people to qualify for the benefit on a large scale. The Council proposed that all people belonging to the poorest 60% of the population should qualify for the benefit, opening the doors to a new type of targeting, defined more by the exclusion of people with higher income than by the obligation to demonstrate the existence of poverty. The increased coverage and value of this benefit implied, on its own, a doubling of the fiscal commitment with the pension system. Other proposals were directed at stipulating the calculation method and conditions of the solidarity pillar benefits.

The proposals for the contributory pillar were structured in three large blocks. The first block was directed towards raising coverage and contribution density in the system, including a series of measures designed to incorporate self-employed workers and help young and unemployed workers to contribute with state support. These proposals were justified on the evidence of an extremely low proportion of voluntary contributors among self-employed workers and on the high cost of the gaps in social security in the individually-funded system. In particular, the measures to incorporate the self-employed were aimed at aligning the rights and obligations of that sector with those of wage-earning workers, by setting up operating facilities, incentives through access to immediate social benefits, and the legal obligation to contribute, following a transition period. With these measures, the Council argued that it was possible to aspire to an increase in contribution density of 10 percentage points within a period of ten years.

A second block of proposals for the strengthening of the contributory pillar aimed at increasing competition in the AFP industry. These proposals were justified on the grounds of the progressive reduction in the number of competitors in the industry and the high level of commissions charged by the administrators. According to this, it was necessary not only to increase competition, by also to concentrate it on the price variable. To do this, the Report proposed two central measures: (a) to lower the barriers for entering the industry by allowing the separation of accounts administration and fund management by outsourcing services; and (b) to organise a tendering process for enrolment of workers entering the system, to last one year on the basis of a minimal commission. The two measures, taken together, would allow the entry of new administrators, specialising in fund management, without marketing costs, which were one of the major barriers to the entry of new administrators. These proposals contrast with the discussion that had been taking place about allowing the banking sector to manage pension funds as a mechanism for stimulating competition, which was not even included in the Council's proposals. This was because the benefits of such a measure did not seem particularly significant compared with its costs. In fact, while the entry of banking affiliates did not guarantee greater competition, because it could take place by buying out existing AFPs, the ability to restrict the risk of conflicts of interests and joint sales of financial services seemed very limited.

The third group of proposals related with the contributory pillar aimed to raise the yield of the investments. To do this, it was proposed in the first place to replace the investment limits fixed by law with administrative regulation, supported on the recommendations of an investment committee. By this change, it would also become possible to adapt the administrators' model of financial supervision to one based on risk. Furthermore, the Report proposed intensifying the competition on the basis of yield, making the minimum yield rules more flexible and giving the administrators the obligation to fix investment policies and render accounts of them. By these measures, and those directed at increasing competition in the AFP industry, the Report foresaw the possibility in the medium term of raising the yield of the workers' contributions, net of commissions, by one percentage point per year.

Meanwhile the proposals for the voluntary pillar were directed towards increasing the incentives for individual voluntary pension saving and setting up a collective voluntary pension savings scheme, resting on agreements between workers and employers. With these measures, it was hoped to double the coverage of the voluntary systems, so generating an important complement to the solidarity and contributory pillars.

According to the Report's arguments, the reinforcement of the system's pillars would make it possible to achieve the final objectives sought for the pension system at a cost that the state would be able to manage, due to the savings generated by the maturing of the 1981 reform itself. In particular, by proposing a universal basic pension above the poverty line, it was hoped that the risk of poverty in old age would be eliminated. Meanwhile, the contribution of the solidarity pillar itself and the measures to reinforce the contributory pillar would enable the replacement rate to be significantly increased. Specifically, the Report estimated that in the long term the replacement rate could be raised from the 45% estimated for the current system to 70%.

As regards the reduction in the differences in replacement rates between men and women, although the contribution of the solidarity pillar and the measures to increase contribution density would allow some progress to be made in that direction, the Council did not consider them to be sufficient and added a set of proposals directed specifically at gender equality. These proposals included, among others: establishing childcare as a social security right; the separation of the disability and survivorship insurance premiums for men and women, so that the latter could benefit from their lower claims rate; the payment to women's pension funds of a maternity bonus for each live birth, equivalent to a year of contributions on the minimum wage; the possibility of solidarity contributions within the family and the division of pension funds in case of divorce; making the maximum age for coverage under the disability and survivorship insurance equal at 65 years, and eliminating discriminations in minimum taxable income for domestic workers. Given that the objective sought in this area was to make replacement rates for men and women equal at the point of retirement, the Council also proposed making retiring ages equal for men and women at age 65, which meant increasing that of women from age 60.

Finally, the Council's Report proposed a set of measures designed to strengthen the institutional and financial bases of the pension system. In the institutional area, the proposals aimed to set up a single superintendence for the whole system and to create an institution to administer the Solidarity Pillar – the Institute of Social Pensions (IPS) – to replace the old Social Security Normalization Institute (INP). The institutional proposals also included the creation of a users' committee, in charge of overseeing the whole pension system and managing a pension education fund designed to improve members' knowledge and information. In order to safeguard financial discipline, the Report proposed carrying out regular actuarial reports to be submitted to the users' committee for its consideration, and these would also be applied when proposing parametric reforms to the pension system.

As regards the implementation of this set of proposals, the Report put a main accent on the dimension of costs, given the emphasis of the government's program and the Council's terms of reference as regards the generation of proposals that were fiscally possible. For this reason, the first challenge was to determine the cost of the proposals. This was not a trivial exercise, because the amount of the fiscal benefits depended on the pension funds accumulated by each beneficiary, which were also being modified by the Council's proposals. So, in order to determine the costs, it was necessary to seek the support of the Superintendence of AFPs to quantify the beneficiaries of the measures proposed and the Budgets Department to estimate their value. Both institutions used simulation models for the purpose which they had developed in the previous months[20].

Finally the fiscal cost was estimated at the equivalent of 1% of the GDP for the year

20 *The projection model of the Budgets Department was later revealed in DIPRES (2008), Informe de Finanzas Públicas. Proyecto de Ley de Presupuestos del Sector Público para el año 2009, Chapter III.*

2005, once the measures as a whole were being applied to the first generation of members to have contributed under the individually-funded scheme throughout their working life. Since this amount was very similar to the fiscal saving that would occur as a result of completing the transition from the old system, the Council estimated that no additional measures for generating income would be required.

The Report did not include specific proposals as regards the sequence and phasing of the reform, because the time, resources and information available made that task an impossible one. Therefore, the design of a transition mode and the legislative strategy to be used remained as a responsibility for the work that would have to be undertaken later by the Executive.

Nevertheless, the Council Report was emphatic in pointing out that its proposals should not be taken in isolation but as an integrated package, and that taking any of them separately would inevitably affect the efficacy and cost of the whole.

II.6 The subsequent process

On 6th July 2006, after 110 days of work, the Presidential Advisory Council for Pension Reform presented the Final Report to President Bachelet with the result of its work. The delivery of the Report was surrounded by great expectation and had a high level of media coverage, occupying the headlines of the communications media for several days.

The delivery of the Report was followed by intense media deployment of the Council members to explain its contents, because it was felt that a thorough understanding of the proposal was essential for avoiding premature judgements that would complicate its later debate in the Executive and the Congress. To do this, the council members were supported by the executive summary of the Report, which was handed immediately to the executive authorities, members of congress and the press.

The first reactions to the Report were recognition, expectation and caution. A discussion which had looked like being conflictive ended with a proposal that demonstrated a high degree of consensus among the members of the Council, and this was particularly appreciated by the political world. The media, stakeholders, experts and leaders of opinion devoted themselves to understanding the whole set of proposals in the Report. For several days, the media provided information on the new dimensions of the reform that were beginning to become known. As stakeholders began to understand the proposals that affected their own interests, they started to adopt more cautious or openly critical attitudes, but this occurred at the same time as political leaders were acknowledging the value of the proposal as a whole and valuing the more popular proposals, such as the creation of a solidarity pillar.

After a very short time, there was a consolidation of the perception that the Council's proposals would enable a comprehensive, substantive and responsible pension reform to take place, and that halting the process that had been launched would now be no easy matter.

On the side of the Executive, the President rapidly specified the way to proceed. In the ceremony to hand over the Report, she repeated the sequence promised when the Council was formed: the Report would be analysed by an inter-ministerial committee that would prepare the draft law(s) to be presented to the Congress before the end of the year. Then it would be the task of Congress, exercising its constitutional prerogatives, to analyse and approve the Executive's proposals and approve the definitive legislation on the matter. While appreciating the Council's proposals, the President rejected the motion to bring women's retiring age into line with men's, with the result that the Council's most controversial proposal was ruled out. Although this decision made it impossible to achieve the objective of equalising the replacement rate for men and women, it removed from the discussion a subject that would undoubtedly have been a target for fierce attacks, so facilitating the later debate on the reform.

The inter-ministerial committee that had to prepare the Pension Reform bill was made up of the ministries directly involved: Labour and Social Provision and Finance, plus the General Secretariat of the Presidency, MIDEPLAN and the National Service for Women (Servicio Nacional de la Mujer). The bulk of the technical support work was to be carried out by the Superintendence of AFPs and the Budget Department, as had happened during the work of the Council.

The inter-ministerial committee took almost six months to complete its work and the Executive put the Pension Reform to the National Congress in a single bill on 15th December 2006. This bill retained the main proposals of the CAPRP. In particular, the proposed reforms concerning the solidarity pillar, gender fairness, tendering of new members, greater flexibility in the pension scheme and restructuring of the Superintendence of AFPs and INP were practically identical to those proposed by the Council. Nevertheless, the Executive introduced certain important modifications in matters involving the incorporation of self-employed workers (extending the transition period to 10 years, twice that proposed by the Council), omitted various proposals on tax issues and toned down the proposal for separating the administration of accounts and funds. At the same time, the Executive's bill added five important proposals not included in the CAPRP Report: the elimination of the fixed commission; the modification of a series of benefits of the disability and survivorship insurance; the joint tendering of the insurance for all the contributors in the system; the incorporation of banking affiliates in the AFP industry and the creation of integral pension advice centres (CAPRI), under the responsibility of the state. Finally, the Executive's bill included a detailed proposal for the gradual implementation of the reform, and detailed estimates of fiscal costs.

The legislative processing of the Pension Reform bill took almost a year. During this period, there were four main subjects of debate: the speed of implanting the solidarity pillar, the creation of a state AFP, the tendering of the enrolment of new members, and the inclusion of bank subsidiaries in the AFP industry. While the first two topics were promoted by members of the governing coalition, those of the opposition tended to align themselves with the AFP industry against tendering. Meanwhile, the inclusion of bank subsidiaries crossed parliamentary benches, generating a fierce debate. Finally these disputes were settled by speeding up the introduction of the solidarity pillar and some marginal increases in its benefits, the rejection by Congress of the inclusion of banks and a commitment by the government to the Coalition benches to send a bill to Congress to create a state AFP. At the date of closing this document, this last promise has still not been honoured. Other minor adjustments were gradually introduced in the course of legislative processing and the Pension Reform bill was finally passed by Congress on 16th January 2008 and enacted on 11th March. It began to be applied on 1st July of the same year.

In this way, just 27 months after the CAPRP was set up, the Pension Reform in Chile became a reality.

III. Evaluation of the CAPRP experience

III.1 How is the performance of the CAPRP to be evaluated?

The fact that the Pension Reform has been successful and effective does not in itself ensure that the CAPRP has been equally so. At the beginning of this paper, it was argued that the CAPRP arose in response to two objectives of President Bachelet's government program: citizen government and pension reform. In these circumstances, the CAPRP's performance should be evaluated on the basis of two questions: (a) how much value did the Council add to the process of formulating and enacting the Pension Reform, and (b) to what extent did it contribute to generating spaces for citizen participation in public policies?

This section attempts to answer both questions. The influence of the CAPRP on the pension reform is evaluated in three dimensions: first, the correspondence between the Council's proposals and the Law of Pension Reform passed by Congress; second, how much did the Council's work speed up the passing of the reform; and, third, to what extent did the Council contribute unusual approaches or proposals to the Reform.

Meanwhile, the contribution of the CAPRP to the development of a "citizen" style of government is evaluated on the basis of two elements: first, to what extent did the CAPRP constitute an effective forum of citizen participation in the formulation of public policies, and second, how was is possible to reconcile that participation with the formal institutions of representative democracy in Chile.

III.2 The CAPRP's contribution to the Pension Reform

CAPRP proposals in the Pension Reform

How much influence did the CAPRP have on the content of the Pension Reform? The Message that accompanied the presentation of the bill to Congress acknowledges an important contribution:

> "The Council's mission was to prepare recommendations that would serve as a basis for the design of a pension system that would provide effective social protection for the whole population, reinforce the solidarity nature of the system, expand coverage and overcome the gender discriminations that persist at present. This task was fulfilled with complete success and constituted a solid structure for drafting the Pension Reform Bill,"[21]

However, the influence of the Council on the Pension Reform cannot be assessed on the basis of political rhetoric alone, but in terms of the actual impact of its recommendations on the policy options that gained acceptance in the process of formulating policies. The Appendix lists the set of 81 proposals contained in the Council's Report and compares them with the contents of the Law of Pension Reform[22] and other complementary measures that were adopted in accordance with it. This comparison states not only whether the proposal was accepted or not, but also the way in which this was done and identifies other important topics included in the legislation which were not included in the CAPRP proposal.

As may be appreciated in the Appendix, a large proportion of the Council's proposals was finally integrated into the legislation approved by the Congress. In fact, of a total of 81 proposals, only 8 were not included in the legislation or complementary

21 *Message Nº 558-354, dated 15th December 2006*

22 *Law Nº 20,255, dated March 2008.*

measures. It is true that the law made the proposals more precise, which in some cases led to variants of them. For example, the CAPRP proposed a gradual levelling of retiring age for women and at the same time suggested allowing women to take advantage of the benefits of the solidarity pillar during the transition from age 60 onwards, adjusting the amount of the benefits to maintain the same present value as if they had done so from the age of 65. The law, following the President's decision, did not include the change of legal retiring age for women, but did state that they should not be eligible for the solidarity pillar until age 65, which meant that the adjustment to match the present value of the benefits was unnecessary.

In addition to the rules referring to the legal retiring age for women, the main CAPRP proposals that were not included in the Law of Pension Reform corresponded to the payment of pension contributions out of unemployment insurance, the discount on commissions for membership continuance and the recognition of first category credit on the dividends paid on shares in the pension funds.

Law Nº 20,255, meanwhile, introduced some reforms in addition to those proposed by the Council. These were concentrated in two areas: the disability and survivorship insurance and the institutional framework. In the first case, the Law of Pension Reform introduced modifications in the benefits structure of the insurance, established unified tendering of that insurance for the whole universe of pension system members and transferred the payment of the corresponding premium to the employers. In the second case, the law complemented the Council's proposals with the creation of the Instituto de Seguridad Laboral (ISL) (Institute for Safety in the Workplace), transferring to it the functions involved in administering the industrial accidents insurance, previously exercised by the INP; created the Centros de Atención Previsional Integral (Integral Pension Advice Centres) (CAPRI) to provide social security members with information and advice, and created the Pension Consultative Council as a body providing the Ministry of Labour and the Treasury with independent technical advice on the macroeconomic and financial aspects of modifications in the costs and benefits of the system.

In the balance, all the issues tackled by the CAPRP were included in the Pension Reform and in the central body of its proposals. In the margin, the legislation finally approved was somewhat weaker in terms of the incorporation of non wage-earning workers and stronger on the subject of improving the disability and survivorship insurance. In addition, the legislation took care of a series of issues concerning the implementation of the Pension Reform, which the Council had neither space nor time to tackle, including additional details of institutional design, phasing and sequencing in the implementation of its various components.

Comparison with other advisory councils

The influence of the CAPRP on the Pension Reform can be contrasted with the result of the work of other presidential advisory councils or commissions that operated in the course of President Bachelet's administration. Of particular relevance is the comparison with three similar experiences: (i) the Presidential Advisory Council on Childhood Policies; (ii) the Presidential Advisory Council on Quality of Education, and (iii) the Presidential Advisory Council on Work and Fair Treatment[23]. Table 4 summarises the main characteristics of the four advisory councils and gives details of the degree of consensus in their proposals and their influence on administrative measures or later legislation.

Of these four commissions, only that dealing with Childhood Policies had a programmatic layout similar to that of the Pension Reform. In fact, both were set up simultaneously and carried out the majority of their work in parallel. By contrast, the commissions on Quality of Education and Work and Fair Treatment, were set up in response to campaigns and under pressure from social stakeholders. They covered a much wider and more conflictive range of issues and required more work time.

The Presidential Advisory Council on Childhood Policies had a very important impact on the public policies of President Bachelet's government, giving rise to the "Chile Crece Contigo" system, which has been providing overall support since 2006 for boys and girls in their early years of life. Hundreds of crèches and nursery schools have been built under the auspices on this program. New ways of supporting children's early stimulation and their bio-psycho-social development have been put in place and personalised care in childbirth has been included as a health right for mothers. To a large extent, the influence of this Council was due to the high degree of agreement in its recommendations, with only 5 dissident opinions being expressed in the whole Report prepared by the group. The main difference between this Council and that of the Pension Reform was the degree of political stricture to which it was subjected. In fact, while most of the proposals of the Council on Childhood Policies were implemented administratively, and with

23 *For a complete review of the data on these advisory councils, see Aguilera , C. (2009) "Un análisis de las Comisiones Asesoras Presidenciales del Gobierno de Michelle Bachelet", Governance Program Discussion Paper, Flacso-Chile.*

the main funding coming from the national budget, the Pension Reform had to be legislated[24] in its entirety.

The Council on Quality of Education, meanwhile, which was called in response to the student campaigns of 2006, was the most numerous and the most complex in operational terms. It was made up of 81 members, many of whom took part as representatives of students or of trade unions linked with education. Since this council's discussions did not have the status of a binding negotiation, its report contains numerous differences of opinion from among its members. Thus the report of this council has divided opinions on 27 issues (in several cases divided between 3 or 4 groups of council members), covering both the diagnosis and the principles and proposals[25].

Though it can be argued that the Council on Quality of Education provided evidence of deep discrepancies in values among its members and its report is more a map of those discrepancies than an expression of agreements, it was the precursor of the draft of the new General Law of Education (LGE) which replaced the old Basic Constitutional Law of Teaching (LOCE). This change represented a very important sign in the direction of recovering the importance of the right to education, valuing the importance of quality and fairness and increasing social control over educational sponsors. Nonetheless, since passing the LGE at the beginning of 2009, Congress has not managed (as of the close of this paper) to dispatch the three laws that make it applicable: the creation of a superintendence of education, the creation of an agency to ensure the quality of education and the law to reinforce public education.

24 *As shown in Table 4, the legislative influence of the Council on Childhood Policies was mixed: while the initiatives on the Single Family Subsidy (SUF) and the ratification of "Chile Crece Contigo" were processed successfully, this did not happen in the case of proposals on the maternity benefit. In the case of the council's proposals on childcare as a social security right for the working mother (shared with the CAPRP) and the tax funding of the proposed benefits, these did not receive the Executive's backing.*

25 *In fact, at the end of the council's work, the representatives of the secondary students and teachers absented themselves from the closing activities.*

TABLE 4

COMPARATIVE ANALYSIS OF PRESIDENTIAL ADVISORY COUNCILS 2006-2008

ADVISORY COUNCIL	ORIGIN	MEMBERSHIP	CONSULTANCY MECHANISM	DEGREE OF AGREEMENT ON RECOMMENDATIONS	INPACT ON PUBLIC POLICIES	ASSOCIATED LEGISLATION
Pension Reform	Government program	15 expert members	Hearings, Opinion studies, Web page	High 10 minority votes	- Pension Reform approved in 2008 - Advance of transition of Solidarity Pension System. - Adjustment of rules for Pension Reserve Fund.	- Law 20,255 of Pension Reform, 17th May 2008. - Law 20,301 that regulates benefits under: funeral grant, school insurance and death allowance for PBS disability beneficiaries without resources. - Law 20,366, brings forward the System of Solidarity Pensions, 29th July 2009. Significant volume of complementary law, in the form of regulations and circulars.
Childhood Policies	Government program	14 expert members	Hearings Web page	High 5 dissenting opinions in notes of the Report	- Automatic SUF for all who meet requirements, so abolishing the system of maximum monthly regional quotas. - Creation of Integral Childhood Protection system: "Chile Crece Contigo", first as a budget program and then institutionalized in permanent law. - Historic increase in public investment in crèches.	- Law Nº 20,203 (03.08.2007): guarantees the right and automatic access to family subsidy of all pregnant women, mothers and boys and girls from birth to 18 years of age, who met the access requirements for the subsidy concerned. - Creation of "Chile Crece Contigo", as budget program in Budget Law for 2007. - Law Nº 20,379 which sets up the Inter-sector Social Protection System and institutionalizes the Integral Childhood Protection System "Chile Crece Contigo" dated 12th September 2009. - Law Nº 20,367, 7th August 2009, modifies the labour code and grants leave to the mother in case of adopting a child. - Law Nº 20,166, 12th February 2007, (parliamentary motion supported by the Executive) granting mothers the right to breast-feed, even where there is no crèche. - Bulletin 1309-13 (parliamentary motion supported by the Executive, in second reading in the Senate) lays down rules to make the use of maternity leave more flexible; premature births and adoptions.
Quality of Education	Student campaigns	81 members: experts, student and trade union leaders	Hearings, Regional work groups, Web page	Low 27 divided opinions in diagnosis, bases and proposals	- New General Law of Education with higher requirements for sponsoring educational establishments. - Creation of a new institutional framework focused on Quality of Education and on the transparency and rendering of accounts of the system. - More resources for the sector (extraordinary increase in subsidies).	- Law Nº 20,370 that set up the General Law of Education, 12th September 2009. - Law nº 20,247 which modifies DFL Nº 2 of the Ministry of Education, from 1998, establishing an increase in the subsidies for educational establishments. - Bill to create System for Ensuring Quality of Nursery, Primary and Secondary Education. Bulletin Nº 5083-04, second reading, Education Commission, Chamber of Deputies. - Bill to Reinforce Public Education. Bulletin Nº 6251-04, first reading, Education Commission, Chamber of Deputies.
Work and Fair Treatment	Workers' campaigns and demands from the church	48 experts, some political figures	Hearings, Web page Regional forums Survey	Average Divided opinions on 21 proposals 10 minority votes	- Reform of unemployment insurance. - Bonus for hiring young people.	- Law Nº 20,328 which improves the mandatory unemployment insurance and introduces other legal rules, enacted 27th January 2009. - Law Nº 20,338 which creates the subsidy on youth employment, enacted 25th March 2009.

SOURCE: PREPARED BY THE AUTHOR.
SUF= SINGLE FAMILY SUBSIDY.

Finally, the Council for Work and Fair Treatment, which arose in response to contractors' mobilisations and the Catholic Church's call for an ethical wage, was situated midway between the other three councils. It had 48 members, mostly experts, and followed the practices of the CAPRP very closely. Nevertheless, given the breadth of the subject matter referred to this council and the high degree of ideological division on some issues, its report did not achieve the level of consensus of those corresponding to the pension reform and the childhood policies. In the balance, the report of this council records divided opinions on 21 issues and 10 minority votes. Possibly because this is the most recent of the advisory councils and it was published in the run-up to the financial crisis of 2008-2009, its influence on public policy is still limited, though the modification of the unemployment insurance and the creation of a subsidy for employing young workers are among its achievements.

As may be seen then, the four advisory councils formed during the government of President Bachelet seem to be linked with important policy initiatives during this period. However, this link is clearer in the case of the CAPRP than in any other, due to the combination of a high degree of agreement in its proposals, its influence on public policy and its political testing through the debating of a significant body of legislation.

Value added by the Council

The fact that the Council's proposals have had a significant influence on the legislation regarding the Pension Reform does not mean that this has added value to the process. Many studies on advisory commissions in a variety of political environments have warned of the risk that these may be motivated by delaying tactics and may mask hidden agendas or seek to deactivate political pressures, without providing real solutions to public policy problems[26]. If the CAPRP really contributed value to the 2008 pension reform, this should be reflected in the Council's ability to add value over and above the information and ideas already available for formulating proposals in this area[27].

In this respect, there is no doubt at all that, despite the political vetoes on changing the individually-funded system, as mentioned in the second section of this paper, there had been discussion on the needs and possibilities of the pension system long before the pension reform became an item on Michelle Bachelet's program and the

26 *See, for example, Weller P. (2004) Royal Commission and the Making of Public Policy, Macmillan Education Australia, South Melbourne.*

27 *A second dimension of the value added by the Council is given by its ability to involve citizens and facilitate the legislative process, which is evaluated in the final part of this section.*

CAPRP came into being. In such circumstances, the Council's contribution of value to the content of the pension reform must be evaluated on the basis of the extent to which it changed: (i) the vision for the future of the pension system and the values sustaining it; (ii) the diagnosis of the capacity of the current system to carry out this vision; and (iii) the specific reform proposals to bring the reality closer to the vision for the system. For purposes of this evaluation, there is a list below of the dimensions and issues in which CAPRP made a difference, compared with the ideas that were current before the Pension Reform appeared on the political agenda of the presidential campaign in 2005. These comparisons are summarised in Table 5.

As regards the vision of the pension system, it must be emphasised that social security in Chile, even after the creation of the individually-funded scheme, followed a logic in which the central referent of the system was wage-earning work. Just like most of the pension systems in the world, the Chilean system was funded with contributions expressed as a proportion of the monthly wage deducted by the employer, and pensions determined on the basis of past contributions and time worked, these being paid to the retired worker him/herself and handed on to his/her spouse or children in the event of his/her death. According to this logic, it was not surprising that self-employed workers were admitted only voluntarily and without any of the rights accruing to dependent or wage-earning workers. This approach was also reflected in the view of the administrators, which concentrated their attention on the situation of the members with greater contribution density. Meanwhile, the benefits for poor elderly people were seen as part of a welfare policy, excluded from the contributory system, where needs are evaluated in the context of the family group rather than in relation to the individual.

The CAPRP changed this view of the pension system, transferring attention from the retired workers to the entire group of elderly people in the future, regardless of their work and family record. This change was fundamental in a context in which the population of elderly people was beginning to increase significantly, in which the labour market had become considerably more heterogeneous and variable and in which family structures were also changing, with a weakening of the importance of the extended family and intra-family solidarity as a solution to the problem of elderly people without social security coverage. In structuring this vision, the Council not only acknowledged the limitations of the individually-funded scheme, but also the substantive changes undergone by the economy and Chilean society in the 25 years that had elapsed since the 1981 reform. This change of view was reflected in several of the Council's proposals, especially in those referring to a solidarity pillar with wide coverage and tax-based funding; the elimination of the contribution period as a pre-requisite for access to the benefits of the solidarity pillar; the incorporation of self-employed workers, with obligations and rights equivalent to those of the employed, and the inclusion of rules aimed at giving equal rights to men and women.

TABLE 5

AREAS OF VALUE ADDED BY THE CAPRP

DIMENSION	SUBJECT	PREDOMINATING VIEW IN EARLY 2000s	CAPRP VISION
View of the pension system	Rationale of the system	Continuity of income, mandatory saving	Continuity of income, prevention of poverty in old age
	Target population	Wage-earners	Universal
	Complementary benefits	Welfare pension depending on poverty of the household	Assured minimums per individual
	Structure of the system	Exclusive schemes	Complementary schemes
Diagnosis of the system	Coverage	Insufficient coverage	Low contribution density for high proportion of workers
	Gender	Low widow's pensions	Exclusion of women, inequality in replacement rates
	Functioning of the AFP market	Incentives structure affects decision-making rationale	Serious ignorance of the system
	Yield	Unequal yield due to fixed commission	Low IRR for vast majority of members
	Fiscal pressure	High commitment with minimum pension	Low commitment due to low eligibility for minimum pension.
Reform alternatives	Increasing coverage	Formalisation of work	Incentives, ease of administration, equalling of rights and duties for self-employed
	Inadequate pensions	Phasing of access to GMP, intra-system solidarity	Solidarity pillar, integrated with the contributory pillar, with tax-based funding
	Fair gender treatment	Social security for housewives, with solidarity contributions	Elimination of discriminations resulting from social division of work and pension calculation parameters
	Yield of funds	Increase investment limits	More competition in fund management
	Reduction of costs	Limit transfer of members to reduce marketing costs, change basis for calculating and applying commissions	Separate functions, competition in each segment of the market
	Institutional structure	Member participation in AFPs	Participation of users in education and supervision of the system.

SOURCE: AUTHOR'S OWN WORK.

In terms of the diagnosis, it has already been said that the initiative to push for a Pension Reform was amply supported by the Social Protection Survey (EPS) which began to be applied in 2002. This information fuelled a large part of the Council's diagnosis work, especially as regards: (i) members' knowledge of basic aspects of the existing pension system; (ii) the motivations and incentives that affect behaviour within it; and (iii) the forecasts of the system's benefits, both under the individually-funded scheme and in terms of access to the State-guaranteed minimum pension. The CAPRP obviously did not generate this information, but it did act as a catalyst, complementing it with information emerging from its own survey, qualitative studies and evidence received in the hearings, and transforming it into a comprehensive diagnosis of the pension system.

A key issue on which the Council, backed by the information from the EPS, differentiated its diagnosis from the ideas that were prevalent in the mid-2000s was that of coverage. Until then, there was a predominant idea that the pension system had not managed to increase its coverage, in spite of the 1981 reform[28] . This resulted in the notion of a population divided between a group that was well-protected by the system and another that was excluded. The Council, when it analysed the information coming from the EPS and the studies of the Superintendence of AFPs, reached a different conclusion: given the high mobility of the work force in Chile, the problem was actually one of low contribution density, with a high proportion of the population having many social security gaps and low fund accumulation, which would prevent them not only from self-funding a good pension, but also from qualifying for the state-guaranteed minimum pension. In these circumstances, the proportion of workers who would be in a position to obtain a pension with a reasonable replacement rate would be lower than expected[29].

Despite the fact that the problem of low contribution density had begun to a certain extent to form part of the diagnosis on the pension system as a result of the EPS, the Council developed its implications in two directions. The first referred to the social security position of women. Until the mid 2000s, the few references to women's social security position referred to the situation of widows' pensions and the lack of protection for housewives. The Council expanded this agenda considerably. Consistent with its vision of the pension system as a universal protection mechanism against the risks associated with old age and low pensions as a problem of contribution density, the Council tackled the social security problems of women as a problem of fair treatment at the heart of the pension system and not as a peripheral issue, and proposed an extensive package of solutions. The

28 *Measured as the ratio between contributors and the work force.*

29 *On these matters the Council leaned heavily on the study by Berstein et al (2205), op.cit., prepared with information from the EPS.*

Council also worked out the consequences of low contribution density on the fiscal commitments with the pension system. In particular, on observing that fewer pensioners in the new system would meet the requirements for obtaining the minimum pension, the Council concluded that the fiscal expenditure associated with the system would fall more rapidly than expected once the system reached full maturity. The savings generated by this reduction then became the main source of financing for the measures proposed by the Council.

In a similar way, the Council stipulated that the yield of those enrolled in the system should be estimated as the internal rate of return (IRR) of the worker's contributions, comparing the present value of all his/her contributions (including commissions paid to the administrators and the insurance companies) and the present value of all his/her benefits, including the pension of the principal and his/her derived pensions[30]. Although the Council did not produce precise calculations of this yield, due to the absence of complete working careers under the individually-funded scheme, it did comment that these factors could reduce yield considerably. As regards the economic rationale of members' behaviour, the Council combined the data from the EPS with that collected in its own qualitative studies, to find serious, generalised levels of ignorance regarding basic aspects of the pension system's operations. Those levels of ignorance justified a considerably more active role on the part of the State in educating the members, regulating the information and offers of the AFPs, promoting competition, and guiding – or even limiting – decisions contrary to the interests of the members themselves.

From the above it may be concluded that the main element that differentiates the diagnosis developed by the Council on the functioning of the pension system from the studies and data available at the beginning of 2006 is that it complements the views of the industry's stakeholders and the specialists with a view from the perspective of the members.

The differences in the Council's view with regard to the objectives of the pension system and in the diagnosis of its problems resulted in important contributions in the shape of proposed solutions. In matters of coverage, the Council adopted a proactive approach, which included a wide range of measures to increase the contribution density of workers who are not wage-earners; in matters of pension sufficiency, an unusual scheme was proposed for the solidarity pillar, designed to complement rather than replace the contributory scheme; in matters of fair gender treatment, the proposals abandoned the paternalistic view of women in the pension system and dared to include the controversial levelling of the legal retiring ages

30 *Special recognition is due to Manuel Riesco's contribution to the debate on this point, to be found in his testimony in the Council's hearings, in CAPRP (2006) op.cit., volume II, pp.64-85.*

of men and women; in matters of yield, it proposed a profound change in the essence and institutional structure of the system of investment limits; in matters of competition, it proposed a set of measures to reduce entry barriers on the one hand and encourage the entry of new competitors on the other, exerting pressure to bring down commissions. Finally, the Council made a detailed institutional proposal to provide the basis for this set of transformation, taking user participation to the very hub of the system.

III.3. CAPRP's contribution to citizen participation in the formulation of Chile's public policies

As was stated at the beginning, citizen participation was one of the pivotal elements of President Bachelet's program of government. As candidate, she spoke about "citizen government" and in presenting her program of government she gave the subject a personal, challenging seal. The program included a series of proposals for raising citizen participation, including automatic enrolment on electoral registers, popular legal initiatives, affirmative action and direct election of regional authorities. As regards the formulation of public policies, the Program states:

Despite not having been included in the Program of Government, the Advisory Commissions have later been presented as one of the greatest advances in matters of citizen participation during this period.

Although the reasons why the advisory councils came to be recognised as a more important participation mechanism than others proposed at the end of 2005 are beyond the scope of this study, it is worth asking oneself to what extent these councils, and particularly that of the pension reform, have really fulfilled this role. What follows contains an examination of the CAPRP's contribution to citizen participation in two dimensions: to what extent did the instances of participation affect the Council's discussions and proposals and how does its work connect with the institutional process of legislative debate and enactment of the Pension Reform.

Citizen participation in the Council's work

The CAPRP was clearly conceived as a committee of experts. That character was made quite explicit in the program of government and in the initial summons. In such circumstances, the Council cannot be considered in itself as an instance of participation.

The relationship between the Council and the citizenry was established through the hearings process. For this reason, the CAPRP's contribution to citizen participation in the pension reform can be evaluated on the basis of the influence of the hearings on the Council's analysis and proposals.

As was commented earlier, the hearings attracted a wide spectrum of participants, each of whom had the opportunity to expound his/her attestations, opinions and proposals, which were recorded in documents that went to form part of the Council's Final Report.

The hearings had a central influence on the Council's work. In the opinion of its members, this stage of the process was vital in broadening their perspective on how the pension system was working, making positions more flexible and bringing them closer to the real situation of workers, members and pensioners. In the words of one of the council members, "nobody's thinking was the same after the cycle of hearings as before it".

The hearings influenced the Council, in the first place, by putting the voices of the various different actors in the pension system on the same level. This occurred because it opened a wide space for trade union and social organizations. These organizations not only took up almost 40% of the time of the hearings, but managed to convey ideas and experiences through them that strongly marked the Council's subsequent agenda.

The Council was impressed by the seriousness with which the workers' organizations took their responsibility. The Council's first hearing corresponded to the Central Unitaria de Trabajadores (CUT), led by its president, Arturo Martínez, who gave a balanced, coherent and reasonable presentation. The workers' organizations that followed him maintained a high standard in their presentations, their answers to council members' questions and the documents that they handed in. The evidence of the organizations of self-employed workers (market stall-holders, traditional fishermen, small farmers, domestic staff and taxi-drivers) also had a strong influence on the Council's priorities, not only because they revealed such a high degree of vulnerability, but also because they demonstrated the existence of organizations that could be allied with the state when the moment came to incorporate these workers into the pension system.

The voice of the workers and of the social organizations had a strong influence on the change of viewpoint adopted by the Council towards the pension system. If it decided to evaluate the system from the point of view of the users and the elderly people of the future, this was, to a large extent, because the voice of these actors was the one that was heard most clearly in the hearings' process.

In the second place, the hearings allowed the Council to become familiar with well-drafted technical proposals, which served as a basis to enable the Council to produce its own proposals. These came not only from experts in the field, but also from the organizations attending and the international bodies. When making its proposals, however, the Council acted with independence, adding value to the ideas received in the hearings and making connections that had not been thought of. The proposal for the solidarity pillar, for example, chose a scheme other than the one put forward by Guillermo Larraín, former Superintendent of AFPs. It took elements from the proposals suggested by experts as different as Salvador Valdés and Manuel Riesco, and those suggested by the CUT, but added a design that was more efficient from the point of view of fiscal resources.

The influence of the hearings on the Council was not something fortuitous. The hearings formed part of the model proposed from the program of government itself and their importance was reiterated at the point when the Council was set up. The council members were chosen for their ability to listen and both the actors in the system and the promoters of specific reforms were sought proactively to participate in the hearings. For purposes of concentrating the council members' attention on the participants' presentations, there were no other activities or exchanges during the month that the audiences lasted, apart from listening and interacting with those who came. All this shows that the hearings were not part of a public relations exercise but probably the most important component of the Council's work.

Citizen participation and legislative process

How much did the Council contribute to the legislative process through which the Pension Reform was debated and approved? This is a matter of the greatest importance, because there has been questioning on various occasions and in various places as to whether advisory councils weaken the institutions of representative democracy whose precise role is to fix agenda and define policies.

In this respect it is worth emphasising the fact that advisory councils or commissions are common in consolidated democracies. In the United States, federal advisory committees are even regulated by the law[31], whereas in the United Kingdom they have been functioning for over 200 years as *Royal Commissions,* an institution inherited and adapted by many Commonwealth countries which maintained the parliamentary regime and institutions of Westminster. In the case of Australia, these commissions also have a legal framework and have been operating for a long time[32] . On many occasions these commissions have had a crucial influence on public policy.

Possibly the most pertinent example for our case is that of the Royal Commission headed by Lord Beveridge, which proposed the pillars of the British welfare system in 1943. More recently, both the United States and the United Kingdom have

31 Federal Advisory Committee Act, 1972.

32 Weller, P. (1994) Op.cit.

commissioned advisory councils to analyse and propose reforms for their pension systems[33].

On the other hand, as Aguilera recalls (2009), the governments of the Concertación set up advisory commissions or committees on various occasions to consider important areas of policy[34]. Of these, the most outstanding are the Truth and Reconciliation Commission (Rettig Commission), the Commission on Truth and New Treatment for Indigenous Peoples (Aylwin Commission) and the National Commission on Political Imprisonment and Torture (Valech Commission). However, as is emphasised in Aguilera's own paper, the presidential advisory commissions are distinguished from these previous experiences because they are essentially committees of experts called to tackle specific problems of public policy. In consequence, it may be said that the potential contradictions of the new advisory councils with the institutions of representative democracy were not resolved by previous experience in Chile. At the same time, those potential contradictions occur in the context of a political regime that is much more strongly presidential than that of the United States or the other Anglo-Saxon countries quoted, where the contribution of the presidential advisory councils confronts a relatively weak legislature, especially on issues related with public finance and pensions[35].

In these circumstances, the best way of evaluating the relationship of the CAPRP with the legislative process is by comparing it with other pension legislation in Chile.

In this sense it is worth mentioning that since the 1981 pension reform, 40 legal

33 *In the United States, in May 2001, President Bush formed a 16-member commission to "study and propose recommendations to preserve social security for the elderly and at the same time produce wealth for the younger generations". The commission's work ended in 2005 with proposals to include a system of voluntary, individually-funded accounts. Meanwhile, in the United Kingdom, the government of Prime Minister Tony Blair set up a pension commission in 2002 as an independent body to review the British system of private pension saving. This commission, consisting of three members, carried out numerous studies, and in 2006 presented a report that recommended replacing the existing system with a mandatory complementary scheme based on individually-funded accounts, plus a series of adjustments to ensure that this scheme complemented the public pension system in force since 1945. These proposals had different outcomes: whilst in the United States no legal reform has so far been forthcoming, in the United Kingdom the reforms proposed by the pension commission are in process of implementation.*

34 *Aguilera, C. (2009) "Un análisis de las comisiones asesoras presidenciales del gobierno de Michelle Bachelet", Working Paper, Governance Program, FLACSO Chile.*

35 *In this respect, it should be remembered that the Political Constitution states that the laws on pension matters are proposed exclusively by the President of the Republic.*

modifications have been made to D.L. 3,500, of which about 15 were passed after the return to democracy in 1990. This is stated in the CAPRP report itself. During this period numerous legal reforms were also made to the old pension system and the welfare pension system. Nevertheless, only a few of these are of sufficient magnitude and relevance to serve for purposes of valid comparison with the 2008 reform. These are the law that created the system of voluntary pension saving (Law Nº 19,768 (2001)), that which created the multi-fund system (Law Nº 19,795 (2002)), and the law that regulated the purchase of life annuities (Law Nº 19,934 (2004)). Table 6 summarises some basic data on the legislative process of these laws, as also on that of the pension reform law (Law Nº 20,255 (2008)).

TABLE 6
DETAILS OF THE LEGISLATIVE PROCESS OF PENSION LAWS

Law	Size (Nº of Articles)	Instructions received at first constitutional reading	Processing time
Voluntary Pension Saving (Law Nº 19,768 – 2001)	6 permanent articles, 7 transitory articles	73	5 months
Multi-funds System (Law Nº 19,795 – 2002)	1 permanent article with 32 modifications to DL 3,500. 10 transitory articles.	Substitutionary instruction from the executive introduced multi-fund system to a bill that originally only modified the pension funds' investment limits	13 months
Life Annuities (Law Nº 19,934 – 2004)	3 permanent articles, 10 transitory articles	87	10 years
Pension Reform (Law Nº 20,255 – 2008)	102 permanent articles, 55 transitory articles	427	1 year

SOURCE: AUTHOR'S OWN, WITH DATA PROVIDED BY THE NATIONAL CONGRESS LIBRARY.

As may be seen, the Pension Reform law, with 157 articles in total, is by far the most extensive of the four pension laws quoted. This occurs because the other three laws refer to specific aspects of the system's operation, while the 2008 reform touches practically all its dimensions. Despite this, the Pension Reform was processed in a very short period, comparatively speaking: a little over 12 months. The greatest contrast in this respect is with the life annuities reform, in which Congress took ten years to approve a law with only three permanent articles[36]. The only one of the social security laws quoted in Table 5 that was approved in less time was that of voluntary pension saving, which took only four months to be approved.

Table 5 shows that the speed with which the Pension Reform was processed was not achieved by limiting the voice of Congress. This is illustrated by the large number of instructions received in the first constitutional reading (427), which far exceeds the volume of instructions received by the other bills quoted. Neither can this performance be explained by favourable political circumstances. On the contrary, the period during which the Pension Reform was processed was one of great political conflict caused by the divisions within the ruling Coalition and a more belligerent attitude on the part of the opposition. This resulted in the defection of several members of parliament belonging to the governing block, which caused it to lose its parliamentary majority, and by the so-called "eviction theory" mooted by certain opposition leaders.

The above facts acquire particular relevance if one considers that the 2008 reform was the first comprehensive pension reform passed in normal democratic political conditions. In fact, the two main historic landmarks in the development of the pension system in Chile – the creation of social security in 1924 and the reform of 1981 – occurred in exceptional political conditions.

The creation of social security in the early 1920s was characterised by a double transition. On the one hand, the extension of the state's responsibilities into the social sphere, which was expressed in a set of reforms that created the scaffolding of the Chilean "welfare state" of the 20th century and on the other, the transition of the political regime from a parliamentary republic to a strongly presidential regime, with the passing of the 1925 Constitution.

In social affairs, the decade began with an abrupt change of attitude among the main political actors, which resulted in competitive proposals for social legislation generated by the two major political blocks[37]. To a large extent, this change of attitude was a response to the eruption of the labour movement in the country's

36 *The contrast is even greater with the bill that attempted to regulate the transfers of members between AFPs. This bill was presented in 2006 as a reaction to the commercial war being waged between the AFPs to capture members in the mid-1990s, was kept in debate for over two years in Congress and was finally replaced by a ruling from the Superintendence of AFPs which required the member to go personally with his/her ID card to the AFP in order to apply for a transfer, without the legislative process ever being concluded.*

37 *For a detailed review of the bills under debate, see Yañez, J.C. (2008) "Social Intervention in Chile, 1907-1932, RIL Editores, Santiago, Chile.*

political and social arena[38]. At the same time this period was marked by the crisis of the parliamentary system, in which the Congress had a series of mechanisms to block presidential initiatives, which led to repeated confrontations between the President and the Congress[39]. As a result of these two phenomena, the social legislation which was presented originally in 1921 was subjected to a long and complex debate in Congress, which included the parallel debate on labour code bills in the Senate and Chamber of Deputies. The processing of the social laws ended in September 1924 with a session of Congress in which army officers placed themselves in the galleries to apply direct pressure on members of parliament, in an episode known as the "sound of sabres". This led to the bills under debate being hastily passed, including the creation of the mandatory labour insurance, the first nation-wide pension institution in Chile. This episode was followed by the resignation of the President, Arturo Alessandri, the formation of a governing junta and a string of attempted military coups which culminated in Alessandri's return to the country and the passing of a new Constitution which was to govern the country for the next 55 years.

Where the 1981 reform is concerned, it took place right in the middle of a military dictatorship which considered it to be one of its emblematic social reforms. This reform was the result of a process that began in 1974 with a study by ODEPLAN which, after being interrupted by the crisis in 1975, began again at the beginning of 1979. During that year a series of parametric reforms were ruled for the old system of pension "cajas", aimed at homogenising it and improving its actuarial balance. The pension reform that created the individually-funded scheme managed by AFPs was passed by the Governing Junta in 1980.

The individually-funded scheme began operating in May 1981. Active workers had the possibility of switching voluntarily to the new system, which was promoted by: (i) the incentive of an average 11% increase in take-home pay caused by the lower contribution rate in the new system; (ii) an intensive publicity campaign which emphasised the advantages for the workers of changing to the individually-funded scheme and ridiculed those who opted to stay in the pay-as-you-go scheme, and (iii) direct pressures from employers, including the state.

With this background, the passing of a comprehensive Pension Reform in 2008 after only 12 months of legislative processing and with broad parliamentary support, despite the unfavourable political climate, constitutes an exceptional achievement.

38 *Arellano (1985) op.cit. Chapter I contains a brief review of how the so-called "social question" gained space in public policies in Chile.*

39 *Among these were the refusal to close debates and the dismissal of ministers, giving rise to the so-called "ministerial rotation". With regard to this, see Castedo, L. (1999), Life and Death of the Parliamentary Republic", Sudamericana, Santiago, Chile.*

This achievement may be put down to three factors: first, the existence of broad prior consensuses on the problems of the current system, the aims of a reform and its main components. The extent of these consensuses is shown not only by the high vote in favour of the reform, but also by the fact that the main social actors did not question it. In fact, while the pension reform was being prepared and debated, there were no social demonstrations against it. In the second place, it may be that the support for the reform was due to its comprehensiveness, which guaranteed that the whole series of problems and challenges being dragged along by the pension system was recognised in the initiative, with measures directed specifically at solving them. By contrast, many previous partial reforms based on incremental reasoning were complicated by the fact that they provided no answers to the problems of the pension system that were not included among their objectives. Finally, the support for the Pension Reform bill may have been justified by the high public exposure that it had gained in the previous months. During that period, expectations were raised among citizens that the pension reform would be an ambitious one, and this increased the political cost of opposing or misrepresenting it.

As may be seen, the work of the CAPRP, by producing proposals that had earned the consensus of its members, by tackling all the dimensions of the pension system and by giving wide publicity to the hearings, deliberations and proposals, played a central role in relation to each of these factors.

IV. Lessons learned and projections of the CAPRP experience for the use of Advisory Commissions in the formulation of public policies.

The previous sections describe the experience of the CAPRP as a successful example of the use of advisory commissions for the formulation of public policies. The Council managed, in a very short time, to produce a proposal that provided the bases of the main social reform of Michelle Bachelet's government. By including the points of view of a whole series of social actors and providing proposals that commanded a virtual consensus among its members, the CAPRP built a foundation of legitimacy for the reform that made swift legislative processing possible, something unheard-of in the history of social security in Chile.

In order to draw out lessons from this experience that might be relevant for other experiences of advisory councils aimed at formulating public policies, it is useful to review the objectives set for councils of this type and see which institutional and operational arrangements are most effective for achieving them.

Aguilera (2009) suggests that the main objective of presidential advisory councils was the search for legitimacy, giving them a participative sense that made it possible to confront the country's problems of political representation[40]. This would enable conclusions and proposals to be put forward that would be considered morally superior to proposals coming from the government or parliament, reducing the suspicions or qualms that frequently beset the more traditional processes of formulating public policies. The search for legitimacy was at least as important, or more so, in the case of councils dedicated to establishing "historic truths" in Chile, such as the Rettig, Valech and Aylwin Commissions. A similar objective seems to have guided a high proportion of the commissions created over the course of time in Australia to investigate events of great social impact, such as the suicide of Aborigines in prison or the activities of security bodies[41]. The legitimacy produced by advisory councils, however, can also be used for less laudable purposes, such as disguising controversial government proposals, postponing decisions, neutralising social protest movements or responding to pressures from public opinion.

In the second place, Weller (1994) suggests that advisory councils can be an effective tool for rational formulation of public policies. This is defined, by contrast with an incremental approach designed to solve specific policy weaknesses, as a systematic exercise of distinguishing between realities and opinions, including the retrospective examination of information, a rigorous review of alternative solution strategies and the choice of proposals with greatest expected value. In other words, the advisory councils, because of their plurality, independence and technical capacity, may make it possible for a problem to be reviewed in depth, producing an objective diagnosis of the policies currently in place and proposing comprehensive solutions that the traditional political process, bound by the limitations of its own past decisions and the pressures from stakeholders, would have difficulty in producing. For this reason, it is vitally important that the work of an advisory council be focused on a specific problem, because there may be exponential ramifications to issues that are ambiguously or vaguely defined.

Finally, Marsh (2000) maintains that effective governance calls for integration ability. This refers to the formal political system's ability to create or decant support from the public and from stakeholders for certain political actions. Marsh argues that the integration ability of the institutions of representative democracy has been gradually eaten away as a result of globalisation, weakening of the political parties, confrontational political dynamics and the multiplication of stakeholders and

40 *Aguilera, C. (2008) op.cit. p.11*

41 *Söderblom, J.D. (2001) "Royal Commissions of Inquiry: Perspectives in Rational Decision-Making Public Policy – including a Case Study of the Hope Royal Commission into Intelligence and Security", in www.world-ice.com.*

autonomous social movements[42]. In these circumstances, it is almost impossible to formulate viable and sustainable strategies without a structured process of conversation with the relevant actors. The advisory councils are one of several alternatives for producing this structured conversation[43].

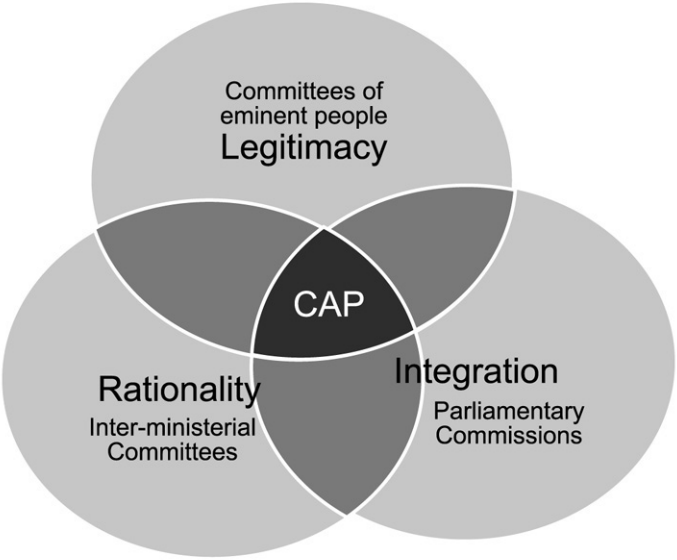
The above analysis has a double significance for advisory councils such as the CAPRP. In the first place, each of the previous objectives can be achieved by various types of deliberative advisory or decision-making bodies. In fact, legitimacy can be achieved both by committees of experts and by committees of eminent people or "good men", as in the case already quoted of the commissions on historic truth. Meanwhile, the reasonable formulation of public policies is also an aim of inter-ministerial commissions that seek to incorporate the views of several sectors of the administration or external advisory services of prestigious international bodies. Finally, the integration (decanting) of public support is also sought by technical parliamentary commissions, which usually include hearings with external actors in their deliberation processes. So, as is illustrated in Figure 2, Presidential Advisory Councils (CAP), such as that involving pension reform, correspond to the conjunction of these three objectives, rather than to each of them taken separately.

42 *Marsh, I. (2000) "Gaps in policy-making capacities: interest groups, social movements, think tanks and the media", in Keating, M., J. Wanna and P Weller (eds.) Institutions on the Edge? Capacity for Governance, Allen and Unwin, pp.193-198.*

43 *Marsh also includes the communications media, think tanks and parliament. The forum preferred by Marsh is that of specialist parliamentary commissions, but it must be remembered that these have a significantly different dimension in a federalized parliamentary system such as that of Australia.*

FIGURE 2

AIMS OF DELIBERATIVE INSTANCES IN PUBLIC POLICIES



SOURCE: THE AUTHOR

In the second place, if the CAPs have to meet these three aims, not just any organization or mandate will enable it to be achieved. For a council to achieve legitimacy it must be independent of the government; it must be made up of people who do not form part of the Administration and must deliver its proposals promptly for decision-making purposes, so that it is not seen as a delaying tactic. For a council to develop a rational approach to the examination of public policies, it must have a clear mandate and limited objectives and have ample access to information. Finally, for a council to be capable of achieving political integration, it must incorporate a wide variety of views, even beyond those represented by its own members, and act with full transparency, including a clear explanation of its proposals.

This relationship between the aims and requirements of the CAPs is shown schematically in Table 7, which includes specific ways and means for carrying out each of the requirements mentioned.

TABLE 7
OBJECTIVES, REQUIREMENTS AND WAYS AND MEANS FOR CAPS

AIM	REQUIREMENT	WAYS AND MEANS
Rationality	Clear mandate Limited objective Access to information	Terms of reference Well-defined problem Authority for requesting information Generation or access to new information Capacity to self-analyse
Legitimacy	Independence of the government Limited deadlines	Members independent of the government Administrative autonomy Temporary nature
Integration	Integration of views Transparency	Plural political and disciplinary composition Members independent of interest groups Public hearings and consultations Dissemination of the process Public report

SOURCE: THE AUTHOR.

Of the ways and means of carrying out the aims of the CAPs as suggested in Table 7, two are worthy of special attention because of their relevance to the Chilean experience of commissions of this type. In the first place, the importance of having a well-defined, limited problem as the subject of a CAP analysis. In our analysis, this definition is essential to enable the CAP to contribute to rationality in the formulation of public policies, because otherwise it would be impossible to evaluate alternatives in terms of their cost and benefit for achieving the desired aims. This means that the CAPs cannot be responsible for agenda-setting, a responsibility that corresponds to the political process, but for the analysis and selection of alternatives. So, an effective CAP is an expression of the combination of a top-down process of agenda-setting and a bottom-up process of generating proposals to solve a specific problem on the agenda.

In the second place, the relationships proposed in Table 7 help to solve the question put by Aguilera (2009) as regards the integration of the CAPs, in other words, the dilemma between committees of experts or committees with trade union or political representation. While Aguilera seems to suggest that the second formula would be more effective from the point of view of citizen participation, our analysis suggests that its effect might be ambiguous, or even counterproductive from the point of view of integration, i.e. the ability to involve and represent social actors. This occurs because if an advisory council is made up of political or union representatives, they are submitted to the opposing forces of the group's work dynamic and their own accountability to those they represent. When facing the latter, involvement in a CAP exposes a leader to all the costs of a negotiation and none of its benefits. Any concessions he makes will be seen as the gratuitous abandonment of an aspiration with no real benefit in exchange, since the Council will only produce proposals that the government and legislature will have the autonomy to accept or refuse.

This analysis makes it possible to understand the causes of the CAPRP's success and the limitations faced by other CAPs formed during President Bachelet's government. The CAPRP had all the mechanisms of ways and means included in Table 7 and was therefore able to fulfil the three aims of legitimacy, rationality and integration. Something similar occurred with the CAP on Childhood Policies which operated under very similar conditions. By contrast, the CAPs on Quality of Education and Work and Fair Treatment were carried out in far more adverse conditions, originating to a large extent in the political events that led up to their formation.

In particular, the CAPs on Quality of Education and Work and Fair Treatment corresponded to far wider mandates, especially in the second case. This occurred because both corresponded to social protest movements that referred to problems not envisaged in the government's agenda. In the formation of these CAPs, the political responsibility of first setting a policy agenda was passed to the council members, something which made their work more difficult, both politically and operationally. Furthermore, being composed of political and trade union leaders, these CAPs could not reach consensus solutions on a number of issues, and this was particularly obvious in the case of the CAP on Quality of Education. In fact, when faced with the imbalance between the costs and benefits of giving way on their positions in favour of an agreement, these leaders opted, in issues with strong ideological divisions, to maintain their positions and explain them by minority votes, or simply to present grounds for alternative views and proposals. In this way, the Quality of Education CAP Report ended up being a map of alternative positions (in some cases up to three or four).

Even so, the CAPs on Quality of Education and Work and Fair Treatment managed to make significant contributions to public policies in their respective areas, which were followed by important legal reforms and programs. The second of these reports in fact managed to deepen the discussion of these matters significantly and also to generate fresh proposals for advancing the public agenda. These achievements must be seen as a merit of the efforts of the councils and those who chaired them, and the operational designs with which they worked. Nonetheless, this does not necessarily constitute a model to be followed in the future, due both to the problems of their original design and the changes that have continued to occur in the attitudes of social actors towards instances of this type. The withdrawal at a late stage of the student leaders from the CAP on Quality of Education and the refusal of the CUT to take part in the CAP on Work and Fair Treatment show that to a large extent these actors give priority to instances of negotiation rather than consultancy and in these conditions it is likely, paradoxically, that they will prefer to express their views at a hearing of a CAP made up of experts rather than commit themselves to take part in a CAP with social representation.

These lessons are useful for the future of the CAPs. With the experience of the CAPRP, it is possible to conclude that, under certain conditions, instances of this type may obtain fundamental achievements in advancing a specific policy agenda and, at the same time, serve as a mechanism of broad participation in the formulation of public policies. Nonetheless, the analysis of the differences in performance of the various CAPs and the institutional conditions in which they were created indicates clearly that CAPs cannot be used for just anything, nor function just anyhow. They require careful institutional and operational design and it is largely in those initial stages that their result is at stake.

THE CRISIS OF THE PAY-AS-YOU-GO SYSTEMS AND THEIR FAILURE TO KEEP THE PROMISE OF DEFINED BENEFITS: RECENT DEVELOPMENTS IN THE COMPLEX WORLD SCENARIO

ÁNGEL MARTÍNEZ-ALDAMA[1]

1 *Ángel Martínez-Aldama is a Licentiate in Law and in Economic and Business Sciences from the Universidad Pontificia Comillas (ICADE), Madrid, Spain. Currently (since October 2010) he has acted as Vice-president of the European Federation for Retirement Provision (EFRP). Since 2005 he has been a member of the Management Committee of the European Funds and Asset Management Association (EFAMA). He is also a member of the Board of the International Federation of Pension Fund Administrators (FIAP) and the Ibero-American Federation of Mutual Funds and has also been a Member and Secretary of the World Pension Association, WPA.*

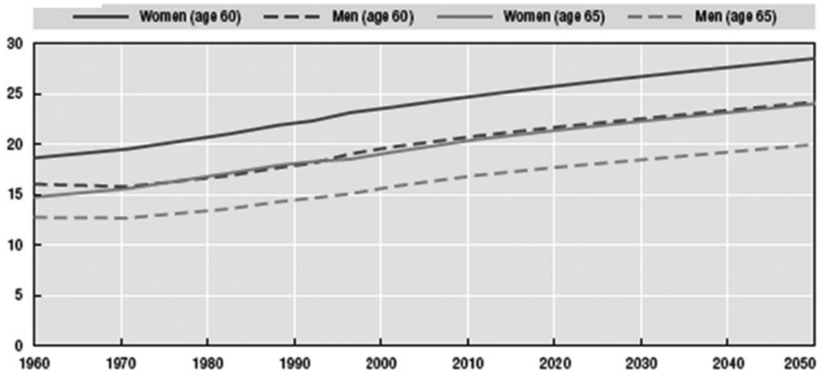
I. Context

The ageing of the population

Between 1960 and 2010, life expectancy at age 65 increased by about 3.9 years in the case of men and 5.4 years in that of women in the countries belonging to the Organisation for Economic Co-operation and Development (OECD) (see Graph Nº 1).

GRAPH N° 1

LIFE EXPECTANCY AT AGE 60 AND 65 BY SEX, OECD AVERAGE, 1960-2050



SOURCE: OECD.

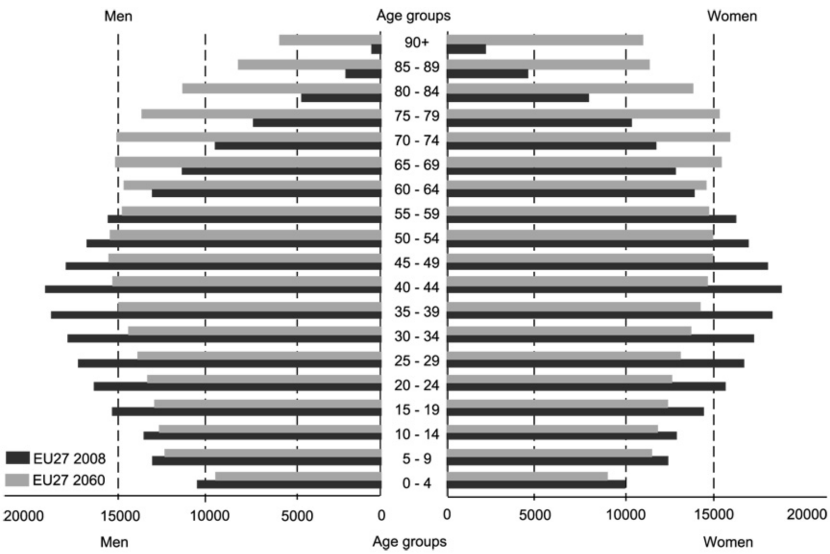
What is this context that we are facing? In 1990 it was estimated that pensions would have to be paid for 15 years (in the case of men), whereas current information enables us to estimate that by 2050 they will have to be paid for some 20 years. This undoubtedly constitutes a huge challenge. The point is that nobody can say to what extent the information given will be obsolete in a few years time, since life expectancies have been consistently underestimated.

Population pyramid

The European population pyramid is an important point (see Graph Nº 2). We see clearly that the base of the pyramid will get narrower in the next 50 years, while the upper part will get wider in the section close to the group aged 65 and over. An enlightening figure: in the year 2060 there will be 120 million retired people in Europe, of a total population of 480 million.

GRAPH Nº 2

EUROPEAN POPULATION PYRAMID



SOURCE: EUROPEAN COMMISSION.

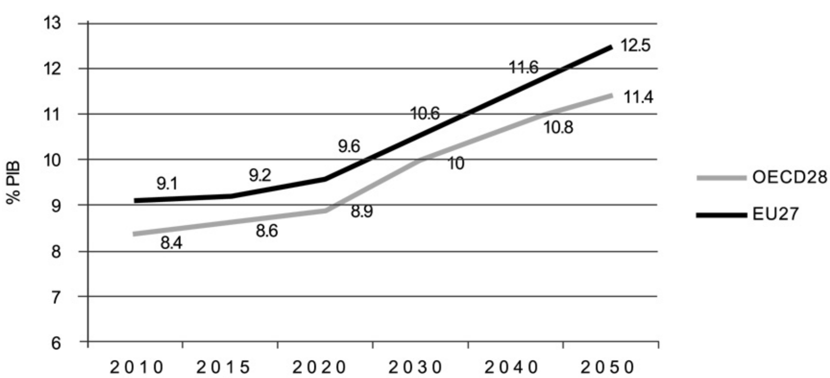
Public expenditure on pensions

What is the public expenditure being dedicated to pensions in Europe at this point in time? We are speaking currently of some 9.2% or 8.6% of GDP in the case of the 27 countries in the European Union (EU) or the 28 countries of the OECD, respectively (see Graph Nº 3).

If we look at Table Nº 1, it is possible to see that 10% of the GDP was dedicated to pension payments in 2007 in the case of the 27 EU countries, and by the year 2060 that expenditure will be 13% of the GDP. In this table it is also possible to see what is being dedicated to health, unemployment and education: in 2007 it was 13% of the GDP, whereas in 2060 it will be 15% of the GDP. This means that about 23% of the GDP was being dedicated in Europe each year to pay for education, unemployment, health and pensions and that by 2060, this figure will reach 28%. In other words, Europe is going to have to pay out an average of almost 30% of its total annual GDP, in order to maintain pensions and provide education, health and unemployment protection. This really constitutes a very significant challenge and clearly poses the question as to whether this situation is sustainable.

GRAPH Nº 3

EUROPE: FORECAST OF PUBLIC EXPENDITURE ON PENSIONS: 2010-2050



SOURCE: PREPARED BY THE AUTHOR USING OECD DATA.

TABLE Nº 1

PUBLIC EXPENDITURE FORECAST FOR 2060 WITHOUT REFORMS (%GDP)

Countries	Pension Expenditure (% GDP)			Expenditure on health, dependency, unemployment and education			Total expenditure		
	2007	2060	Variation	2007	2060	Variation	2007	2060	Variation
Luxembourg	8.7	23.9	15.2	11.4	14.1	2.7	20.0	38.0	18.0
Greece	11.7	24.1	12.4	10.4	13.9	3.5	22.1	38.0	15.9
Netherlands	6.6	10.6	4.0	13.9	19.3	5.4	20.5	29.9	9.4
Spain	8.4	15.1	6.7	10.8	13.0	2.2	19.2	28.2	9.0
Belgium	10.0	14.8	4.8	16.7	18.9	2.2	26.5	33.4	6.9
United Kingdom	6.6	9.3	2.7	12.3	14.6	2.3	18.9	24.0	5.1
Germany	10.4	12.7	2.3	13.1	15.6	2.5	23.6	28.4	4.8
Portugal	11.4	13.5	2.1	13.1	14.4	1.3	24.5	27.9	3.4
France	13.0	14.0	1.0	15.4	17.1	1.7	28.4	31.1	2.7
Denmark	9.1	9.2	0.1	15.7	18.2	2.5	24.8	27.4	2.6
Sweden	9.5	9.4	-0.1	17.6	20.3	2.7	27.2	29.8	2.6
Italy	14.0	13.6	-0.4	12.1	14.2	2.1	26.0	27.6	1.6
EU15	10.2	12.6	2.4	13.3	15.7	2.4	23.5	28.3	4.8
EU27	**10.2**	**12.6**	**2.4**	**13.0**	**15.2**	**2.2**	**23.1**	**27.8**	**4.7**
EU25	10.2	12.5	2.3	13.1	15.4	2.3	23.3	28.0	4.7
EU10	9.7	10.7	1.0	9.7	10.9	1.2	19.2	21.3	2.1

SOURCE: EUROPEAN COMMISSION: "2009 AGEING REPORT: ECONOMIC AND BUDGETARY PROJECTIONS FOR THE EU-27 MEMBER STATES (2008-2060)".

Net worth of the pension funds as proportion of the GDP

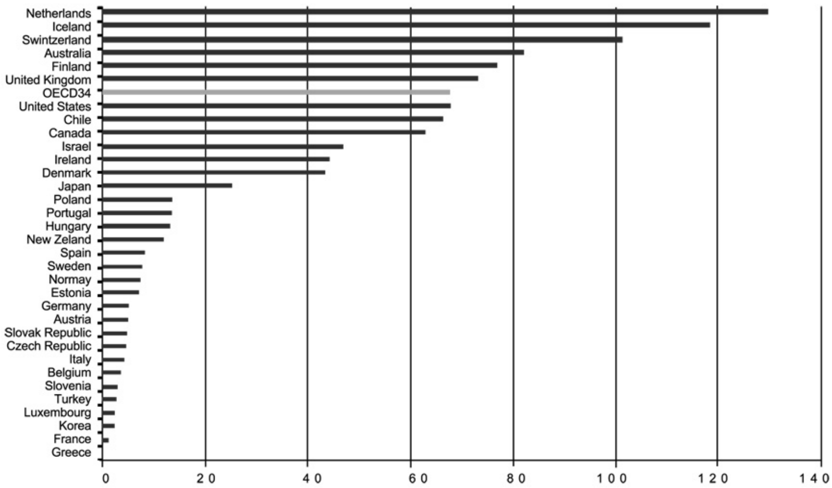
The weighted mean of the Pension Funds' net worth over GDP in the OECD is 67.6% (including the United States; see Graph Nº 4)[2].

As may be seen in Graph Nº 4, all those countries in which the pay-as-you-go pillar has been combined with a mandatory second pillar with individual funding (occupational or personal) and a third pillar of voluntary savings (as in the cases of the Netherlands and Sweden), have managed to achieve a considerable accumulation of wealth. However, most of the countries inside Europe (beginning with Hungary, Spain or Germany) are well below 20% of GDP in terms of their pension wealth.

2 *In Germany the accrued liabilities are not included and neither is the privately-managed pay-as-you-go system of the second pillar in France or the Trattamento Fine Rapporto (TFR) in Italy.*

GRAPH Nº 4

NET WORTH OF PENSION FUNDS AS PERCENTAGE OF GDP (OECD 2009)



SOURCE: OECD.

Public/private replacement rates

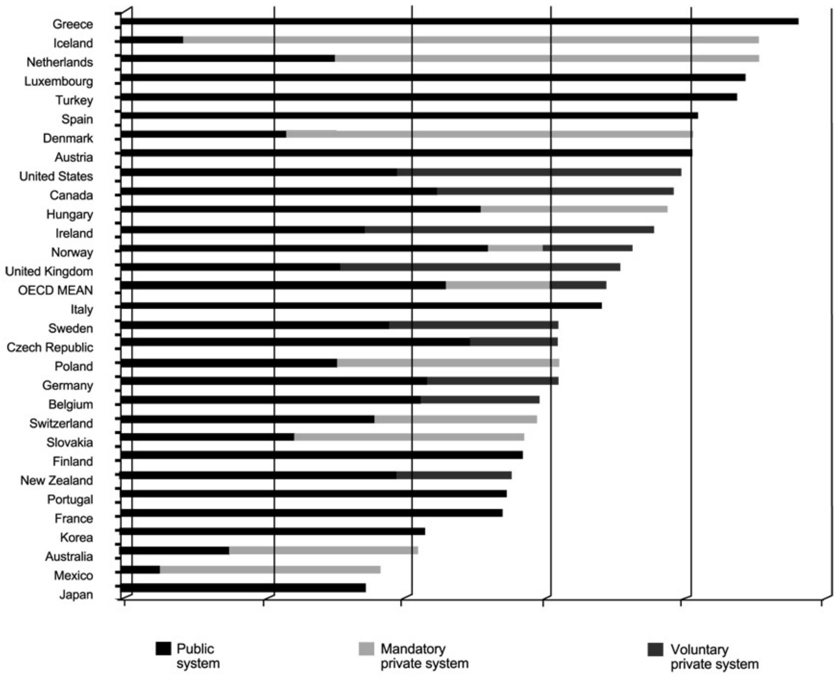
As may be seen in Graph Nº 5, only 4 countries in the OECD (Spain, Greece, Luxembourg and Turkey) provide replacement rates of over 80% from the public system.

It is also possible to see that most OECD countries (21 out of 30) have a balanced system (public-private).

The case of the Netherlands is remarkable, with almost two-thirds of the replacement rate coming from the employment system and only a third from the pay-as-you-go system. In the future, the pay-as-you-go systems will only be able to cover 25% of the replacement rate in the best of cases, so most of the measures being taken are designed to reinforce complementary systems (mandatory and voluntary individually-funded systems).

GRAPH Nº 5

REPLACEMENT RATES IN PUBLIC AND PRIVATE PENSIONS (OECD 2009)



SOURCE: OECD.

II. Reforms of the public pension system at international level

II.1 Parametric Reforms

Which are the parametric reforms that are being carried out at this very moment and are also causing very significant controversy at the level of social and public debate? Basically, the following:

1. Delaying legal retiring age

Obviously, in order to qualify for a pension, people in Europe are going to have to retire much later. In Table Nº 2 it is possible to see the legal retiring age that exists at present in the various countries, comparing the year 2009 and the maximum envisaged in legislation with the new reform proposals. Legal retiring age is to be raised in the great majority of the countries considered, except in those where retiring age is linked automatically with life expectancies.

TABLE Nº 2

Country	2009 (M/W)	Maximum envisaged M/W	Variation M/W
Germany	65	67	+2
Austria	65/60	65/65	0/+5
Belgium	65	65	0
Bulgaria	63/60	65/63	+2/+3
Czech Republic	62/60	65/65	+3/+5
Cyprus	65	65	0
Denmark	65	LE	
Slovakia	62/57.5-61.5	62/62	0/+4.5-0.5
Slovenia	63/61	63/61	0
Spain	65	67	+2
Estonia	63/61	65/65	+2/+4
Finland	65	65	0
France	60-65	62-67	+2
Greece	65/60	LE	
Hungary	62	65	+3
Ireland	65	68	+3
Italy	65/60	LE	
Latvia	62	(65)	(+3)
Lithuania	62y6m/60	(65/65)	+2y6m/+5
Luxembourg	65	65	0
Malta	61/60	65/65	+4/+5
Netherlands	65	(67)	(+2)
Poland	65/60	(67/67)	(+2/+7)
Portugal	65	65	0
United Kingdom	65/60	68/68	+3/+8
Romania	63y4m/58y4m	65/63	+1y6m/+4y6m
Sweden	61-67	61-67	0

SOURCE: PREPARED BY THE AUTHOR USING DATA FROM THE EUROPEAN COMMISSION.
NOTE: IN BRACKETS, PROPOSED REFORMS; LE: AGE LINKED TO LIFE EXPECTANCY; y: YEARS, m: MONTHS.

2. Bringing real retiring age closer to the legal age

A series of measures are being taken in an attempt to bring the actual retiring age closer to the legal age, such as:

(i) Increasing the minimum age for early retirement. In Europe there has been a tremendous trend towards early retirement. The mean age for early retirement in some countries was as low as 53 and 55 years, for example. But this trend has been reversed. A few examples may be seen in Table Nº 3.

TABLE Nº 3
MINIMUM AGE FOR EARLY RETIREMENT

Country	Initial M/W	Maximum envisaged M/W	Variation M/W
Austria	60/55	62/57	2
Belgium	60 (RER) and 58 (NER)	62 (RER) and 60 (NER)	2
Spain	61	63	2

SOURCE: PREPARED BY THE AUTHOR USING DATA FROM THE EUROPEAN COMMISSION
NOTE: RER = REGULATORY EARLY RETIREMENT AND NER = NORMAL EARLY RETIREMENT.

(ii) Increasing the number of years required for the pension

Increases are already being foreseen in the minimum number of contribution years required to qualify for a full pension. These vary from a minimum of 2 years (Spain) to a maximum of 6 years (France) (see Table Nº 4).

TABLE Nº 4
NUMBER OF YEARS REQUIRED TO QUALIFY FOR PENSION

Country	Initial M/W	Maximum envisaged M/W	Variation M/W
Belgium	35(RER) and 38/35 (NER)	40	+5 (RER) and +2/+5 (NER)
Bulgaria	37/34	40/37	3
Denmark	25	30	5
Spain	35	37	2
France	35	41	6
Greece	35	40	5

SOURCE: PREPARED BY THE AUTHOR USING DATA FROM THE EUROPEAN COMMISSION
NOTE: RER = REGULATORY EARLY RETIREMENT AND NER = NORMAL EARLY RETIREMENT.

(iii) Establishing incentives to extend the working life

An attempt is being made to reward people who postpone retirement (in Germany, Austria, Belgium, Spain, France and Portugal, for example) and to penalise early retirement (in Germany, Austria, Spain, France, Italy, Greece and Portugal, for example).

3. Calculating the pension using a modified calculation formula

There has also been a growing tendency to reduce the amount of the pensions awarded by modifying the calculation formula. This has basically included:

(i) Modifications in the bases.
The bases for calculating pension have been of two types:

- **Those referring to the whole working life.** The countries that have chosen this option are: Slovakia, Greece, Italy, Poland, Portugal, United Kingdom and Sweden.

- **Those referring to an extended period.** The countries that have chosen this option are: Austria (from 15 to 40 years), Spain (from 15 to 25 years), France (from 10 to 25 years) and Malta (the 10 best years of the last 40 instead of the 3 best years in the last 10).

The other option has consisted in updating the bases with price indexes (which generally have lower growth than wage indexes) or mixed indexes.

(ii) Updating pensions by price indexes
In order to update pensions, most countries use price indexes, although some consider indexes made up of prices and wages (Slovakia, Finland, Hungary, Poland and Switzerland) or use price indexes only partially (Austria, Italy and Portugal).

(iii) Sustainability factors
Several different countries have found it necessary to introduce, say, an automatic adjustment mechanism for the key parameters of the pay-as-you-go systems (pension, retiring age) to enable them to be sustainable. Some examples are shown in Table Nº 5.

TABLE Nº 5
EXAMPLES OF MODIFICATIONS IN SUSTAINABILITY FACTORS

Germany	**The index-linking of the pension to wages will be adjusted on the basis of the dependency rate**
Denmark	**Retiring age is linked with life expectancy**
Spain	**As from 2027 a sustainability factor will be applied (implementation pending)**
Finland	**There is a link between pension benefits and a coefficient of life expectancy**
France	**The period of contribution needed to calculate the pension is adjusted to life expectancy at age 60.**
Italy	**The amount of the pension depends directly on certain "coefficients of transformation"[1] calculated on the basis of life expectancy. Retiring age is linked with life expectancy.**
Portugal	**The amount of the pension is adjusted according to the coefficient between life expectancy at age 65 in 2006 and the life expectancy at that same age in the year immediately prior to retirement.**
Greece	**As from 2020, retiring age with be linked with life expectancy.**
Sweden	**The amount of the pension is adjusted by life expectancy at the moment of retirement.**

SOURCE: EUROPEAN COMMISSION, OECD AND BANK OF SPAIN.

II.2 Structural Reforms

Some countries have introduced deeper reforms in the bases of their pension system. Many of these reforms have involved abandoning the pay-as-you-go defined-benefit mechanisms for others with defined contributions. In all cases, these reforms have been introduced gradually and have been accompanied by incentives to introduce other complementary private schemes (individual or occupational), in order to maintain adequate income levels in retirement. Among the defined-contribution models, a lot of interest has been aroused by the "notional accounts" system introduced in Italy (1995), Sweden (1998) and Poland (1998); and the "points system" in Germany, which is a variant of the previous one.

In the systems of notional accounts, benefits are calculated at the moment of retirement, transforming the worker's theoretical account balance (contributions increased by a fixed growth factor, normally wages or GDP) into a lifetime annuity pension on the basis of mean life expectancy at that age.

3 *The coefficient of transformation is a percentage which is applied to the total contribution amount and establishes the gross amount of the annual pension. The benefits to which the pensioner is entitled depend on the contributions that he/she has paid, corrected in inverse proportion to the remaining life expectancy at the moment of retirement.*

In a points system, the worker obtains "pension points", the value of which depends on whether the contribution paid in a given year is based on a higher or lower income than the mean of the income of all the contributors. In the retirement pension, the points of each year are accumulated and that sum multiplied by the value of a point, which is fixed by the government.

In recent years, it has also become a practice on the part of many public pension systems to constitute the so-called "reserve funds" to complement the funding of the benefits in moments of economic crisis (see Table Nº 6). In 2010, the total assets in the OECD countries were equivalent to USD 4.8 trillion, compared with USD 4.6 trillion in 2009. The mean ratio of assets over GDP was 19.6%.

TABLE Nº 6

SIZE OF THE PUBLIC RESERVE FUNDS FOR PENSIONS IN SELECTED OECD COUNTRIES AND OTHER LARGE ECONOMIES, 2010

Country	Name of the Institution	Founded in	Assets under management USD billions	% GDP	% increase
Selected OECD Countries					
United States	Social Security Trust Fund	1940	2,609.0	17.9	2.7
Japan (1)	Government Pension Investment Fund	2006	1,312.8	25.9	n.a.
Korea	National Pension Fund	1988	280.4	27.6	16.7
Canada	Canadian Pension Plan	1997	136.0	8.6	13.0
Sweden	National Pension Funds	2000	124.7	27.2	8.1
Spain	Social Security Reserve Fund	1997	85.3	6.1	7.3
France (1)	AGIRC-ARRCO	n.a.	71.7	2.7	n.a.
Australia	Future Fund	2006	65.8	5.5	8.4
France	Pension Reserve Fund	1999	49.0	1.9	11.1
Ireland	National Pensions Reserve Fund	2000	32.3	15.9	9.3
Belgium	Zilverfonds	2001	23.3	5.0	4.3
Norway	Government Pension Fund – Norway	2006	23.1	5.6	16.9
Portugal	Social Security Financial Stabilisation Fund	1989	12.8	5.6	2.5
New Zealand (2)	New Zealand Superannuation Fund	2001	11.2	7.9	17.1
Chile	Reserve Fund for Pensions	2006	3.8	1.9	12.2
Mexico	Reserve of the Mexican Social Security Institute (IMSS)	n.a.	3.6	0.3	-6.7
Poland	Demographic Reserve Fund	2002	3.4	0.7	39.1
Total OECD countries selected (3)			*4,848.1*	*19.6*	*5.0*
Other large economies					
Saudi Arabia	General Organisation for Social Insurance (1,4)	1969	400.0	106.4	n.a.
China	National Social Security Fund	2001	126.5	2.2	10.3
Argentina	Sustainability Guarantee Fund	2007	45.7	12.3	26.4
Total other large economies (3)			*572.2*	*75.9*	*14.6*
Reminder: Sovereign investment funds with pension approach (5)					
Norway	Government Pension Fund – Global	1990	509.1	122.8	16.6
Russian Federation	National Wealth Fund	2008	88.4	5.9	-2.7

SOURCE: OECD GLOBAL PENSION STATISTICS.
NOTES: AGIRC: GENERAL ASSOCIATIONS OF OLD-AGE INSURANCE INSTITUTIONS FOR MANAGEMENT CATEGORIES.
ARRICO: ASSOCIATION FOR THE WAGE-EARNERS COMPLEMENTARY SCHEME.
(1) INFORMATION CORRESPONDING TO THE YEAR 2009.
(2) INFORMATION CORRESPONDING TO JUNE 2010.
(3) WEIGHTED AVERAGE OF ASSETS AS % OF GDP AND % OF INCREASE.
(4) OECD ESTIMATION.
(5) THE GOVERNMENT PENSION FUND – GLOBAL OF NORWAY AND THE NATIONAL WEALTH FUND OF THE RUSSIAN FEDERATION ARE SOVEREIGN INVESTMENT FUNDS AND NOT PUBLIC RESERVE FUNDS FOR PENSIONS, DUE TO THE FACT THAT THEIR AIM GOES BEYOND THE FINANCING OF EXPENDITURE ON PUBLIC PENSIONS.

II.3 Reversion of Reforms in Eastern Europe

The reversion of the pension reforms is another of the structural changes made by the governments of several countries in Eastern Europe, in order to enable them to finance the payment of pensions in the pay-as-you-go systems. There have basically been two cases:

1. ***Transference of assets from the private systems to the public system***
   We have the case of Bulgaria, which in 2010 transferred part of the assets of the private pension funds (BGN 100 million) to a state fund, which will represent the accounts of the workers who retire in 2014. There is also the case of Hungary, which in 2010 suspended the payment of workers' contributions into the second pillar of mandatory individual accounts until the end of 2011, reassigning them to the first public pay-as-you-go pillar. It then eliminated the second pillar, transferring it to the first pay-as-you-go pillar.

2. ***Reduction in contributions to the private system.***
   This is the case of countries such as Estonia, Latvia, Lithuania and Poland, which passed transitory measures that reduce the contributions to the second pillar of individual accounts and increase the contributions to the first pay-as-you-go pillar, managed by the State.

Clearly, these "counter-reforms" are not going in the right direction for the workers' best interests. The European legislation, in this sense, does not make matters any easier.

There is a European Council Regulation[4], dating from 1997, which in one of its articles[5] states the following:

"On evaluating compliance with the deficit and debt criterion, *and the later phases of the excessive debt procedure, the Council and Commission* ***shall duly take into account the application of pension reforms*** *which establish a multi-pillar system including a fully-funded mandatory pillar, and the net cost of the publicly-managed pillar. It shall take particular notice of the characteristics of the general pension system created by the reform, and specifically whether it promotes long-term sustainability without increasing the risks for the medium-term budget position".*

In other words, it states on the one hand that countries should implement pension

4 *(EC) Regulation 1467/97 issued by the Council on 7th July 1997: re the acceleration and clarification of excessive debt procedures.*

5 *Article 2, Sub-section 5.*

reforms because they are financially sustainable, but on the other hand, there is a legal impediment, with those countries that have introduced reforms having to comply with a certain limit in terms of the level of debt (the debt engendered by the reforms is taken to be part of the total debt in this case). It would appear that rules of this type are starting to be relaxed, but rather late in the day, because some countries have had to reverse their pension reforms and return to the first pay-as-you-go pillar in order to comply with the regulations imposed by the European Union.

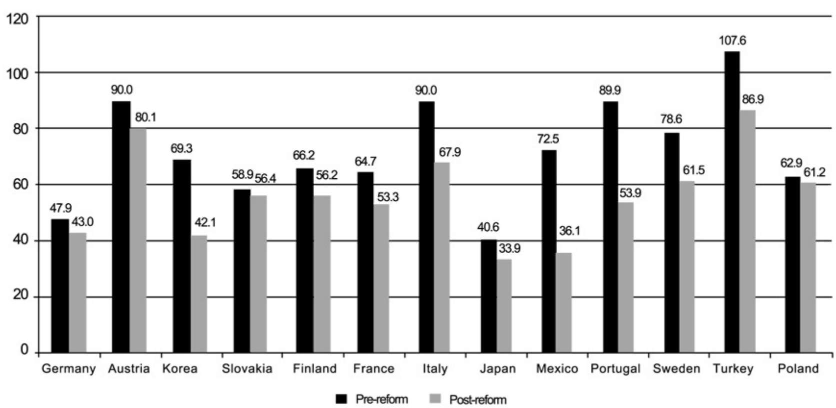
III. Consequences of the Reforms

Among the consequences of the reforms that have been implemented, the following can be mentioned:

1. Reduction of the amount to be received on retirement

GRAPH Nº 6

REDUCTION OF THE GROSS REPLACEMENT RATE



SOURCE: OECD.

Graph Nº 6 shows the countries for which the reforms of the pension system have meant a reduction in the theoretical gross replacement rate for the worker with an average wage, according to OECD estimates (2009). This clearly shows how the reforms are directed towards reducing the amount of benefits granted.

2. ***Hardening of access and eligibility conditions for pensions.***

3. ***Failure to keep the pension promise.***

4. ***Lack of knowledge about the future public pension (with few exceptions, there is no information about the estimated public pension).***

IV. Encouraging Individually-Funded Systems

The consequences listed in the previous section imply that the importance of the individually-funded systems will be ever greater in the different countries, their aim being to complement the sources of income for retirement.

So there are various European countries where individually-funded systems are being encouraged. The following are a few examples:

1. **Germany.** The Riester Reform (2001) introduced the second pillar (a private occupational pension plan), in which the law obliges the business owner to offer the worker the possibility of converting part of his/her wage into a future benefit. Both the second and third pillars (voluntary private pension plan) have considerable tax incentives.

2. **United Kingdom.** In the case of companies with 5 or more employees which have not set up an occupational Pension Plan or contributed a minimum 3% of wages to a personal pension plan, there is the obligation to provide their staff with access to a stakeholder plan and allow the corresponding deduction of contributions from the payroll. As from 2012, all employees between 22 years and retiring age will be enrolled in a Pension Plan by default, unless they object specifically.

3. **Czech Republic.** Reform is slated for 2013. This includes the possibility that workers will be able, as from that year, to transfer 3 percentage points of their mandatory pension contributions to the private funds, on condition that they add 2 percentage points of their own income to the contributions.

4. **Sweden.** The reform of 2000 made it obligatory to transfer 2.5% of wage to the individual funding accounts, maintaining the 16% of the wage paid into the pay-as-you-go system (previously 18.5%).

V. European Commission[6] White Paper

This document aims basically to lay down ways of obtaining safe, adequate and sustainable pensions at the political and public discourse level. It states that pension reforms are essential for economic growth and also gives specific recommendations on pension reforms.

In order to achieve safe, adequate and sustainable pensions, the White Paper mentions that it is necessary to improve the balance between years worked and years in retirement and to develop private pension saving in order to achieve adequate replacement rates.

As measures to support the reforms, the White Paper suggests:

(i) Raising retiring age and the number of years worked.

(ii) An indirect role for the European Commission, in following up and spurring on pension reforms (in 2013 there is a proposal to restrict early retirement).

(iii) Increasing contributions to the private systems, by (a) greater involvement in pension provision; (b) ways to improve the access/coverage of Member States; (c) financial support for designing effective systems; (d) optimization of tax incentives; (e) greater protection for workers in case of insolvency (in 2012); (f) improving the quality of the third pillar and introducing a new proposal on pension fund portability (in 2013).

VI. Keys for the Future

The answer to the following questions constitutes the keys for the future:

1. Are the parametric and structural reforms sufficient?

2. What reforms/trends can be foreseen for the future? Stepping up those already in place? The surest thing is that reforms will be stepped up.

3. What will be the consequences of these reforms on the individually-funded programs? Obviously, the lack of sustainability of the pay-as-you-go systems will lead to initiatives directed more towards the individually-funded systems.

6 *White Paper "Agenda for adequate, safe and sustainable pensions" (2012).*

4. What improvements must be introduced in the individually-funded systems to avoid their being impacted by the crisis of the pay-as-you-go systems?

The European Union must be very clear in reaching a commitment to enable individually-funded systems to be introduced over a period of 15 to 20 years. What parametric reforms will allow is the sustainability of the pay-as-you-go systems, but only for the next 10 or 15 years. The only way to make pensions sustainable and payable will be by encouraging the third pillar of voluntary savings and, especially, the second mandatory pillar.

THE EUROPEAN DEBT CRISIS: WHERE WE ARE NOW AND THE PROSPECTS

GONZALO RENGIFO[1]

1 *Gonzalo Rengifo is a licentiate in economic and business sciences from CUNEF (Colegio Universitario de Estudios Financieros) in Madrid, Spain, and has participated in a number of different financial specialization courses. He joined Pictet in 2002 with responsibility for the Spanish, Portuguese and Latin American markets. He began as an analyst and portfolio manager in Safei in 1988, later occupying various responsible positions in the Private Banking area in Banco Urquijo and as Deputy Managing Director of Schroders in Spain. Gonzalo contributes frequently on radio and television as an expert in economics.*

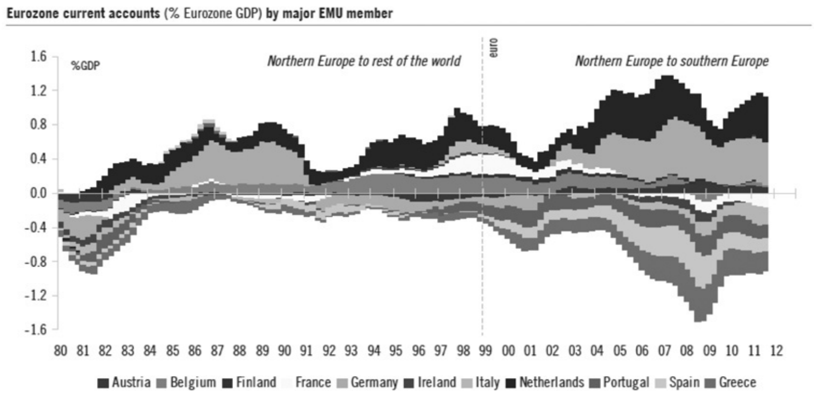
This brief article offers Pictet's view on the current European debt crisis, with an analysis of the current scenario and how it seems likely to develop. The first part gives the most significant data characterizing the current situation while the second part describes the policies which have been put in place so far to put a stop to the crisis. Finally the third and fourth parts of the document provide insights into how the problem of European debt should be solved and what the key messages may be for the Eurozone.

1. The current situation

Graph Nº 1 shows the balance of trade between the European countries prior to the entry of the Euro in 1999. One curious and interesting detail to be noted is that Germany had a trading deficit with the rest of Europe 7 or 8 years before the entry of the Euro, whereas France, Italy and the Netherlands had a trading surplus. As from 1999, however, countries like France and Italy began to show a deficit and it is possible to see that Germany today is the country with the largest surplus, followed by the Netherlands.

GRAPH Nº 1

EUROZONE CURRENT ACCOUNTS (% EUROZONE GDP)



SOURCE: PICTET ASSET MANAGEMENT.

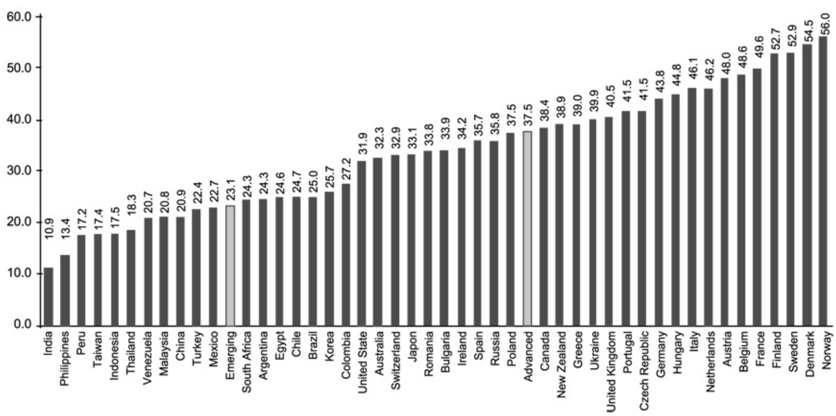
Why bring up Graph Nº 1 when starting to talk about European debt? Because one of the countries to have gained greatest benefit from the introduction of the Euro in the past 12 years has clearly been Germany. Between 60% and 80% of Germany's exports are intra-European. What is the inter-connection or inter-dependence between the countries? This issue needs to be discussed, not only at the level of debt, but also that of trade links, because in some way the development of the larger countries, which are very wealthy at this moment, has been due to the strong demand from the countries on the periphery. Furthermore, the Euro, as a currency, was not cheap enough for the countries of southern Europe, and those countries have been losing competitiveness and productivity. What has been done is to compensate those economies with expansive fiscal policies, leading to a resulting growth in debt.

Regardless of the fact that there is a very significant crisis in Europe, not everything is being badly done. An important issue to be emphasized is the efficiency of the collection of tax revenue, since at the end of the day that is what determines the resources available for solving the crisis and paying the debt.

Graph Nº 2 shows the data referring to the collection of taxes in the year 2010. In that year the mean of tax collection (tax income as % of GDP) for developed countries was around 37.5%, whilst in the emerging countries the mean was approximately 23%. Now the ability to collect taxes at the level of the GDP of European countries is between 45% and 50% of GDP, meaning that resources are available from the fiscal point of view. In other words, tax collection is efficient.

GRAPH Nº 2

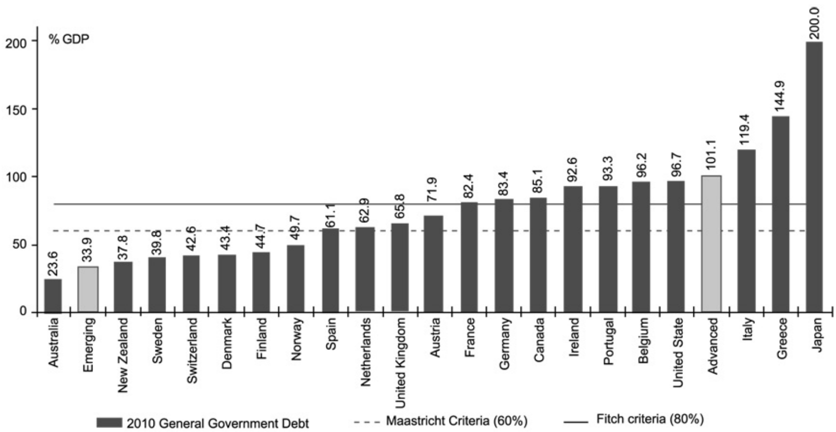
FISCAL REVENUE TO GDP RATIO IN 2010



SOURCE: PICTET ASSET MANAGEMENT.

From the point of view of sovereign debt over GDP (see Graph Nº 3) it is possible to see that the mean is around 100% in the developed countries. There are certain cases with lower levels, which might leave room for slight optimism, but we shall soon see that this is not so. The fact that in the case of Spain the sovereign debt over GDP is 60%, in line with that of the United Kingdom, gives some hope. But France and Germany are already above the 80% level advised by Fitch as the maximum level of long-term sustainability.

GRAPH Nº 3
GENERAL GOVERNMENT DEBT-TO-GDP RATIO: MAJOR ADVANCED (21) ECONOMIES

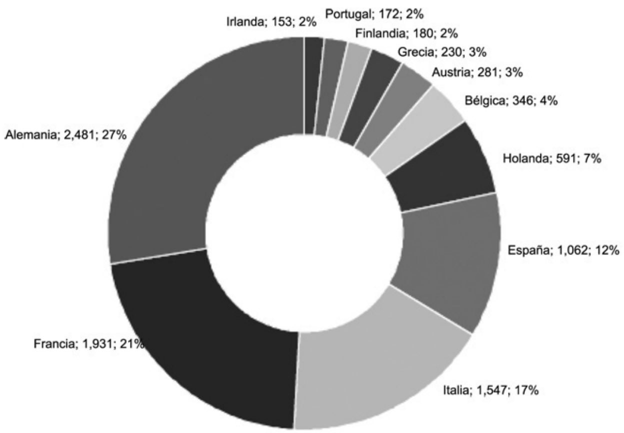


SOURCE: PICTET ASSET MANAGEMENT.

Graph Nº 4 shows how the GDP of the Eurozone is distributed between the various countries which make it up. Germany has 27% of the GDP, followed by France with 21%, Italy with 17%, Spain with 12% and the Netherlands with 7%. It is interesting to note that the countries which have just been rescued: Greece, Ireland and Portugal, represent only 7% of the GDP of the Eurozone.

GRAPH Nº 4

EUROZONE COUNTRIES: GDP IN BILLION OF EUROS AND IN PERCENTAGE OF TOTAL EUROZONE GDP



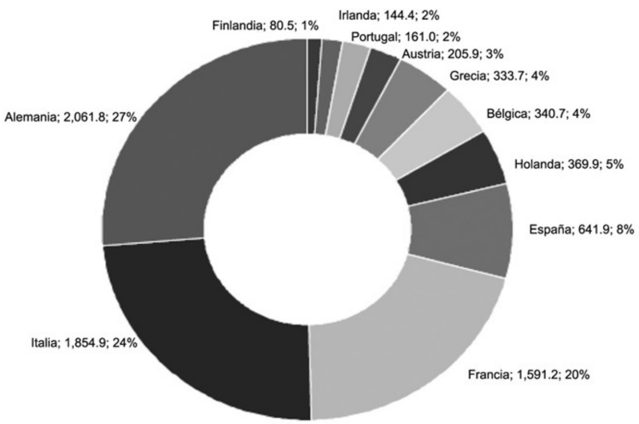
SOURCE: PICTET ASSET MANAGEMENT.

In terms of the debt that has been issued, - in other words, the European debt that everyone says is unsustainable and that on-one will be able to pay -: Who has it? Who issued it? According to Graph Nº 5, Germany has EUR 2 trillion, Italy almost EUR 2 trillion too, France EUR 1.6 trillion, and Spain, EUR 640 thousand million. In the case of the rescued countries, they account for 8% of the total debt.

From Pictet's point of view, this is still a manageable problem. A fact that cannot be ignored is that the financial savings of German families amount to 4.8 trillion Euros, equivalent to USD 6 trillion. In other words, there is plenty of wealth. If there is a thing that is not lacking in Europe, it is money or economic means. The fact that there is no capacity for putting that money to work is another issue.

GRAPH Nº 5

EUROZONE COUNTRIES: PUBLIC DEBT IN BILLION OF EUROS AND IN PORCENTAGE OF TOTAL EUROZONE DEBT

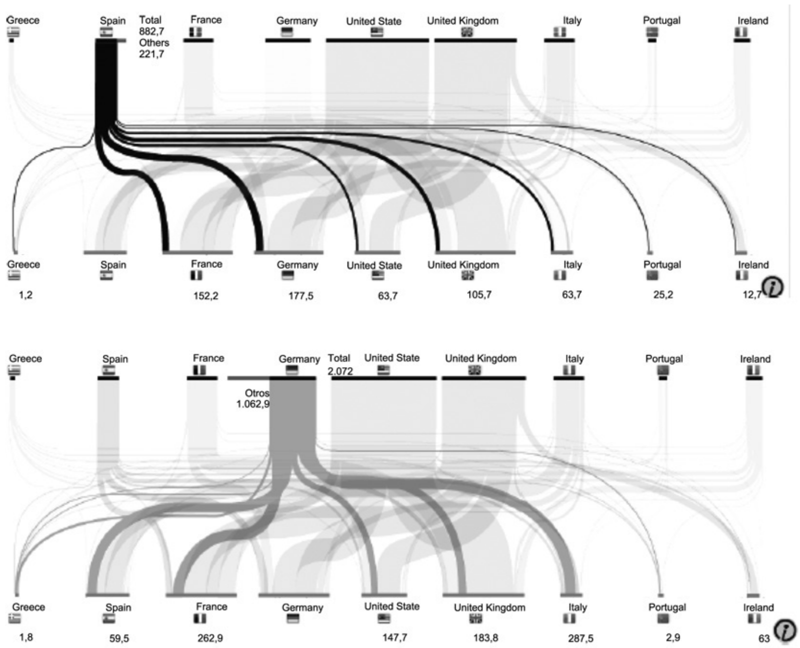


SOURCE: PICTET ASSET MANAGEMENT.

In Figure Nº 1 it is possible to see a matrix showing which European countries owe money to the rest of Europe. On the debt issue, as one might imagine, interdependence or inter-connection must be taken into account: in other words, everyone owes money to everyone. Also being discussed is the effect of problematic countries infecting the "healthy" ones, which is what could happen with Spain and Italy, both "too big to fail", as the Americans say.

Given below is an analysis of what would have to be done to orchestrate a wider rescue if this should prove necessary.

FIGURE Nº 1
WHO OWES MONEY TO WHOM (USD BN)



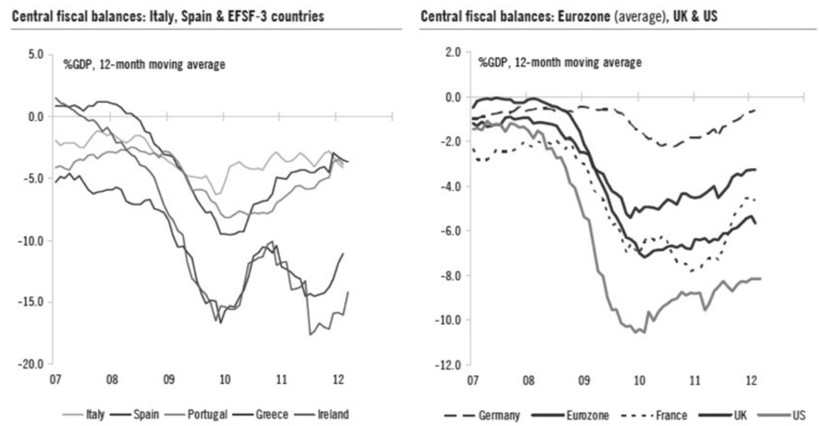
SOURCE: PICTET ASSET MANAGEMENT.

II. What has been done so far?

The fact is that the Europeans are doing their duties. From the political-fiscal point of view, encouraged by Angela Merkel, President of Germany, all the countries have launched austerity programs designed to reduce the high existing levels of fiscal deficits. It is true that there is one country that may be considered an outsider today, namely Spain, where each week brings an update, with an upward rather than a downward trend. However we are seeing that they are implementing a lot of cuts in expenditure.

As may be seen in Figure Nº 2, fiscal balances in Europe have generally improved. The Eurozone has a deficit of less than 3%, better than the position of the United Kingdom and the U.S.A. An interesting issue to be mentioned is that Italy and Germany are in balance, relatively speaking.

FIGURE Nº 2



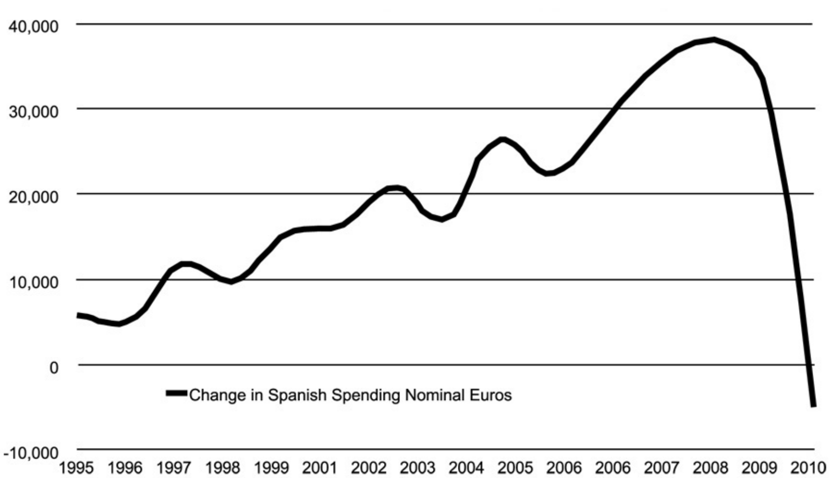
SOURCE: PICTET ASSET MANAGEMENT, CEIC, DATASTREAM AS OF 25.02.2012.

In Spain there is fiscal discipline which is becoming increasingly rigid (see Graph Nº 6). Fiscal expenditure in that country, as may be seen, has been cut to a minimum. Whether these fiscal austerity plans are really sustainable without growth policies or incentives and economic development measures, is a separate issue,

With regard to possible scenarios for the future, Pictet has carried out a series of simulations from the point of view of the sustainability of the debt (see Figure Nº 3). With an interest rate of between 5% and 7% on the debt, Italy in the next 4 years will have a debt of between 119% and 132% of the GDP. In the case of Spain, using the same assumed range of interest rates, the debt could be between 98% and 106% of the GDP in four years' time.

GRAPH Nº 6

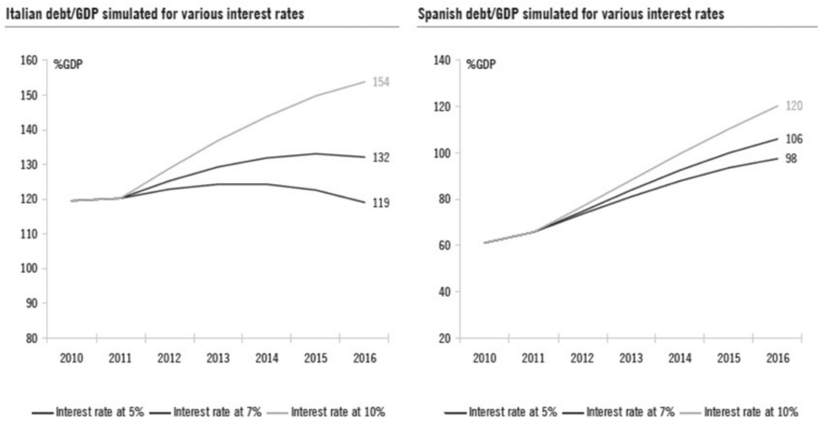
THE REVOLUTION IN SPANISH FISCAL POLICY (1995-2010)



SOURCE: PICTET ASSET MANAGEMENT.

FIGURE Nº 3

CHANGES IN SPANISH AND ITALIAN DEBT OVER GDP UNDER VARIOUS INTEREST RATE SCENARIOS

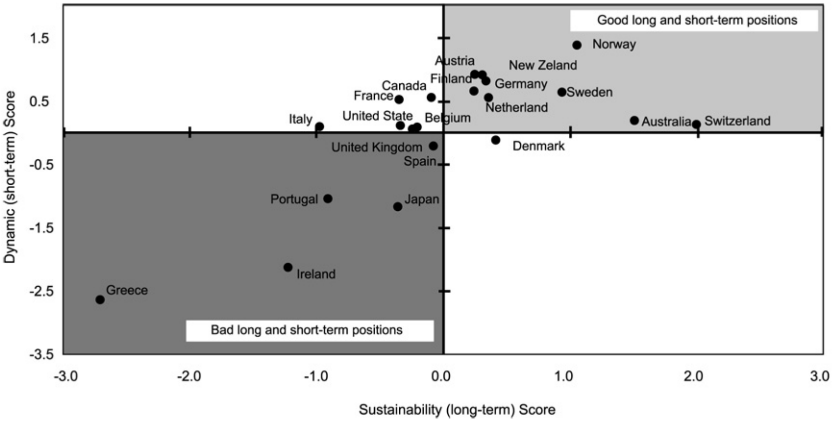


SOURCE: PICTET ASSET MANAGEMENT.

Graph Nº 7 shows a scatter diagram where each country is placed according to its score in terms of short and long-term sovereign debt. It can be seen that the countries with good short and long-term positions, such as Germany, the Netherlands and Sweden, are the only ones to be found in the right upper quadrant, while in the lower left quadrant are those with bad long and short-term positions, which obviously include the recently rescued countries (Greece, Ireland and Portugal) and also countries such as Spain, Italy and the United Kingdom.

GRAPH Nº 7

SOVEREIGN DEBT LONG AND SHORT-TERM SCORES FOR DEVELOPED ECONOMIES: A SCATTER DIAGRAM VIEW



SOURCE: PICTET ASSET MANAGEMENT.

What is being done from the European point of view? At this moment, all the discussions and decisions are on a political basis: there is discussion on both the Monetary Union and the tax policy. All aspects are being checked. There are a lot of people discussing whether or not the Euro will eventually go bankrupt. In Pictet, however, the probabilities of a rupture of the Euro are thought to be minimal. What we do see, however, is greater tax integration. When politicians mention something we are not used to, we already know what will happen: there will be Eurobonds and a centralized tax policy. Pictet is of the opinion that this is the route map that will probably be followed in Europe.

III. Solving the debt problem

How should the Europeans solve the debt problem? There are 4 ways of doing it. The first, obviously, is to pay the debt, but there is no money to do so. The second option is a rescue, and three rescues have already been carried out so far. The third way lies in suspending payments, or sovereign bankruptcy: we already have the case of Greece, where the term Grexit is being heard with growing frequency. And finally, what has yet to be done is the monetization of the economy: in other words, the role of the European Central Bank is the key to solving this crisis. The European Central Bank must follow exactly the same route map as the Federal Reserve System in the United States (FED).

From the point of view of the economic package announced at European level, Greece has been given a package of €110 billion, with a 70% remission of the previous debt package. Ireland has been awarded a package of €85 billion and Portugal €78 billion. An additional package of €720 billion has also been created; €60 billion funded by the 27 members of the EU; €440 billion by the creation of the European Financial Stability Fund (EFSF), guaranteed by 16 members of the Eurozone; and €220 billion from the International Monetary Fund (IMF). The European Union is now left with an effective loan capacity of €575 billion.

The European Central Bank has been actively buying bonds since July 2011. It has bought over €175 billion in bonds, mainly Italian and Spanish. In order to make this quite clear, what Europe has put to work at this point in time is enough to finance and cover the three countries that have been rescued so far, plus funding needs up to 2014, but no more than that. This means that the package is clearly insufficient. That is the reason for the discussions currently taking place in the press.

What should be done? As was stated above, nobody at Pictet is betting on the bankruptcy of the Euro, because that would be so expensive as to be non-viable per se. For that reason, there will be greater tax integration and, above all, active transfers of facilities and aid from the countries of northern Europe to those of the south.

IV. Eurozone: the key messages

Surprisingly, there is going to be growth in Europe, and more than one might think. Europe will grow between 0.5% and 1% during 2012, which will mean a certain growth in the northern countries, but decline in the peripheral countries.

To close, it is sufficient to state that, in the opinion of Pictet, there is a clear route map for emerging from the European debt. By taking a series of actions, we shall see the problem being resolved, sooner rather than later.

The first action consists in submitting Greece to major surgery, and this will surely mean condoning the total debt, with that country remaining in the Euro.

The second action lies in avoiding the European Central Bank's firebreaks and instead following the route of the FED. The European Central Bank will have to adopt three measures immediately: (i) tell the market that it is going to buy Italian and Spanish bonds without limits; (ii) implement another system of Long-Term Refinancing Operations (LTRO) for the banks, with longer terms (3 years); and (iii) tell the market that everyone, or all the countries in the European Union or Monetary Union, must comply with fiscal discipline: they will have a limit on the cost level of risk premiums. If the European Central Bank really carries out these measures, the whole situation will fall into line.

The third action lies in control or auditing. In other words, there will be supra-European auditing of all budgets at national level.

In fourth place, there must be a fall in interest rates in Europe. The inflation figures in Europe are showing a downward trend. It is to be hoped that this does not lead to deflation, as has happened with Japan. The only way that the European Union can reduce debt is, clearly, by creating inflation. With 4 points of inflation, the debt will be reduced by 20 points in 4-5 years, without efforts and without economic growth.

Finally, what is of key importance and is already being discussed, are the pro-growth policies, which must be consistent with reducing public spending. It is necessary actively to combine austerity measures in spending with measures aimed at activating economic growth. With the help of the European Central Bank, there is still time. Now it remains to be seen whether the Europeans are capable of implementing these actions in time, and in the most appropriate manner.

BASIC CONDITIONS FOR THE STABILITY OF AN INDIVIDUALLY-FUNDED PENSION SYSTEM: THE ARGENTINE CASE

JORGE CASTORINA[1]

1 *Jorge Castorina is a Certified Public Accountant qualified at the University of Buenos Aires (UBA), Argentina. His areas of expertise are auditing, pension schemes and insurance. He currently works as Advisor to the Argentine Association of Contributing Pensioners (AAJA). He was Executive Director of the Chamber of Retirement Benefit and Pension Fund Administrators (CAFJP) between 1997 and 2002. He has also spoken and taken part in congresses, forums and seminars, locally and internationally, and is author of papers, notes and newspaper articles on insurance and pension schemes. He was co-author of the book "Manotazos a los fondos previsionales".*

Before beginning my talk, I want to express my special thanks to the authorities of the International Federation of Pension Fund Administrators (FIAP) and the Mexican Association of Retirement Fund Administrators (AMAFORE) for having entrusted me with the responsibility of speaking on "the Argentine case". I hope to respond to that trust and be able to fulfil such an honourable charge.

I. Introduction

The problem of the counter-reform of pensions in Argentina at the end of the year 2008 was not a technical problem, but rather a political one. This must be emphasised because the present article refers to many political aspects, performing a kind of autopsy, to see why the aforementioned counter-reform really occurred.

In Argentina, the Peronist party has been in government for 70 years, with two brief breaks when the radical party was in power. When General Juan Domingo Perón, leader and creator of the Peronist movement, returned to Argentina in the 1970s, he temporarily appointed Héctor J. Cámpora, a man with extreme leftist ideas. When Juan Domingo Perón came back to Argentina, he was forced to eject the groups supporting the Cámpora government from the Plaza de Mayo, the so-called "young idealists", who were youngsters with ideas similar to those of Che Guevara, originally from the Argentine. From that moment on, those youngsters went into hiding and became a guerrilla or terrorist group.

With the passing of time, former president Néstor Kirchner took office and these young idealists returned, now 55 or 60 years old, and it is they who are governing the country today in different positions and functions. The name Cámpora came up again, because Máximo Kirchner, son of the president now in office, created a youth movement with that name. They seized strategic positions in all areas and are now capturing and recruiting young people for election purposes.

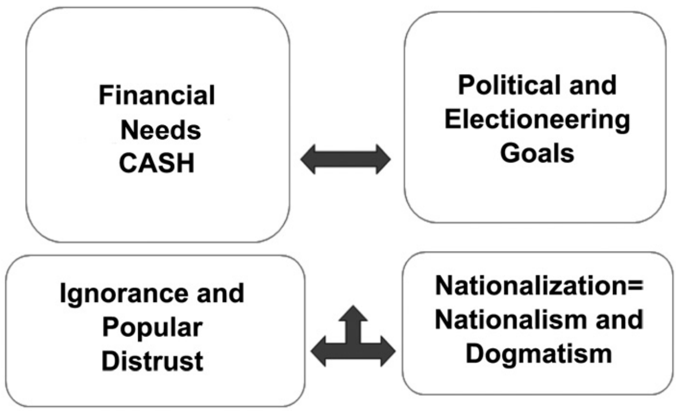
This present article explains the facts that caused the counter-reform and whether it could have been avoided, the acts that might have helped to avoid it, the contingencies that can be attributed to the political sector, the aspects that can be attributed to the private sector of Retirement Benefit and Pension Fund Administrators (AFJP) and the basic risks that affected the stability of the system.

II. Which facts caused the counter-reform?

The main problem that caused the abolition of the private individually-funded system was the financial need of cash (see Figure Nº 1). In the specific case of the AFJPs, the financial cash needs were not so much a question of meeting the government's pressing need for ready money but, were important above all, because of the inflow of monthly contributions that they would be receiving in due course.

Political and electioneering goals are also part of the equation. As was to be expected, once the funds confiscated from the AFJPs had been obtained, they were used for any number of purposes that had nothing to do with the terms laid down in the pension regulations and with the natural goal that funds contributed by workers during their working life should have.

FIGURE Nº 1
ARGENTINA: FACTS THAT CAUSED THE COUNTER-REFORM



SOURCE: PREPARED BY THE AUTHOR.

Loans have been granted since the pension funds were confiscated, to General Motors for example. Also, computers are being given away and funding has been made available to televise football for everyone, transmitting on several television channels aligned with the government and on the public channel. All this has been done with the pension funds confiscated from the AFJPs, so that on those of football for everyone programs there are now only two advertisers: 3 minutes for a private advertiser and all the rest corresponding to public propaganda, with constant reference to the government's achievements.

But the first and most fundamental achievement, mentioned repeatedly in all television programs and on all channels, is that the most revolutionary act of the present government has been the recovery of the workers' pension funds, referring incorrectly and exaggeratedly to the abolished system as a business run by 4 or 5 rogues, who took the opportunity of making a financial profit using the Individually-Funded System. This idea has unfortunately taken root and been accepted by the popular masses of Argentina, given their idiosyncrasy and to whom it was directed. The idea had quite a favourable breeding-ground, due to popular ignorance and distrust of the individually-funded system and retirement in general.

In Argentina, over these past 40 or 50 years, it has been very common to hear *"I'm working on my own retirement. I do my own savings because I don't believe in the State, or in finance companies, or in the AFJPs"*. So, by giving the nationalisation, or rather confiscation, a sense of false nationalism like that of recovering the Malvinas, Aerolíneas Argentinas and recently YPF, it found fertile soil at that moment, with nobody voting against.

It is worth making a proviso: the politicians who habitually attend the President's speeches and who applaud obediently every time she refers to this nationalisation are the same politicians who applauded in 1993 when the private individually-funded system was created. None of them has ceased to occupy legislative positions or public functions and today they maintain that the pension funds have been recovered for the workers.

So, nationalisation has been given an epic nationalistic tone, supported by the dogmatism of certain leftist political parties and the traditional Unión Cívica Radical party. The charters of those parties stipulate that public services must be in the hands of the State, so they supported the confiscation and abolition of the system with their vote.

III. Could the counter-reform have been avoided?

The answer is that the counter-reform could not have been avoided, due to the following circumstances:

First: in Argentina we are governed by a populist, demagogical party. Second, the resources were easy to confiscate, thanks to the popular and political support upheld by nationalistic sentiments. Third, there were certain high-risk aspects of the private system which were genuine risks or symptoms to be taken into account, but it is worth stating clearly that they were not the real reasons behind the abolition of the system.

Even if we had had the very best system, it would still have been confiscated for the reasons given above and, fundamentally, for the government's financial needs which were already beginning to be reflected in the year 2008. Argentina, a soya country par excellence, had the great fortune to achieve a permanent surplus with the tax on soya, which allowed it to act on the basis of welfare criteria, creating subsidies for work plans, single mothers, a misnamed "universal" child benefit and a series of other welfare benefits that meant a spectacular political kick-off for running a demagogical campaign. However, in the year 2008, when the lack of financial resources became obvious, they grabbed the first and most important thing that came to hand, the funds of the AFJPs. First they nationalised the post office, then Aerolíneas Argentinas, then the AFJPs and just recently they have confiscated YPF, absorbing Repsol. Still remaining are the mining companies, possibly the uncommitted balances of the banks and perhaps reinsurance.

IV. What acts might have contributed towards avoiding the counter-reform?

Possibly, a consideration of the following issues might have contributed to avoiding a counter-reform.

First, a long-term investment policy: the financial instruments in which the AFJPs were allowed to invest were aimed at the short term. The AFJPs had no possibility of appearing as operators with a social goal, so their activity was confused with a purely financial one and it was easy to accuse them of carrying on a business that was essentially financial.

Secondly, greater involvement in the real economy: a struggle went on in an entrepreneurial sector of the AFJPs to try to persuade them to make investments aimed at the real economy, to invest in regional economies, for example, or in so many other items on the investment menu, to avoid short-term thinking. However, a herd approach was applied in using the financial instruments, because most of the 11 or 12 administrators remaining in the market – of the 22 originally set up – followed the 2 or 3 leaders, in order to avoid being left behind in terms of the "unit value".

Thirdly, a higher level of contribution capitalization: the capitalization of the contributions was very small and this served as a criticism, a permanent red light, which allowed the authorities and politicians opposed to the private system to stress the fact that there was very little capitalization. The commission was calculated on the wage, so the remainder left for contributing was very small. It was this element that served permanently to discredit the system.

Fourthly, to have higher substitution or replacement rates: those rates were not at a sufficient level to justify the argument that the private system was better than the public pay-as-you-go system.

And fifthly, more energetic action on the part of the AFJPs and partners to clarify and defend the system: there was something akin to a resigned silence on the part of the AFJPs. They offered no resistance when there began to be signs of a possible confiscation of the funds. They did not even accept the offer of assistance from FIAP to help avoid the dispossession or contribute towards clarifying the situation. Not one of the leaders of the chamber or the AFJPs came out in defence of the system. It must be said quite frankly that they did not do so because, from the moment that they started to follow instructions from their respective head offices abroad, they had no autonomy to make the attempt especially in the case of the large AFJPs.

V. Contingencies attributable to the Public Sector

Certain unforeseeable political facts also converged in the counter-reform as a result of:

(i) Lack of State policies
(ii) The non-existence of a prevailing Rule of Law
(iii) Violation of the separation of the branches of government
(iv) Judicial insecurity, whatever the party in power
(v) And, in addition, 2 transcendental facts. Argentina has been the world's main defaulting country, first in the year 2001 and then in the crisis of 2008 and 2009.

VI. Aspects attributable to the Private AFJP Sector

The following elements constitute the basic risks attributable to the private AFJP sector, which in some ways contributed to the counter-reform.

1. Haste in the introduction of the system, without consensus

The individually-funded system in Argentina was introduced in a hurry and enacted in the legislature without having a full, formal consensus. It was driven by strong political will, but without the necessary consensus, which meant that the system lacked adequate armour-plating right from the start.

2. The system introduced was mixed, with State participation

Another of the problems resulted from the fact that it was a mixed system, with State participation. This was very serious, because the payments and all the paperwork involved in the private system were carried out in the National Social Security Administration (ANSES), the body that manages the public pay-as-you-go system. As a result, the ANSES intervened in the payment of the AFJPs' benefits, frequently delaying them. The AFJPs had to make advance payments of millions of funds to avoid pensioners' chaining themselves to the doors of their offices, to urge them to hurry the paperwork along.

3. High level of participation of the state component until it reached average maturity

Due to the nature of the system, before it reached maturity, the high level of participation of the state component was greater at the beginning than the private component of AFJPs, an aspect that was never explained sufficiently clearly and gave rise to selfish criticisms aimed to confuse, such as "….*what was the point of the private system if the public system was contributing most anyway*….".

4. The high level of management commissions, due to errors in the system's design

5. Low replacement rate compared with the target of a moving 82% of the minimum wage

The mobility of the minimum wage, as a replacement rate, is enshrined in the Constitution. How can having a substitution or replacement rate of 40% be justified, when there are schemes that already apply the moving 82%, having also ratified a law - subsequently vetoed by the current President - stipulating that the workers should enjoy that replacement rate as a percentage of their last wage? That was a strong argument for criticising the private system.

6. The undecided and transfers

There were all the typical problems that usually occur when undecided people end up in an administrator that they have not chosen, and this generated a multitude of criticisms. The same thing happened with transfers.

7. Investments

There was a predominance of investments in financial instruments and among them a high placement in public securities.

At the beginning, the investment menu established a maximum of 50% in public debt bonds. When there was no way left to increase investment in state securities because that limit had been reached, the AFJPs were expected, by using creative accounting, to invest in common investment funds, by means of which it was possible to increase investment in State securities. In that way, a point was reached when 75% of the funds was invested in the public sector instead of 50%, meaning that when the State took the system over, it held on to 75% of that joint debt.

The herd effect in investments, as also the absent or scant investment in infrastructure and the real and regional economy, did nothing to secure the system and avoid the confiscation that finally occurred.

8. Ownership structure with a predominance of Banks and Financial Institutions

9. Lack of foresight in failing to ensure the resources for the transition specifically by law.

10. Public finance and submission to the short-term requirements of the Executive.

VII. Miscellaneous

The new public pension system has its own characteristics, or rather calamities. It is stated that the new system, on the one hand, is supported on solid actuarial bases and techniques, and on the other, that it preserves the funds that have been contributed. The reality clearly demonstrates the falsity of both the characteristics mentioned.

Today, on many posts in the streets of Buenos Aires, on public transport vehicles and on the rear windows of a few cars, it is possible to see lawyers' advertisements offering immediate pensions, with or without contributions (see Image Nº 1)

IMAGE Nº 1

SOURCE: PHOTOGRAPH PROVIDED BY THE AUTHOR.

It is also possible to meet a relatively young relative or friend and hear him/her say: *"I'm already retired. How? Thanks to the "pension moratorium[2]"*, where you can enter without having paid any contributions and charge and deduct from there the contributions that you never paid. This puts a question mark over the government's first slogan "Argentina - a dependable country".

The effects of moratoria of this type also question a second government slogan "Redistribution of wealth". Thanks to the moratorium, 2,500,000 pensioners without contributions and 800,000 high-income pensioners entered the system

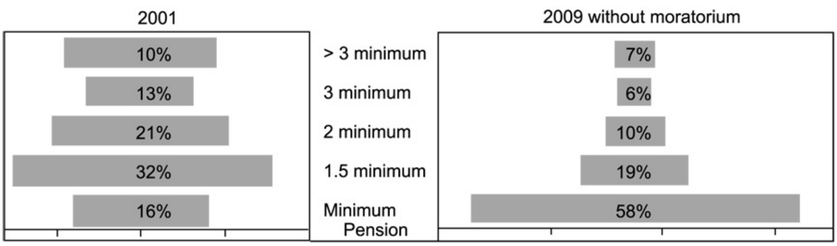
2 *In the case of those who have never paid contributions or those who need to make up the required years of contributions, they have to apply under moratorium Law Nº 24,476, paying the first quota on starting the paperwork. When they start charging the retirement benefit, the quotas will be deducted monthly. The person applying under the moratorium must not be collecting any other payment from the social security system, whether national, provincial or municipal. If he/she collects any other benefit, he/she must renounce it in order to qualify for this pension. In the case of pensioners, the pension debt must be paid before applying for this retirement pension.*

because there was no control on the socio-economic level of those joining. There are people who have an apartment worth US$ 3 million in Avenida Libertador and are receiving pensions under that moratorium. There are pensioners who are not resident in Argentina and have applied for their pension through agents. This is costing the pension system some ARS 24 thousand million, i.e., USD 5 thousand million per year, which comes out of the funds contributed by the workers and those confiscated from the AFJPs.

Figure Nº 2 shows the pension pyramid, before and after the reform.

FIGURE Nº 2

PENSION PYRAMID, 2001-2009

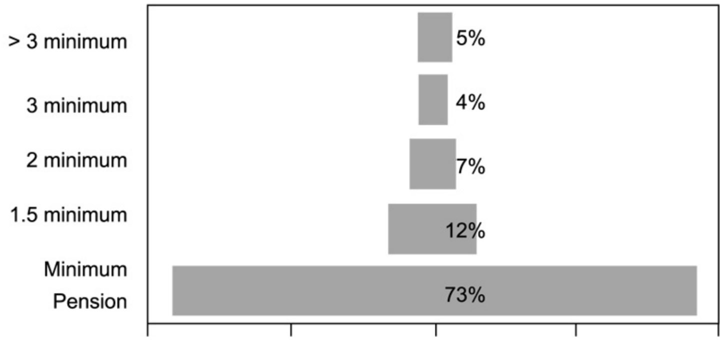


SOURCE: COHEN, DIAZ FRERS AND LEVY YEYATI (2010).

In 2009, still without moratorium, but with the public pay-as-you-go system in force (and the individually-funded system abolished), the physiognomy of the pyramid had changed compared with what existed in 2001, because retirement pensions had already started to be given at the lowest level, the minimum retirement pension. But no improvement at all was given, proportionally, to all those who earned more than ARS 1,000.

At this point in time, with moratorium, 73% corresponds to minimum pensions and the remainder are the pensions of those who earned more than ARS 1,000 (see Figure Nº 3).

FIGURE Nº 3
PENSION PYRAMID WITH MORATORIUM, 2009



SOURCE: COHEN, DIAZ FRERS AND LEVY YEYATI (2010).

As regards the Sustainability Guarantee Fund, it must be stated that on 31st December 2011 it had a balance of ARS 199,490 million, which represents an increase of 12.1% compared with the balance at the close of 2010, but with inflation more than double that percentage. The calculation being made is that within 5 years there will no longer be enough funds to pay the retirement pensions, mainly because the loans to the government are made at insufficient rates and the investments are made without criteria as to yield or guarantees of redemption security, if such were to occur.

VIII. Future prospects for Argentina

What we are seeing is uncertainty and fear on the part of citizens concerning the government's respect for fundamental constitutional rights and few possibilities of immediate changes by way of a generational transformation of the critical mass of the electorate, in terms of ideologies, education and work culture.

BASIC CONDITIONS FOR THE STABILITY OF AN INDIVIDUALLY-FUNDED PENSION SYSTEM: THE CASE OF CHILE

SERGIO BAEZA[1]

1 *Sergio Baeza has a degree in Business Administration from the Catholic University of Chile and is a B.A. and M.A. from the University of Notre Dame. He was president of Pension Fund Administrator (AFP) Santa María of Chile from its foundation in 1981 until 2006. In his capacity as President of the Chilean Association of Pension Fund Administrators, he took part in the founding of Chile's Central Securities Deposit in 1993 and is president of that company to this day. He is also president of SCOMP, a company belonging to the AFPs and Insurance Companies of Chile, which negotiates retirement pensions on a daily basis. He is also Vice-president of AFP Cuprum in Chile.*

The election of Reagan and privatization of pensions in Chile

The start of the individually-funded system in Chile has a symbolic date, 4th November 1980. On that same date, Ronald Reagan was elected president of the United States. It was an auspicious beginning. Reagan, a president who promoted free-market ideas, together with a reform based on attempting to give a private solution to a public problem.

Just a few days after Reagan's election, I was in the United States looking for a partner for the company that we were launching in Chile. I was working in the most important private bank in the country, which had competence in the administration of funds and individual accounts, but not in the area of life annuity insurance, which was an important component of the new system that was just beginning.

I knocked on various doors with no result. At a final attempt I found, to my surprise, that there was a team of people who had been following the Chilean pension reform. They said to me: "We are going to invest with you, because we have been in this business for the past 150 years, but if what you are putting together in Chile really works, it will be an example to be followed by the whole world."

Widespread support for the private system

Enrolment began on 1st May 1981. What we had expected to take a year took place in a month. It was an avalanche of enrolments. By the end of the first year, we had 1.4 million people of an eligible total of 2.2 million contributors from the state system. An average of six thousand enrolments was processed every day for a year. This meant that large sales forces had to be capable of collecting physical signatures, which was the way of transferring to the new system. It was necessary to sign a formal document, with a personal signature, in order to be able to switch, but masses of people did so.

Rejection of the state system

Unfairness in the old pay-as-you-go system

It is worth asking: what was behind the vast support received by the new privately-managed system based on the individual capitalization of workers' contributions? There was a vigorous rejection of the previous state pay-as-you-go system, which had a series of defects, among them being its total unfairness.

Different groups of workers had different retirement conditions. For example, blue-collar workers in the Social Security Service "Caja", the largest, which grouped or received 60% of workers, had to meet an age requirement of 65 years. If they started work at age 20, this meant 45 years of contributions. Meanwhile, private employees, another large group, had a different condition based not on age but on years of service, which in this case were not 45 but only 35. Public employees, who had slightly more negotiating power, had achieved retirement with a full pension after 30 years. Banking employees, who had even more clout, managed it after 24 years and law-makers made laws for themselves: for example, members of parliament could retire after 12 years. This was unfair by any standard.

Non-existent connection between effort and reward

The state system also suffered from a fundamental fault: there was no connection between effort and reward. The winners were those who were lucky or had "friends at court" or contacts in the government then in office, and they achieved advantages in that way.

The employee never saw the contributions. They were paid by his employer and therefore perceived by the employer as a tax. If he/she did not pay them, they constituted a debt that could be postponed, re-negotiated and even condoned. The employee knew nothing about it. The funds did not go into his account, but were an obligation on the part of the employer. The employee used to get worried towards the end of his/her working life, because state benefits were based on the last 120 wages. This meant that there was concern right at the end to ensure that the wages would reflect the real position, because it was on that that the pension was based. However, prior to that stage there was great under-contribution, with both employee and employer having a stake in under-contributing or under-declaring: the employee received a bigger take-home wage and the employer had less to pay. There were also random benefits. For example, the "cajas" had very little money to invest because almost everything that came in was paid out in pensions, but the Private Employees Pension Fund (EMPART) had a small fund and invested it, among other things, in loans to members, which were long-term housing loans without indexing. The person who had the luck, contact, clout, knack or cunning to get one of these loans had a free house after ten years, because inflation cancelled out the debt.

Non-viability of the pay-as-you-go system for demographic reasons: fall in the birth rate and increase in life expectancy

But there was also a rejection of the previous system because everyone was beginning to realise that it was not viable and was suffering from demographic non-viability. In Chile, in the 20 years between 1960 and 1980, the number of active workers for each pensioner fell from 10/1 to 2/1. In order to sustain that demographic revolution, it would have been necessary to multiply contributions by 5 or divide benefits by 5. Both these things actually happened, but mainly benefits were watered down through inflation.

Pension privatisation

Then came the campaigns to readjust pensions and groups were able to achieve a re-adjustment that came some way towards approximating what they had lost through inflation, depending on the relative clout that they possessed. For that reason, one of the fundamental tenets of the new individually-funded system, namely re-adjustable or index-linked pensions, is the equivalent of a life-belt for a shipwrecked sailor. People swam vigorously to get hold of that lifebelt.

One very important element is that the privileges and lack of fairness came to an end. Now there was total connection between individual effort and the reward received. The pension depends only on the individual effort to save, not on political advantages, contacts, knack or cunning. The State keeps itself for those who are really weaker, and supports them with a guaranteed minimum pension.

It also put an end to evasion. Contributions became the employee's responsibility, not the employer's. The employer now became a mere channel, a mere collector of the contribution, with the obligation to pay it to a Pension Fund Administrator (AFP). Non-payment is no longer a debt on the part of the employer, but now constitutes a breach of a fiduciary relationship and is punishable by gaol.

Furthermore, millions of inspectors have appeared: the members themselves, who receive their account statement every so often and can go whenever they like to the offices of their AFP to see whether their employer has deposited the corresponding contributions. With that inspection, evasion came to an end, and at the same time as all this, the funds began to be managed efficiently. Now there really were funds and they were beginning to be managed well.

Correct decisions in design

There are some important correct decisions in the design of the new system that explain its early success.

Increased take-home pay for the member

One of the fundamental elements of that success was an increase in people's take-home pay of around 7%, due to the decrease in the size of contributions compared with the previous system (see Table Nº1). The calculation has been made for the largest fund, that of the Social Security Service (SSS), which included 60% of the people. The basis of this reform is that the contribution is no longer chargeable to the employer, but to the employee. In the example, the cost for the employer continues to be $100 in all cases and in the case of the SSS when it is chargeable to the employer, there is a deduction of $25.63, meaning that the employee is left with a take-home wage of $74.37. In the transition, when the change of basis takes place and the contribution starts being the employee's responsibility, the take-home pay remains the same, but in the final phase, when the person actually changes to the new individually-funded system, this cost is $20.47 instead of $25.63, producing a difference of 7% in the employee's favour. Everybody understood that message very quickly, and the result was that avalanche of enrolments in the new system.

TABLE Nº 1

INCREASE IN TAKE-HOME PAY FOR A WORKER IN THE SOCIAL SECURITY SYSTEM (SSS)

	Initial	**Transitional**	**Final**
Cost to employer	**100.00**	**100.00**	**100.00**
Contributions payable by the employer	**25.63**	**0**	**0**
Contributions payable by the employee	**0**	**25.63**	**20.47**
Employee's take-home pay	**74.37**	**74.37**	**79.53**
Increase in take-home pay: 79.53/74.37= 1.07			

SOURCE: THE AUTHOR.

Maximum limit on investment in government debt

Another of the correct decisions included in the design consisted in fixing a maximum limit of 50% on investment in government debt, with no minimum floor. The reform also took place at a time when there was money to spare in the fiscal coffers and there was no need to count on the pension funds in order to finance the government. The government was able to do without the income from the old system completely, to continue paying the pensions of the old pay-as-you-go system and begin to pay the Recognition Bonds to the new system without touching the pension funds, but using only its own efficiency and its own spare fiscal resources. Those spare fiscal resources are disclosed precisely because the State's debt with the members of the new system, through the Recognition Bond, begins to appear in the accounts. In 1982, the posting of that Bond already amounted to 42% of the GDP.

Strict regulation from the very outset

The stability of the new system was gradually achieved a day at a time and, among other things, by strict regulation. Former president Pinochet was particularly interested in the success of the system. He appointed the first Superintendent personally and gave him clear instructions, so that all steps would be taken to ensure that not a single peso was lost. And it was like that from the very beginning.

The regulations also made the administrator separate from the fund under management. At one point there were 22 administrators in Chile. Not all of them did well and today there are 6. Those that got lost along the way lost their shareholders' capital, but they did not lose the workers' funds.

Transparency in investment was also ensured. The funds can only be bought and sold in formal financial markets. The buying and selling can only take place at market prices and the investments are valued on a daily basis.

Good results consolidate the privatisation

The results of the early years also helped in the consolidation of the new system. In the first 7 years of the new system, there was an average annual yield of 15% over inflation (see Table Nº 2).

TABLE Nº 2
REAL ANNUAL YIELD OF THE NEW SYSTEM, 1981-1987

1981	25%
1982	27%
1983	23%
1984	3%
1985	13%
1986	12%
1987	6%

SOURCE: HERNÁN CHEYRE, "LA PREVISIÓN EN CHILE AYER Y HOY" CEP 1988, PAGE 99.

But this is not a short-term sprint; it is a long race with many obstacles. The first massive obstacle was faced in 1983. In 1982, Chile abandoned the fixed exchange-rate scheme and moved to one of flexible exchange rates. Many dollar debtors became insolvent, including banks. The pension funds had a large proportion of their deposits in banks. The banking sector was rescued by means of a mechanism whereby the Central Bank purchased the non-performing portfolio with a long-term repurchase obligation. Some banks are still paying off that "overdue portfolio" today, but the system weathered the crisis.

Improvements over time

Over the course of time, other reforms were introduced to improve the system. In 1986 permission to invest in shares was granted, coinciding with the privatisation of a series of important companies that were in State hands. These performed excellently on the stock exchange and upheld the yield of the pension funds.

In 1990 investment abroad was allowed, which may seem trivial today, but at that time it was something difficult. The pension funds were accused of "selling our national heritage". It was thought that the Chilean pension funds ought to be invested only in Chile and there was no concept of international risk diversification.

Then in 2002 two very important reforms took place: first, that of voluntary pension saving in mutual funds, insurance companies and banks, which was important because it brought the pension funds into competition with other actors in the financial service. There had been recurrent criticism that the funds were expensive to manage, but this opening up to competition with other actors showed that the reverse was true, that the pension funds are the *low cost provider,* the cheapest in the market, managing at 50 or 60 basic points as opposed to the 100, 200 or 300 of the mutual funds.

Secondly, the Multi-fund scheme was introduced, allowing a wide range of investments in five different funds, with differing graduations of equities, so providing options for workers of different ages to take on different risks, depending on the stage in the life cycle where they find themselves and their level of risk-aversion.

Finally, there was the great reform of 2008. It was a solid reform which has many virtues in my opinion, but the main one is the fact that it incorporates and coordinates the non-contributory pillar with the mandatory and voluntary pillars, putting an end to the antinomy between solidarity and capitalization. A Basic Solidarity Pension (PBS) of USD 160 per month was brought in (the minimum wage in Chile being about USD 400 per month), and a limit of US$ 500 per month was set, the so-called Maximum Pension with Pension Solidarity Support (PMAS), up to which the State provides support. So the State supports those who have nothing at all with USD 160 and helps those who have managed to save something and have self-funded a pension of some size by providing decreasing quantities, starting at USD 160 and ending at zero. In that way it produces the integration, the continuum, between the solidarity system supported by the state and the individually-funded system.

The end of the transition

31 years have gone by, a whole generation, and we are reaching the end of the transition. What happened, for example, to those who did not change? They did not change because it was not in their interests to do so – that was the case of those close to retirement in the old pay-as-you-go system. In general they were about 50 years old and they remained in the old system. Today the youngest of them are 82 years old and in 10 years time will be 92. The truth is that there are very few of them left. In practice, for the State, the weight of paying the pensions of the old system has diminished very considerably. They are rapidly dying out. In 10 years time that debt will no longer exist.

What happens with those who did change? With those who did change, the State has the debt of the Recognition Bond. The largest bonds are for those who had worked in the old system for many years, a person 45 years old for example, who changed system after 25 years of service and was entitled to a big bond. That gentleman, who was then 45 years old, is now 75 and charged his recognition bond many years ago (the bond is paid at age 65). The youngest workers who changed to the new system were 20 years old in 1981 and had no years of service, so their bond was negligible. What has happened to them? They are now 52 years old and in 13 years time will be charging their bond, but it will be very small. Today the debt in Recognition Bonds is no more than 5% of GDP, so the State has freed itself from the weight of pensions in both the old system and the new.

The freedoms gained

To close, a reflection on the freedoms that Chile has gained with this pension reform, both for individuals and for the country. Wage-earners now have the freedom to choose where to pay their contributions (by choosing an AFP), how much to pay in voluntary contributions, which type of fund (Multi-funds), when to retire and how to retire (a range of different pension options). In other words, a series of freedoms has been gained that were unsuspected and not even dreamed about by people in Chile 30 years ago.

And what has the country gained? It has gained that immense freedom that so many countries in Europe would love to have today. Chile is neither overwhelmed nor tied down by its pension debts. People fund their own pensions and the State can dedicate its spare funds to really caring for those who have most need.

THE PRIVATE PENSION SYSTEM: WHAT IS ITS KARMA? PUBLIC IMAGE AND RELATIONSHIP WITH STAKEHOLDERS

GABRIEL ORTIZ DE ZEVALLOS[1]

1 *Gabriel Ortiz de Zevallos graduated in Economics from the Catholic University of Peru and has a Master's in Public Administration from the University of Harvard, U.S.A. He has been Executive President of APOYO Comunicación Corporativa since 2004, a company in the APOYO Group, dedicated to advisory services on reputation and corporate communication, including issues of Social Business Accountability (RSE in Spanish). As from 2012 he has been working as Communications Advisor to the Peruvian Association of Private Pension Fund Administrators.*

Industries have an image DNA

I believe firmly in the Peruvian Private Pension System (SPP) and defended it when it first came into being. I produced bulletins for members of congress, explaining the problems in the pay-as-you-go system and the advantages of the private system. I also directed a study to identify the political factors involved in the reform[2]. But when thinking about the SPP's image or its relationship with different stakeholders, it is necessary to concentrate on the weak points. It is only on the basis of a clear knowledge of those points that one is in a position to help legitimize the system, a concern that has arisen repeatedly in the last few years. I should like to emphasise that the reflections included here only claim to be relevant for the countries of Latin America. Communication is something intrinsically cultural and varies from country to country, so even within Latin America each person should filter what is applicable and what is not.

In no country has reforming social security been easy. Introducing the SPP in Latin America was not easy either, but a set of factors coincided to make it possible. A study by Carmelo Mesa Lago[3] analyses the political variables that facilitated that process in the 1990s. Among the lessons that can be learned from that study is that the favourable opinions of technocrats and multinational bodies, added to a severe fiscal crisis and the extremely serious state of the national pension systems, were crucial in causing the balance between political actors to tip in favour of reform. Furthermore, in some countries the fiscal transition cost was reduced, affecting members' rights that would become apparent in the future but were not visible in the short term. Much later on, the legitimacy of the SPP is no longer limited

2 *The political economics of the institutional reforms in Peru: the cases of education, health and pensions (Gabriel Ortiz de Zevallos, Hugo Eyzaguirre, Rosa María Palacios and Pierina Pollarolo). Office of the Chief Economist of the Inter-American Development Bank (IDB), Working Paper R-348 of the Latin American Research Centres Network. March 1999.*

3 *The Politics of Pension Reform in Latin America, Carmelo Mesa-Lago and Katharina Müller. Journal of Latin American Studies, Vol. 34, Nº 3, August 2002.*

to the space of technocrats, political actors and multilateral bodies. Today it is a key element in citizen legitimacy, influenced naturally by the mid-term results of a system whose maturity is still to come. The Pension Fund Administrators (AFPs) have to think about the long term, about the relationship with their stakeholders, about sustainability based on the licence to operate. The Argentine case demonstrates all too clearly the risks of not having sufficient legitimacy among the membership and citizens in general. For reasons that are more than evident, the level of resources that the SPP manages to accumulate is, and will be, a temptation for populist political actors, who have been a recurrent theme in Latin American history, and if there is no clear approval of the system among members and public opinion in general, that risk will persist. A task for the agendas of all AFPs and their professional associations is to concern themselves actively, and to institute actions, to bring that legitimacy into being.

The individual funding model in many countries is defined today as neo-liberal and is associated with privatisation. In the 1990s these labels were good, but that is no longer so today. From the communications point of view, labels have a life of their own over and above the contents, and generate risks of politicization and regulatory changes. It is also important to recognise that in many countries the SPP was introduced in response to the financial crisis of the pay-as-you-go systems and their fiscal impact, and not as a proposal that responded in itself to the concern about how to improve people's pensions. The prior debate that can be remembered by the population in general is not *"how can we improve pensions" but "how can we face up to this crisis and get out of this bankrupt system"*.

Behavioural economics has proved aspects that are important in understanding the pension systems' markets: people are not capable of comparing the future and the present correctly. Pension savings, if voluntary, would be insufficient. But traditional microeconomics also makes a very important contribution: demand reflects willingness to pay and the value that people place today on a given good or service. It may be that they undervalue it because they are short-sighted, but that does not alter the fact that they perceive it as less valuable. To sum up: people do not value saving for pensions as highly as they should, which means that they are not very pleased at being forced to save today. The deduction today versus the pension tomorrow is not valued as it should be.

There are some additional elements of behavioural economics that may also usefully be mentioned. People have a natural tendency to compare. In other words, if there are two similar options, the human brain is biased towards deciding which is better, paying little attention to other options (which might be better than either if studied more carefully). The natural comparison in the case of SPP, in countries where the public system still continues, is between the conditions that each one offers. And that is naturally judged from the standpoint of the possibilities and knowledge of the man in the street. An element added not by economics but by communications studies is that examples have great power of persuasion, far more than arguments or significant statistical evidence, except in specialist circles. What science dismisses as anecdotal evidence is what may be most persuasive.

Finally, behavioural economics has also shown that a great range of options produces less sense of well-being among individuals, however paradoxical that may sound. People feel happier with their decisions when they choose from a reasonable number of options. If that were a particular case of a more general phenomenon, which consists in the fact that complexity produces anxiety and this encourages people to take refuge in simpler options, it would still be relevant for the SPP: if the system is very difficult to understand, many people will look for a reasonably plausible simple position which calms their anxiety when facing uncertainty. In industries that are inherently complex, the risk of such a simplification being unfavourable for their reputation is always an important one.

The industry's image

Every industry has an image DNA, a kind of karma. That is obvious, for example, if we compare funeral parlours and the ballet. Funeral parlours clearly have a very negative karma and the ballet – unless one is watching the film The Black Swan – a very positive one. Now it is not the fault of the funeral parlours that people die. Working in a funeral parlour is possibly hard and uncomfortable and, when all is said and done, these are people who attend us at an extremely difficult point in our lives and we should value them more. A lesson that should be learned from this reasoning is that the SPP, like any other industry, has karma and it matters very little whether it is fair or not.

Within an industry's karma, one firm may have a performance that allows it to develop a good reputation and differentiate itself from its own industry (and if that is sufficiently generalised, gradually change the karma of the industry as a whole). In fact, a person who contacts a funeral parlour may be very relieved if the person who attends him/her is tactful and sensitive to his/her grief. Even having the most negative karma possible, there are options and behaviours that benefit a company's reputation. It is necessary to be familiar with the karma, but there is no reason to resign oneself to it.

The perception of SPP clients

So, what is the karma of the AFPs? There are various elements that may help to understand it, and we have to be prepared to listen to something we would rather not hear. A first question is how much the service is valued, and we have already given the answer. If it were voluntary, very few people would go for it; therefore they do not value it. That is the first element of the karma: the SPP obliges people to do something that they do not necessarily want to do. The willingness to pay voluntary contributions may be an approximation of how much the service is valued.

Furthermore, in Latin America at least, there are perfectly reasonable arguments for being distrustful (in addition to the previous point). How many times in Latin America have there been cases of people handing over money and then never getting it back? The fact that it is absolutely certain that this will not happen in the SPP does not mean that the man in the street is not justified in thinking that the risk exists. And if any Argentine citizen had such doubts, experience has proved him right. In the simple view of a citizen who does not necessarily make distinctions on matters that are complex and difficult for him, the fact that, some acquaintance lost money that was deducted from his wage at some time in the past, may weigh really heavily. It has to be recognised that people may confuse the SPP with other experiences where they were swindled. There is a distrust that may be legitimate and we have to be capable of breaking it down.

Another element is that the results are only visible in the long term, a concept that for some people in Latin America may seem almost as novel as an iPod. If in Anglo-Saxon cultures, where behavioural economics developed, they use the word "short-sightedness" to describe the inability to think long-term, in Latin America we would perhaps have had to use the term cataracts or blindness. Peru only began to grow steadily in 1994 and mortgages with more or less long terms began to be granted in this 21st century. If the SPP matures in 35-40 years, we have to be aware that in Latin America that period is almost an eternity.

The AFPs offer a product that is complex. One would have to understand how compound interest is calculated in order to understand how a pension fund works and, according to the PISA (Program for International Student Assessment) in mathematics, people in many Latin American countries have difficulty solving problems with operations far simpler than this one. In other words, if our aim is to explain the system rationally, we shall have to be very didactic, because it is possible that it will not be understood.

Furthermore, the AFPs are perceived as being part of the financial system, and the image of the financial system is of someone who thinks only of money. Insufficient advantage has been taken of the goodwill that could be generated by the fact that this is a service for achieving a better old age.

In addition, the rise of the AFPs was linked with privatisation efforts in general, which are now frowned upon and in a large number of Latin American countries at least, there is the idea of the State as daddy, who ought to be able to solve everything in the end. He may be a dysfunctional daddy who fails to meet a mass of obligations and never provides good services, but in the end there is a certain faith that the State will do something eventually.

It would seem that all the above adds up to a fairly negative karma and it is important to be very aware of this in order to develop a strategy to legitimise the industry in the eyes of its members and public opinion in general. We are offering a distrustful and poorly-paid population a benefit 35 years into the future, by compulsorily reducing its wages each month. That same service is not valued highly enough even in countries where the rules of the game are reliable and the long term is a well-established concept, as proved by behavioural economics. And the SPP is seen as part of an industry (the financial sector) which is covetous and has little interest in the welfare of its clients. The challenge is a very significant one.

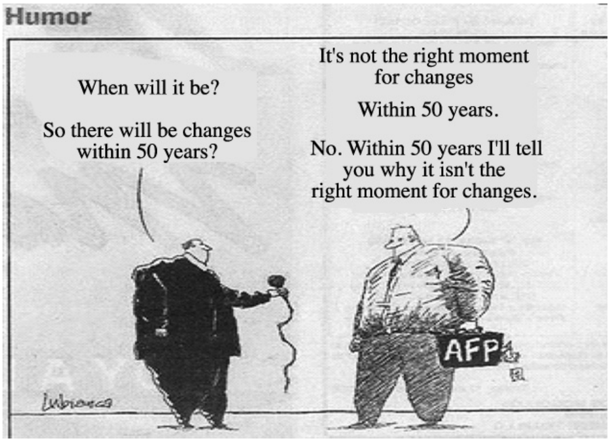
Comprehension and emotion

Emotions play a fundamental role in the way in which people perceive reality and those who have a more technical background tend to forget it. People perceive and form opinions that are very strongly influenced by emotion. Also, in pension issues, old age is a tremendously emotional element. People will see things on the basis of the emotions aroused in them, by the fact that their uncle has to face such and such a situation when drawing his pension, for example. Those are the points of reference for the ordinary citizen, and not laws or abstract concepts or statistical estimates. If there are specific negative benchmark cases that may affect the SPP, it is vital to make an effort to clarify what happened in those cases and explain that they are not representative of the system. It is crucial to understand that what is needed in those cases, before going into explanations, is to listen and allow people to get things off their chest, so that they are prepared to pay attention and process our information without reacting emotionally. An elderly person who receives a very low pension causes indignation, and before people are ready to hear that this is not the fault of the SPP, it is necessary to show empathy and listen sufficiently to open the channel of rational communication that has been blocked by that indignation.

Cartoons are often a way of gathering up those collective emotions. Given below are two examples: the first is on the subject of growing life expectancies and their implications for pension systems.

In the face of the real technical fact that greater life expectancy implies that the accumulated funds may not be enough to hold pension amounts, the cartoon portrays the indolence of a wealthy man who suggests reducing pensions so that life expectancy will fall.

Another example has to do with when reforms to the system can be introduced.



Dealing with the technically valid assertion that the SPP requires regulatory stability for long periods in order to develop properly, the above cartoon suggests that the AFPs will never want to change the model, because they benefit from it (to this, one might add the speculation that people in Latin America tend to think of sum zero game models, where benefit for one implies hardship for the other.)

What can be done?

Jay Conger, in an article that has been considered a classic of the Harvard Business Review[4], states that in order to be able to persuade, it is essential to understand that persuasion is a process and not an event, and that 4 elements are necessary:

1. To achieve credibility;

2. To understand the referential or conceptual framework of the other person and paraphrase our arguments in such a way that the other person understands them: a way in which we are speaking from a common frame of reference;

3. To present evidence as stipulated in the previous point;

4. To generate empathy.

4 *The necessary art of persuasion, Jay Conger, Harvard Business Review, May-June 1998. 4*

FIAP devised a study on the legal framework of communications with stakeholders[5]. It was concluded in that study that certain difficulties did exist, and recommendations were made. In addition, a survey was carried out for this lecture, responses being received from 9 countries[6].

The first study found that people are not really familiar with the subject, though they think they are and show no interest in finding out any more about it; there is difficulty with processing the information and ideas; the product itself is intangible and long-term; there is a risk of ideological issues and political populism becoming involved in the system; the dispersion of members makes efforts to communicate more difficult; and there is great asymmetry of information.

Any scheme for communicating and relating will necessarily mean a constant effort, with a long-term plan, using simple language, addressing the matters that are most relevant for each target audience (members, pensioners) and not waiting for problems to arise.

It is important to look for synergies with supervisory bodies. There have been cases in which it has been possible to produce communication efforts that have involved working jointly, and the resulting common message has allowed greater credibility and clarity to be achieved. It is also vitally important to have pilot evaluations or tests. It is very important to stress this point: if market research is an undisputed tool for marketing products, it is really surprising how easily we believe that the marketing of complex ideas can be based on pure inspiration.

Actions for communicating with members and contributors

Account statements

What usually happens is that account statements are sent out every six or twelve months and are suspended when there are no contributions (exceptions: Bulgaria, Curaçao, Spain, Kazakhstan, Poland, Romania and Ukraine). That is a serious mistake. If we really want to convey a sensation of membership, and to deal with the reasonable doubts that people may have with regard to whether that money is their own and will be there for them when they retire, then there must be much more frequent communication, not only with members who are contributing but also with those who are not. In terms of citizen legitimacy regarding the system, this is the first item to be checked.

5 *Pension funds: Information, education, pension culture and advice provided for members: International Federation of Pension Fund Administrators (FIAP), Rodrigo Acuña. October 2011.*

6 *Bolivia, Chile, Colombia, Costa Rica, Curaçao, Honduras, Peru, Poland and Uruguay.*

Furthermore, in many cases there is no record of the complete working career, due to some error on the part of the regulator, meaning that there is no reflection of how much the system as a whole has received for the person's fund. To make this clearer: if someone changed AFP shortly before the crisis, the historic result of how much he/she has contributed since enrolling in the system and the yield obtained for him/her by the SPP will not appear on the account statement. What will appear as his/her contribution will be the amount transferred from one AFP to the other and the yield obtained by the new AFP. In periods of crisis, that yield is negative, so the impression given is that the AFP has charged him/her for losing part of his/her money.

Offices

The matter of offices is also very important, because people need personal interaction for anything that is complex and produces doubts, not only to resolve those doubts, but also to get things off their chests, including the emotional element which is indispensable for producing empathy. In many countries there is legislation concerning the number of offices that must exist, but the use of other platforms is not allowed in order to avoid confusion and crossed sales. But it is necessary to assess what to do in those places where there are no economies of scale to warrant setting up an office. And in any case, that should not limit agreements being made at union level with universities or chambers of commerce to explain the system and sort out doubts and complaints of any kind. By doing so, there would be a gain, not only in greater presence and ability to interact, but also in receiving part of the positive karma that may exist in a university, chamber of commerce or other similar institution.

Member defence

In some countries (Spain, Dominican Republic) a system of Member Defence has been created, which may be a good idea for producing this interaction that resolves doubts and generates a space of legitimacy.

In other countries there has been greater public sector participation in the matter of possible complaints or user service. That is the case of the pension supervisory bodies in Chile and Mexico, which show comparative details of the yield, commissions and service of the AFPs. There is also the case of the user service office in the case of El Salvador.

Information for members

According to the survey, it is information for members that is really vital. It is important, however, to think of the way in which it is delivered and assess whether that way is the most appropriate.

When there is too much complex information, the member becomes anxious and bewildered and does not read. The information provided must be simple, making access easier for anyone wishing for a higher degree of complexity. Furthermore, the use of incomprehensible terms must be avoided. Here it is also recommendable to use market research tools to find out how much members understand and what they require. It is likely that efforts to simplify must be urged from the private sector to the regulator, but based on technical studies. Regulators tend to use difficult language. But since the product is intrinsically complex, simplifying communications is not sufficient; it is also necessary to make a great effort in terms of financial education.

It is worth repeating that when the contact with the member (and not just the contributor) is sporadic or not very direct, there is a risk that the AFPs will be perceived as being interested only in charging commissions and not in protecting the person's old age, a belief that the system's enemies can easily take advantage of for campaigns against it.

Actions for other audiences

Pensioners

The survey also reveals that the audience with which least work has been done in terms of communication efforts is that of pensioners. This is a very serious mistake, for two reasons. First, people are going to judge the system's performance on the basis of the opinion of people known to them who have retired under the system: that is where the SPP's reputation is made or broken. In Peru, for example, many SPP pensioners receive extremely low pensions because the State did not issue an appropriate recognition bond to give due honour to the contributions that they had paid into the old system. The harm caused to the system's reputation as a result of those pensioners with low pensions is very serious indeed.

The second reason is due to an emotional component. An interesting lesson can be learned from UNICEF, for example. This institution is perfectly clear that children appeal to everybody and produce a significant collective effort. A similar thing is true of the elderly, but the AFPs make little effort to produce such empathy. The AFPs are perceived as part of the financial sector, which has a wolf-like image, and it is difficult to convince anyone that a wolf is going to take care of our grandmothers. There is a need to demonstrate genuine concern for the elderly person. For example, if the AFP is really concerned about the member's old age, it should not stop sending information if that member stops paying contributions. Quite the reverse, the AFP should contact him/her to show that it is interested in helping the person to obtain a good pension. Furthermore, if the person has been made redundant and someone from the AFP calls to inquire about his/her situation and offers support of some kind to help him/her register at employment agencies, or some other benefit that does not need to be expensive, the member will remember that show of interest for a long time.

If the AFPs can manage to achieve an image that has more to do with *"I am taking care of your old age"*, it would mean a radical change in terms of reputation. Achieving this is a process that is neither fast nor easy, but it is a guiding-light towards which we should be steering and it may mean carrying out a variety of activities. One of them lies in making AFP personnel more sensitive to what life is like for elderly people. The sales force could ask members whether they have elderly relatives; everyone has elderly people whom they love and about whom they are concerned. If the AFP, instead of offering its members presents on their birthdays, had inquired even once about their parents and sent them presents (or had given them that option), the members would perhaps have valued it far more. There are some social accountability programs that concentrate on pensioners, but something far more structural needs to be done, something that touches the very culture of the AFPs and SPP in general.

Informal workers

In the case of informal workers with low density and wages and in that of personnel in human resources in general and in unions, the survey shows that a few actions have been taken, but these are considered insufficient. More actions should be taken with this audience, because this would reaffirm the fact that the SPP is not a system for the rich, but a system for everyone, and that it is better than the public system in countries where the two coexist.

University students, school-children and teachers

There have also been efforts in the case of university students, school-children and teachers, as from secondary level. In the field of formal education, which is different from communication, I believe that there should be a more structured, thorough training. As from secondary level, the mathematical bases have been laid to enable pension topics to be understood. It is possible to explain a series of topics more clearly by means of workshops or special courses. Each person who becomes convinced of the benefits of the system compared with the pay-as-you-go system is a valuable ambassador.

There has also been an initiative in primary schools and even at infant level, through stories for children. It would be important to evaluate how that effort was received and what impact it had. As a precaution: it is important to remember that any activity with children requires the consent and approval of the parents, or it may even prove damaging. It should never be considered propaganda. Naturally, the point to be highlighted in these audiences is the promotion of the value of social security, not the SPP as such. An interesting case would be to replicate the marshmallow experiment[7], which has demonstrated that the child's capacity to be able to delay the reward (intimately linked with pensions) is one of the factors that may have the greatest effect on its future benefit. It would be possible to develop a program to promote the attitude of looking to the future in a variety of activities, for both parents and children.

Politicians, regulators and leaders of opinion

All countries have been working with these audiences. It is worth highlighting the case of El Salvador, where a large number of institutions, including all the regulators, have been involved in a great financial education effort. Experiences in Colombia and Mexico are also interesting.

It is also worth thinking about the differences between these three audiences. Although there may be some politicians who are committed to a more technical approach, there will always be opportunist politicians who take advantage of the ignorance of the general public. The vital thing is to achieve citizen legitimacy. The usual problem with the regulators, as has already been said, is that they complicate not only the rules, but also the language in which they are expressed.

Large-scale financial education campaigns

In some countries, such as Chile[8], Colombia and Peru[9], there have been publicity campaigns of pension education. The most recent experience is that of Colombia[10]. The levels of scope of that campaign can be seen in Table N° 1.

7 *An experiment carried out in the 1960s by Professor Walter Mischel, at the University of Stanford. He proved that 4-year-old children who were able to postpone a reward achieved better results as adults on a number of indicators, up to 210 points more on average in results of the SAT tests.*

8 *Advertising spots on http://www.afp-ag.cl/spots2.html*

9 *Advertising spots on http://www.asociacionafp.com.pe/*

10 *BBVA Horizonte: "Adelante con el futuro" educación financiera; Colfondos: "Construyendo su futuro"; ING: "En ING hablamos con claridad"; Porvenir: "Aprendiendo juntos con Porvenir"; Protección: "Protección contigo"; Skandia: "De regreso a la Universidad"; ASOFONDOS: "Campaña de Educación Financiera – Solo en los Fondos".*

TABLE Nº 1

COLOMBIA: MAXIMUM AUDIENCE OF THE MEDIA CAMPAIGN

Medium	Million people
National TV	+ 18
Regional TV	+ 5
Local TV	+ 1
In Print	+ 14

SOURCE: ASOFONDOS OF COLOMBIA.

An additional point to be emphasised is that, although we are experiencing the boom of social networks and internet, one has to be realistic about how much can be achieved on a topic that is not attractive per se. This is the number of visits received by the websites in various countries can be seen in Table Nº 2.

TABLE Nº 2

VISITS TO INTERNET SITES RELATED WITH PENSIONS

Internet	Visits
Country 1	108-147
Country 2	1,546 – 6,074
Country 3	924
Country 4	7-174
Country 5	280-691

SOURCE: PRODUCED BY THE AUTHOR ON THE BASIS OF A SURVEY OF VARIOUS LATAM COUNTRIES.

At the date when the analysis was made, 6,000 visits had taken place in the best of the cases and in that case the campaign included television spots that were disseminated on a large scale. Obviously it is necessary to be on internet, but it is not enough.

In the Colombian case, as in that of El Salvador, the financial education program has involved many institutions: in 2011 there were 63 institutions and in 2012, 74. The program has included all the AFPs in a training program for all their advisors, so that they can give the financial consumer appropriate guidance and information (see Table Nº 3). Of 1,027 sales representatives trained, 89% passed and 11% needed reinforcement. These training courses have been carried out in conjunction with academic and other centres.

TABLE Nº 3

COLOMBIA: Nº OF REPRESENTATIVES SENT BY THE AFPS AT NATIONAL LEVEL

AFP	Sales Representatives
BBVA Horizonte * May 2012	590
Colfondos * December 2010	665
ING * April 2012	453
Porvenir * May 2012	951
Protección * November 2011	953
Skandia * March 2012	477

SOURCE: ASOFONDOS OF COLOMBIA.
*DATE WHEN THE INFORMATION WAS CONSOLIDATED.

Summary and conclusions

To summarise, the AFP industry has a number of factors that involve a negative reputation risk which must be acknowledged in order to be able to work. Managing a reputation strategy well means taking specific actions (not only those to do with communications) to produce greater credibility and show more empathy and commitment with elderly people. This is an industry that has been associated in terms of image with fiscal crises and privatisations, and is at constant risk from political populism. In many cases the initial reform did not take certain aspects into account as it should have done, with the result that people have been affected whose problems can be blamed on the SPP, even though this is inaccurate. The financial sector has a difficult image, and that affects the industry. In dealing with these challenges - which are not even the only ones that exist - efforts appear generally to have been insufficient, sporadic and less than comprehensive, although there are various recent cases which reverse that trend. This would seem to indicate that the industry has been operating within what is known as the trap of *"those in the know"*: the industry's perception of itself seems to have been based on the opinion of those who already form part of a circle acquainted with the virtues of this system, without fully understanding how it is seen by the man in the street.

An interesting mechanism of some of these new initiatives has been to work with the regulator on aspects of communication and financial education. Work must be done on all fronts, with different stakeholders and with long-term vision and commitment. The specific recommendations have been made in the article and there is no point in listing them again, but one specific example may demonstrate the detail of the effort that has to be made: in some countries, the payment slip says *AFP deduction*, instead of, say, *pension savings*. That simple fact is communicational nonsense. Words matter: to say that money is being deducted from my wage does not come across in the same way as to say that I am saving.

Two final concepts of general application that may be useful for this case: in creating a reputation, what one does is more important than what one says, and if the one is inconsistent with the other, credibility is nil. Finally, people remember the recent and the bad. Any element that might be considered bad must be explained very clearly, because it will be a reputational liability. By contrast, if there is something good but not recent, a considerable communicational effort will have to be made to transform it into an asset.

STRENGTHENING THE PENSION INDUSTRY'S PUBLIC IMAGE

FRANCISCO GONZÁLEZ ALMARÁZ[1]

1 *Francisco González Almaráz has a first degree in Public Accountancy and a Master's in Administration from the Autonomous Technological Institute of Mexico (ITAM), Mexico. He has taught the Master's Administration course at the ITAM for 20 years. He was president of the Mexican Association of Retirement Fund Administrators (AMAFORE) from 2001 to 2007. He has 30 years' professional experience in the Bancomer Financial Group, in the areas of Business, Finance, Enterprise and Social Pension Companies. He is currently General Director of Afore Bancomer and Pensiones Bancomer.*

I. Where are we?

The perception of the pension funds in Latin America

Different surveys indicate that public opinion on the pension system in Latin America is not as good as it might be. As we all know, there is enormous ignorance concerning basic aspects of it. Also, the vast majority of workers receive no pensions and have no chance of a pension out of private savings either. There is an enormous sensation of social vulnerability in the countries, which is a consequence of the low coverage of private pensions.

In general, therefore, people tend to blame the AFPs for the faults in the pension systems, whereas in fact they are a result of the countries' structural problems.

What may be behind the opinion of the AFPs?: aspects to be borne in mind

Among the elements that interact in shaping opinion about the AFPs, it is possible to mention the following:

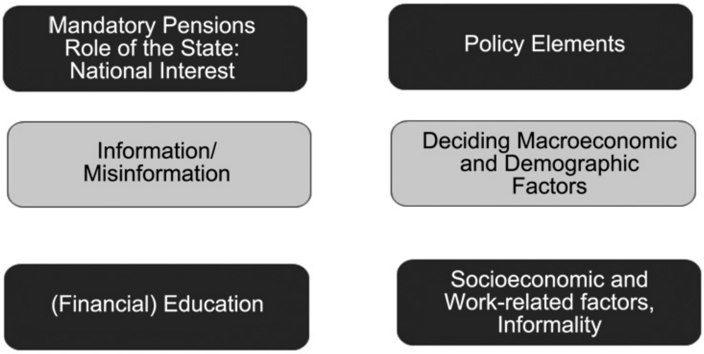
i) The balance of the relationship between the AFP and its members;
ii) Knowledge of how the system works;
iii) Flows of information and misinformation;
iv) The current regulatory framework;
v) Attitudes of the State; and
vi) The role of other stakeholders.

The way in which this interaction between the aforementioned elements takes place will determine to a large extent the general opinion of the population concerning the AFPs.

II. Factors that decisively affect public perception

Different forces act on the operation of the pension system, altering (multiplying or damaging) whatever action is taken by the agents in this market. Figure Nº 1 shows this set of forces.

FIGURE Nº 1

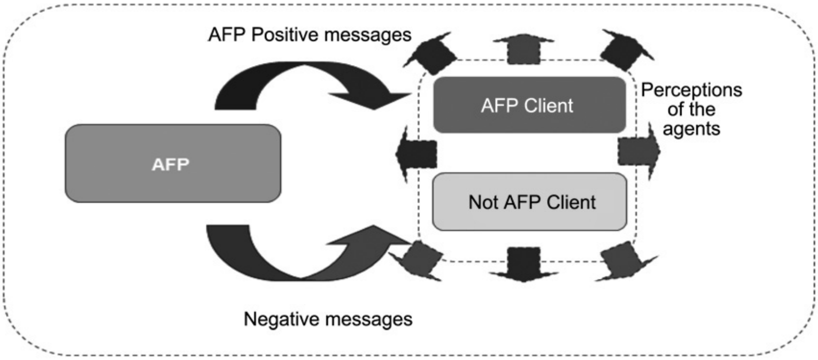


SOURCE: PRODUCED BY THE AUTHOR.

The market and the AFP-Client relationship

Public opinion rests in part on the relationships between the AFPs and their clients and/or potential clients. Actions may convey positive or negative messages to the client, shaping his/her perception of the industry (for example, a complaint dealt with badly, versus a service with an immediate response to his/her concerns) (see Figure Nº 2).

FIGURE Nº 2



SOURCE: PRODUCED BY THE AUTHOR.

External agents

External agents affect the AFP-Client relationship because they transmit signals, both positive and negative.

The State should have a predictable role, but in practice this is not the case. In actual fact, the Executive has its goals, the Congress others of its own, while the regulator, although more objective, also has its own perceptions. The actions taken by the State are highly influenced by the context, which may lead its acts towards political ends.

The problem of creating good public opinion is not one that faces the pension industry alone, but also other external agents, such as experts, non-experts, political candidates, associations and Non-Government Organizations (NGOs) created for that purpose.

Dynamics, interests and global trends

Because pensions are a matter of national interest, all opinions and interests converge. At the same time, there is a lot of ignorance about the subject, which is explained by the complexity of the issues involved: actuarial, demographic, financial, fiscal and labour market aspects. It is very easy to give wrong information.

Global trends include a scenario which will need to be treated responsibly, because the messages to public opinion may be incorrect in terms of the effects of longevity risk and the natural downward trend of yields.

III. Lines of action

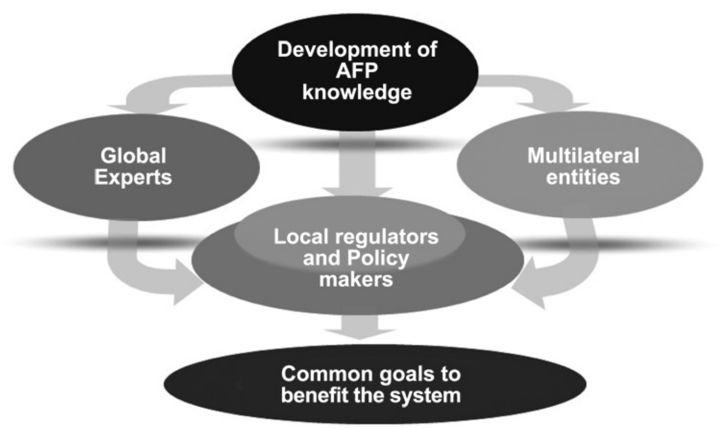
Key stakeholders to be aligned

The improvement in the AFPs' image does not depend only on the client-company relationship. This is an important factor but it is not sufficient; neither is a communications or image campaign. In fact, what is needed is to seek arteries of communication with key stakeholders, such as policy-makers, multilateral entities, regulators and other relevant actors.

It is necessary to act with these key stakeholders, so that objectives can be aligned in favour of the workers. To do this, it is important that there should be a work thesis promoted by the industry, which is perceived as being objective.

It is very important that the development of knowledge should be technical, objective and validated by the interaction of policy-makers, both locally and globally (see Figure Nº 3).

FIGURE Nº 3



SOURCE: PRODUCED BY THE AUTHOR.

Experience has taught us that the AFPs cannot have a passive role and must be a promoters of change in the attempt to align results for the benefit of the pension system. That alignment of goals constitutes a key element and the AFPs must be an active agent, so that the same message is transmitted at every level.

IV. Conclusions

In the early days of the creation of the systems, when the individually-funded pension model had already been exported to several latitudes, the recurrent issues under discussion had to do with the struggle against the pay-as-you-go systems and the advantages of defined contribution versus defined benefits. Today that discussion has been practically settled; all the countries in the world are now moving, to a greater or lesser extent, towards defined-contribution schemes, and that is a considerable achievement on the part of these systems.

A long time ago there was also great discussion about commercial issues, transfers, etc., but that is not so today. It seems that, in several of the countries, the system has already come of age. Chile, for example, after 30 years, has already come through the transition stage and the expenditure on pensions under the pay-as-you-go system is next to nothing. If we were able to measure the total debt of each government, Chile would probably be among the safest countries in the world in terms of its accumulated debt, and that is probably the direction in which several countries need to travel.

In terms of public image, work must be carried out jointly with the authorities and regulators, specifically on matters that are significant for the industry, because in that way much better results will be obtained.

If we are capable of moving in the direction of talking about total public debts, including the social security or pension debts that exist in all countries, the message will be much clearer: the countries that have individually-funded schemes are much safer today than those that have not.

Among the issues that have been discussed recently, much has been said about industrial organization and there is considerable alarm because of Heinz Rudolph's position on whether or not accounts administration should be separated from investment management. It would seem that what we have failed to do is confront the issue and show clear confidence that this is a topic that can be discussed. That is what we need to work towards. In fact, the configuration of the industry does not matter, but what does matter are the costs, and that is the issue that needs to be talked about clearly. The proposal arising from Heinz Rudolph's work is not moving in the direction of changing the industry's organization as such, but of changing the costs of the system. It is necessary to work together with the authorities on how to increase contributions and how to make this system much more attractive and more credible to the workers. The authorities are doing their job very well, in Mexico at least, in the sense of seeing how to extend coverage and how to grant minimum pensions. Pedro Ordorica's proposals are very apposite in terms of reducing the number of weeks and increasing retiring age, but clearly we need to work in the industry on how to encourage the worker to pay money voluntarily into an account, and how to find incentives so that this happens. If the industry is capable of providing incentives for the third voluntary saving pillar in the AFPs, they could have a very different image, because it would enable them to achieve better replacement rates, among other things.

Finally, it is worth mentioning the issue of investment schemes and the matter of corporate governance and conflicts of interest. In Mexico at least, the last 5 General Directors or General Managers of the administrators have come from the financial or investment sector. The General Director of the largest administrator in Mexico, (Banamex) comes from the investment area, which means that most of his approach involves talking about investments, conflicts of interest and corporate governance. Insofar as the industry is capable of moving its whole discourse, together with the authorities, in that direction, there will be a gradual increase in trust among the workers and in their appropriation of their accounts.

THE REPUTATION OF THE INDIVIDUALLY-FUNDED SYSTEMS

ANDRÉS CASTRO[1]

1 *Andrés Castro has a degree in Civil Engineering from the University of Chile. For 18 years he occupied various posts within the Santander Group. He was involved in setting up the Santander Life Insurance and AFP Bansander companies, where he subsequently worked as Managing Director. At the end of 2007, the year in which ING took over the pension business of the Santander Group in Latin America, he became CEO of ING Chile and then also accepted the responsibility in Uruguay. At the end of 2011, after the sale of the ING Group's assets to SURA Group, Andrés Castro was appointed executive president of Sura Asset Management Latin America, a holding that includes pension companies, insurance and mutual funds in five countries in the Latin American region.*

I am fortunate enough to have had a long experience as a manager in the pension system. I have been involved in the pension industry in Chile for over 20 years and also in other countries in the Latin American region. The comments made in this document come therefore from the managers' point of view and from experience, and not from an image expert.

How can we achieve a favourable public opinion of the industry? How can we generate trust, awareness and a sense of belonging among members and pensioners? Those are the two big questions that should involve our efforts as a pension industry.

We know the situation that the European countries are going through with the crisis of their pension systems, very obviously in certain cases. We also know how important it is to build up long-term relationships with those who are, after all, the beneficiaries of our activity: the members, our clients. We must move from being an industry that administers a concession to being an industry that participates with clients to whom we deliver products, who could react like clients of voluntary products and therefore insist that we provide quality service and fulfilment of our promises.

Sustainability of pension systems

One of the ideas that I want to emphasise is that the building of a solid reputation depends on having sustainable systems.

This is the most topical debate in today's world and we see it in cases like that of Europe, where the adverse economic effect of their pension systems has been clear to see, though the population has not generally been made aware of it.

Sustainable systems are those that are seen comprehensively and that form part of a virtuous cycle in the economy and in society's developmental dynamics. Our challenge therefore consists in making stakeholders aware of the advantages of the virtuous circle that is produced around the individually-funded systems.

Today we have examples around the world, very tangible examples, that enable us to certify the sustainability of individually-funded systems. I believe that in honour of sustainability we have to move from observation to proactivity, as a really important attribute of our system. I also believe that we have done well to talk about it with the more intellectual members of the public, in coordination with governments. We have been able to improve our systems in most countries. If we look at the first formula of the individually-funded system and compare it with what we have today, it seems to me that we have made great progress and we have done it together with the significant stakeholders. It is not a minor matter that many countries have been able to improve their investment schemes over the course of the years, offering investment alternatives for members by way of the Multi-funds, introducing voluntary savings schemes and in some countries, such as Chile, harmonising the three pillars of the pension system (non-contributory, contributory and voluntary).

Keeping the promise of value

The second idea that I want to highlight is that, from the basis of a sustainable pension system, it is possible to generate long-term relationships focusing on the promise of value, where communication is a powerful tool.

It is precisely on this issue - the keeping of the promise of value - that I believe we have failed. Maybe we could not do it before, but it has to do with transforming the clients of a concession into real clients and talking with them about the real promise.

It is vitally important to keep the aim of the individually-funded system clearly before us, namely, to facilitate the saving and investment mechanisms and tools that will permit citizens to obtain a worthwhile pension for their retirement, within a coherent legal and financial framework.

The usual approach has been to advise and accompany members in their various life cycles in a comprehensive manner, offering products and services suited to the needs of members and pensioners.

The problem is that there has not been enough talk about the final purpose of the system, which consists in achieving a sufficient accumulation of money to enable a reasonable replacement rate to be obtained. In this sense, a sign of unmet expectations has been given with regard to the view that a regulator, government or individual may have about the replacement rate, because there has been no movement or alignment of expectations.

The challenge therefore lies in achieving that alignment of expectations and developing a plan for approaching the member. All of this without quoting averages, but rather putting special emphasis on each member's replacement rate, and also making the connection between the contributions and the final benefit (pension, final capital and deadlines involved).

We must have an innovative and purposeful industry, which responds to world needs and trends. An example of this is the concept of the "global worker", who requires the ability to move and who carries his pension account in his luggage. Today, making mobility easier is becoming a competitiveness factor for companies and countries.

We must be aware that members do not define a replacement rate at the outset but need to be accompanied and as administrators our task with each member consists in trying constantly, with simple concepts, to make that relationship one in which members are aware of what we are building.

In the Chilean case, which one might expect to be the system with most maturity, we still have much to do, but we also have an experience which indicates that when a member with mandatory savings is transformed into a client with voluntary savings, his/her perception of the system changes radically. This may not be so in terms of the perception of the quality of the service, but the perception of value, ownership and the contribution that that company is making to the member's future savings changes completely and a genuine client is achieved.

Pedagogical method and communication

A considerable amount of work has been done as regards pedagogical method and communication. Mario Marcel referred to a very important subject, namely the 2008 pension reform process in Chile. Certainly that process represents an experience from which other countries must learn.

As administrators, we also have to be a more empathetic industry, prepared to listen, understand the environment and identify the needs and expectations of the various population groups in dealing with the pension system (children, young people and elderly people). It is important to stress the "building the member's pension" point of view and concentrate less on the *"Asset Management"* point of view. In fact, more emphasis should be placed on the *"Wealth Management"* point of view.

I believe that the industry in that sense has also to take advantage of opportunities and produce power-ideas, but always starting from the basics: the industry must be able to show the benefits of the sustainable systems and to design solid communicational and relational strategies with the various groups in society to provide them with adequate information. These seminars are very important in that respect.

Opening an on-going, constructive dialogue is also vitally important, always with the outlook of fulfilling the promise of value and maintaining fair relationships with the various actors involved in the public policies of each country.

There is no doubt at all that setting up strategic alliances for financial and pension education in collaboration with the State is going to become increasingly necessary, on a large scale, and starting in primary and secondary education.

I cannot close these comments without emphatically naming the challenge that we have at this point in time: **to build and guarantee sustainable individually-funded systems, awakening in members and pensioners a sense of awareness and belonging when dealing with the system.**

It seems to me that we can coin certain concepts, such as "sustainability" for example, which I feel was a big issue at this seminar. Another key concept is that of "pension quality", a permanent challenge for us as an industry of course, and one on which we still have a long way to go.

A TRUST FOR PROMOTING AND DISSEMINATING THE FINANCIAL CULTURE OF SAVING FOR RETIREMENT

XAVIER DE URIARTE[1]

1 *Xavier de Uriarte is a Chartered Accountant qualified at the Instituto Tecnológico Autónomo de México (ITAM) and with a Master's in Business Administration from the University of Durham in the United Kingdom. He began work at the ING Bank Mexico, where he boosted the organization's corporate finance. Later on he formed part of ING Capital in New York. Before being appointed Managing Director of ING Mexico, he was the company's Vice-president of Subsidiaries and Deposits. With a career of over 20 years in the financial sector, he is currently Managing Director of SURA Mexico (formerly ING Mexico).*

This article describes a practical case that is being carried out in Mexico to promote and disseminate the financial culture of saving for retirement. This topic is of the greatest importance, since disseminating and promoting financial culture focused specifically on saving for retirement is a crucial, strategic issue that should be on every country's agenda, in order to achieve the legitimization of the individually-funded systems.

I. The initiative

The reform introduced in 1997 produced the need for an important cultural change in Mexico, namely, workers needed to become aware of their accounts, find out about their retirement savings and become involved in planning them.

Formerly there was a pay-as-you-go system, in which workers did not have the tangible relationship that they have today with their retirement accounts.

Since the creation of the new system of saving for retirement in 1997, the pension industry in Mexico has carried out some activities to encourage financial culture. For 2011, the Retirement Fund Administrators (AFORES) belonging to the Mexican Association of Retirement Fund Administrators (AMAFORE) made the commitment to reinforce the actions taken by each administrator for this purpose by setting up a trust for "Promoting and Disseminating the Financial Culture of Saving for Retirement".

An inter-institutional Committee was created, as an industry including not only the AFORES, but also representatives of the National Commission of the Savings for Retirement System (CONSAR), the National Commission for the Protection and Defence of Financial Service Users (CONDUSEF) and the Interactive Economic Museum (MIDE).

II. The strategy

In order to focus the design of the communication strategy effectively, various opinion studies were carried out, such as:

- Debates in families and focus groups to identify the existing perception and expectations concerning the AFORES and the Savings for Retirement System (SAR).

- A national survey of over 2,000 workers on their attitudes to saving.

- Interviews with leaders in the public and private sectors, the communications media, legislature, unions and the academic world.

What were the findings of these studies?

There were both positive and negative findings. For example, it was found that 57% of those interviewed do save, especially in the short term, which is good news. After 13-14 years, 59% already knew what an AFORE was, and that it was for ensuring a pension. It was also found that among account-holders of the AFORES, 92% read and keep their account statements, and that is a very real achievement for the system. Furthermore, it was found that for 81% of people, the balance of their savings is the most important piece of information.

On the side of the negative findings, one of the most important is that 62% believe that God will provide for their retirement. Also, 49% believe that their family will support them in the retirement period, something which is not feasible if one looks at the countries' demographic growth.

In June 2011, the results of this survey were presented to leaders of opinion in the public and private sectors, the academic world, the legislature and the media. Fortunately, the media have taken it as a point of reference, thus achieving the aim of making all players aware of the challenge that exists in Mexican financial culture.

On the basis of the results obtained, a long-term strategy was designed with four main thrusts: first, to generate confidence and knowledge among the system's members; second, to make members value their individual accounts; third, to get account-holders involved with their pension, with complementary or voluntary saving; and fourth, to ask members to absorb the advantages of the system.

This strategy's message is addressed to the 46 million workers currently included in the system, both registered workers[2] and the non-active or assigned workers[3], and of course to the families and potential account-holders who are not yet in the system (young people, independent workers, etc.).

III. Actions 2011

After making a demographic analysis of Mexico and understanding the socio-economic profile of the system's members, a communications campaign was mounted entitled "La Bartola", based on the character in a popular Mexican song. It is a simple campaign, which explains how important it is for workers to look after their AFORE Accounts, using simple, direct, light-hearted messages.

Taking advantage of the La Bartola character and the song, key messages were disseminated via the mass media. Publicity spots were transmitted on radio stations in 16 of the country's cities, reaching almost 8 million people. There was also presence in the free newspapers distributed in Mexico City, Guadalajara and Monterrey, reaching over 6 million people. The campaign was also publicised in metro-bus and metro stations and on public transport in the country's main cities, impacting around 200 million people.

Along with this, an agreement was reached with various companies that gave their support to this campaign, allowing access to 500 thousand employees in Mexico's most important companies by means of posters, triptychs and information videos.

The AFORES have also played an active part in publicising the campaign in the various points at which they have contact with their clients, including messages on the accounts statements. In order to support the union campaign, information was made available to workers at the different fairs organised by the CONSAR. Talks were also given on the functioning of the SAR for employees of Mexico's most important companies and at different universities. AMAFORE personnel also approached radio stations, with messages directly specifically at young people.

As regards digital communication, the institutional site of the AMAFORE was redesigned, and various social networks were set up (Facebook and Twitter). The new site has so far had 39 thousand visits. The site "Prepare your Future" was also created, dedicated to promoting the culture of saving for retirement, with a total of 14 thousand visits so far.

2 *Workers who registered in some AFORE. This includes independent workers and contributors to the Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (ISSSTE).*

3 *Workers who did not register in any AFORE and were assigned to one by the CONSAR in accordance with the rules currently in force.*

In terms of the evaluation that can be made of the campaign, it is necessary to emphasise the fact that it reached 12% of the people, which is a very acceptable percentage, considering that the campaign did not feature on television. In campaigns using similar means, the range reached is generally between 6% and 8%. The media with greatest impact were the radio and public transport systems such as the Metro and Suburban Train. The results indicate that the challenge lies in maintaining financial culture campaigns of this type in the long term, to really produce greater impact.

IV. What comes next?

2012 saw the commemoration of 15 years' existence of the SAR. Although there are some specific achievements in matters of encouraging financial culture, more actions need to be taken to increase knowledge about the workers' individual accounts. Advantage must be taken of forums such as that organised by the International Federation of Pension Fund Administrators (FIAP) to exchange strategies among the different countries, in order to be more precise in the strategies prepared by the industry. All Latin American countries have generally similar demographic and socio-cultural profiles, and one can learn from all of them.

In Mexico, particularly, actions will continue to be taken to generate knowledge and valuation among workers with regard to their AFORE accounts. And alongside that, we shall go ahead with implementing the actions designed to meet the objectives of the second stage of the strategy, which consists in reinforcing the relationship of trust between the AFORES and the workers. We shall continue with the various events, forums and analyses, dissemination via the mass media, specific actions in universities and with workers. An interactive room is also going to be opened in the MIDE, presided by Dr Agustín Carstens, Governor of the Bank of Mexico, on saving for retirement, which will be really important, because we were lacking a presence there. We shall also be reinforcing alliances with academic institutions.

For this type of initiative to be viable in the long term, the pension industry needs to make a commitment to fund it. But it is also important to produce links with other international bodies with experience in the matter. In that sense, to strengthen the Trust even further, it would be highly desirable for institutions such as the Organisation for Economic Co-operation and Development (OECD) or the Inter-American Development Bank (IDB), which are known to have a great deal of experience in this field, to join the project.

CLOSING LECTURE

GLOBALISATION AND FINANCIAL MARKETS: LESSONS TAKEN FROM THE MEXICAN CASE

AGUSTÍN CARSTENS[1]

1 *Agustín Carstens graduated from the Instituto Tecnológico Autónomo de México (ITAM), where he studied for a degree in Economics, graduating in 1982. He obtained a Doctorate at the University of Chicago (1985) and a Master's at the same institution (1983). He began a successful career at the Bank of Mexico in 1980 where he occupied various positions: manager of International Exchanges, Treasurer, General Director of Economic Research and Advisor-Director to the Governor of the Bank itself. He represented the interests of Spain, Mexico, Central America and Venezuela as Executive Director at the International Monetary Fund (IMF). Furthermore, from March 2007 to October 2009 he acted as President of the Development Committee of the IMF and World Bank. He was appointed Minister of Finance and Public Credit in December 2006 and held that post until December 2009 when he was put forward by the President of the Republic himself to be the new member of the Governing Board of the Bank of Mexico. This appointment was ratified by the Senate of the Republic and today he is Governor of that Central Bank.*

I. Introduction

The globalisation process has contributed a lot to the world in these past few years. It has undoubtedly brought great benefits, though, like everything else, it has not always been cost-free.

What are the benefits of globalisation? Undoubtedly the most obvious ones are the increase in commercial interchange and integration of production lines. It has also certainly led to larger sources of funding, to a better distribution of financial resources around the world and also to the possibility of diversifying risks more efficiently. All these benefits have certainly led to increased economic growth and in theory to greater welfare.

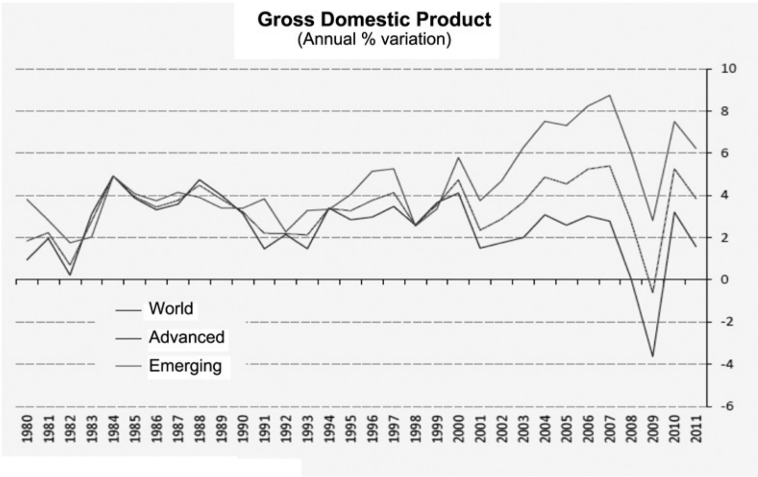
There have also been costs and exposures that have appeared hand-in-hand with the globalisation process. Among the costs we can mention the ever-faster transmission of negative shocks between economies: ever since 2008-2009 we have undoubtedly been experiencing this in a very obvious manner all over the globe. We have also seen increased volatility, mainly during periods of great confidence in the financial system. In some ways, this used to be thought of as a phenomenon exclusive to emerging countries, but now we are seeing it in advanced countries too: the possibility that there may be abrupt reversals of capital flows and the occurrence of the so-called “sudden stops” or abrupt halts in funding, which cause really serious difficulties for different economies.

Taking all this into account, I shall be looking at the benefits and the costs of globalisation. The message is a very simple one: a very good way for a country to be able to join in with globalisation in a decisive manner, taking both the benefits and the costs into account, is to try to have the best economic foundations. When all is said and done, these are what really anchor the main variables in the economy, and though they do not have the power to give a country immunity against the swings occurring in the world, they do ensure that the countries in question pursue a positive, upward course in the medium and long term, so that they do not fall into situations of sudden or recurrent crisis, such as were suffered for many decades by Latin American countries.

II. Globalisation and Financial Markets

Globalisation has also been reflected in a greater synchronisation of economic activity at worldwide level. In Graph Nº 1, based on information from the International Monetary Fund (IMF), two very interesting things stand right out. First, before globalisation began fully, in the early 1990s, advanced and emerging countries actually grew at relatively similar rates and without much synchronisation, whereas now, as globalisation has advanced, it can be seen that the difference in growth capacity between the zones has increased and it can be seen very clearly that since the beginning of this century, the emerging countries have taken off from the growth of the advanced countries. Secondly, the correlation or synchronisation in those movements has increased, and this is seen very eloquently with the most recent data. Certainly, the great recession, as the period from 2009 to the present is now being called, is something that has been reflected in practically all the countries in the world.

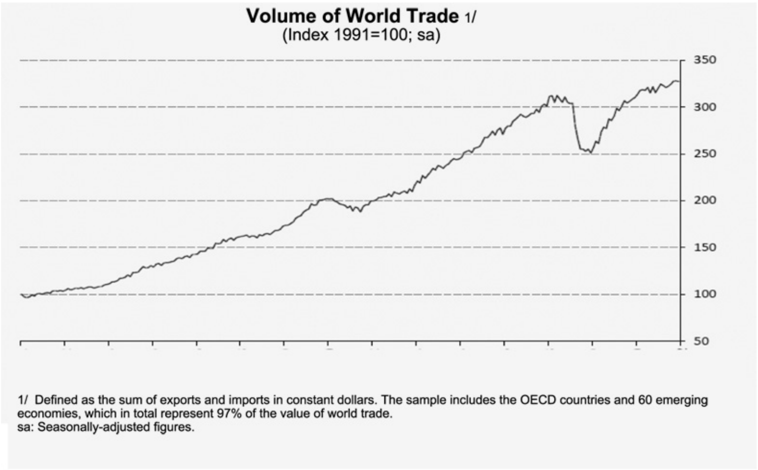
GRAPH Nº 1



SOURCE: INTERNATIONAL MONETARY FUND.

A very clear phenomenon that has been brought about by globalization is the very considerable growth in world trade (see Graph Nº 2). Really, the ease of exchanging merchandise with other countries simply broadens the markets, broadening countries' growth capacities, and that in general explains the fact that the world has a higher rate of economic growth, even though it is also more volatile. The series included in Graph Nº 2 is also very interesting from the point of view that over a very long period, since the beginning of the 90s, there has been a very clear upward trend, with very few exceptions. Then, as is no doubt blatantly obvious, came the very abrupt fall in international trade towards the end of 2008. This was perhaps the clearest manifestation in the globalised world of the collapse of the company Lehman Brothers which, at the end of the day, was the "last straw", to put it colloquially, of the great financial crisis that had been brewing in the U.S.A.

GRAPH Nº 2



SOURCE: CPB NETHERLANDS.

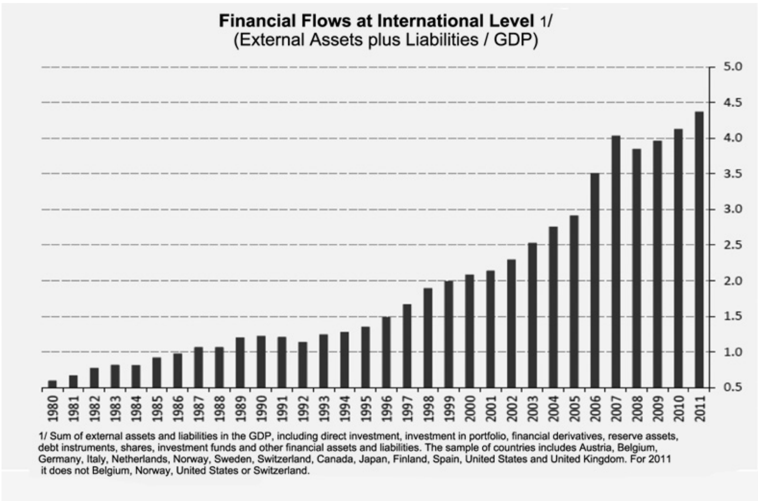
The bankruptcy of a very widely globalised and interconnected financial institution can have very severe consequences on international trade, especially affecting the funding channel. The main reason why trade actually collapsed at that time was because funding dried up from one day to the next on a financial line that is generally held to be very safe: the funding of foreign trade.

This phenomenon is also very close to Mexico. The basic factor that caused economic activity in Mexico to fall so precipitously was that exports from that country fell by about 30% in a matter of weeks, and that obviously meant a very pronounced fall in the GDP even in the first quarter of 2009. However, the funding of foreign trade, which was so critical, was re-established very quickly and in fact there have been positive economic growth figures for every quarter since the second half of 2009.

In Graph Nº 2 it is also possible to see how trade itself bounced back fairly quickly, though it still has not regained such a pronounced slope as it had before the crisis. In general that reflects the fact that the advanced countries have not recovered their growth rate and Europe in particular is involved in a very deep crisis.

The other phenomenon brought about by globalisation is undoubtedly the fact that financial systems have become far more integrated. There has been a tremendous increase in the flows of capital between countries, and that has obviously brought great benefits but also great challenges. The most serious consequence is undoubtedly the fact that very severe shocks can be transmitted by this route. Graph Nº 3 shows how the 2008 crisis interrupted a very important acceleration taking place in financial flows at international level. However, those flows have recovered an upward trend but, as we shall see further on, with great volatility. In fact, due to the interconnection of many financial institutions and systems at global level, a great effort has been made to reinforce the international financial system and reinforce minimum regulatory requirements. These are being expressed much more clearly through the recommendations of Basilea III, and Mexico will perhaps be the first of the G20 countries to incorporate these recommendations fully in its regulatory framework of banking supervision during the year 2012.

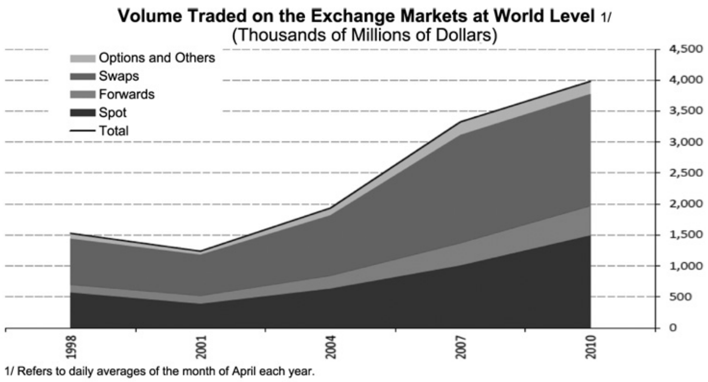
GRAPH Nº 3



SOURCE: INTERNATIONAL MONETARY FUND.

Obviously, with the increase in international trade and financial integration, the exchange of currencies has also increased tremendously (see Graph Nº 4). It is possible to see how exchange operations have increased exponentially at international level, and it is precisely in exchange rates that we see perhaps one of the first phenomena of financial integration and globalisation. Certainly, with far more flows, far more interconnection and far more complexity in the operations, there has not only been greater correlation in economic cycles, but also in movements of foreign currency.

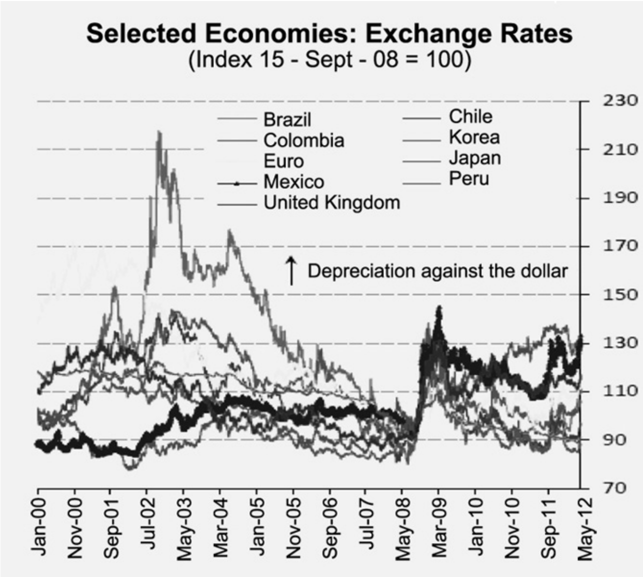
GRAPH Nº 4



SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS (BIS).

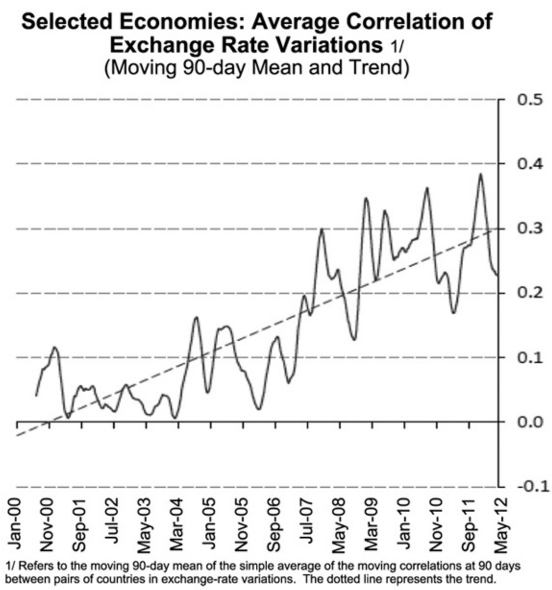
In Graph Nº 5 we see how the exchange rates of very different countries, such as Brazil, Colombia, the euro, the pound sterling, the Japanese yen, the Peruvian currency, etc. had quite dissimilar behaviour patterns prior to 2008. We see that subsequently the correlation of the movements has increased substantially. This can also be seen in Graph Nº 6, which estimates the average correlation between the different exchange rates and shows how that correlation has been increasing quite clearly since the beginning of this cycle.

GRAPH Nº 5



SOURCE: BLOOMBERG.

GRAPH Nº 6



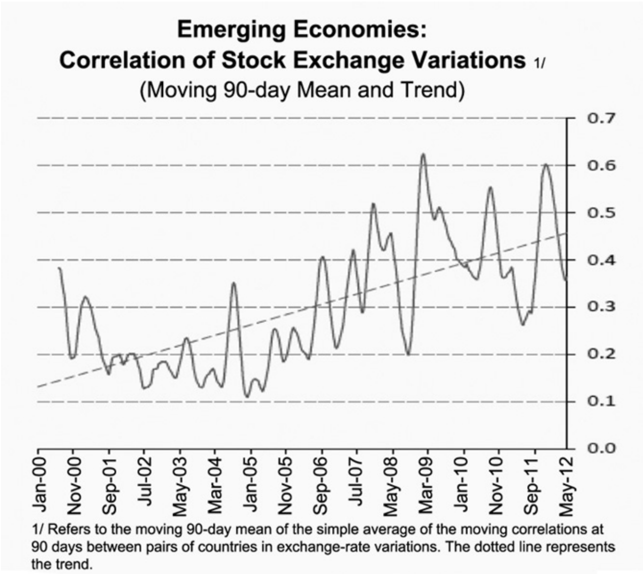
SOURCE: BLOOMBERG.

A similar trend has also been seen in the world's share indexes. We are already almost moving towards a single market. In Graph Nº 7 we see the correlation of the share indexes of different countries and in Graph Nº 8 the correlation of the volatilities of the various stock exchanges. It is possible to see an upward trend in the average correlation between the different indexes.

GRAPH Nº 7

SOURCE: BLOOMBERG

GRAPH Nº 8



SOURCE: BLOOMBERG.

Graphs Nº 9 and Nº 10 illustrate the difficulties facing fund-managers and authorities most clearly, because they show the dramatic increase in the volatility of capital flows. Instead of taking accumulative series over time, the graphs take the weekly flows of funds dedicated to emerging economies (debt and shares), showing the way in which integration has increased. Especially since the crisis, the volatility of the funds has been really incredible and extremely high. This illustrates to a large extent the set of problems being faced by many emerging countries, including Mexico, in recent weeks: these are countries that have healthy foundations, but they are experiencing massive volatility in capital flows as a result of external events (such as the crisis in Europe, for example). This constitutes a very important challenge which has to be faced, and the authorities need the flexibility and preparation that will enable them to face up to that situation. But certainly the industry that devotes itself to investment will also have to be ready to live with this panorama because, unfortunately, it is not going to improve much in the next few years.

In brief, before passing on to consider the case of Mexico more specifically it is worth summing up the benefits and costs of globalisation.

- Benefits: more trade and integration in production lines, additional sources of funding and the possibility of risk diversification.

- Costs: rapid transmission of shocks between economies, greater volatility in episodes of financial crisis and possibility of sudden reversals in capital flows.

This is the very reason why a country becomes less susceptible to being affected by capital flows insofar as it has solid economic foundations, because that makes it possible to maximise the benefits of globalisation and limit its costs. To what extent can costs be limited? Well, in the sense, of course, that if there is destabilising news in the world, the investments in a certain country would possibly tend to be held for a longer period insofar as its foundations are healthy, rather than increasing international volatility by adding the uncertainty that might be generated by weak economic foundations within a given country.

III. Lessons from Mexico's case

The Mexican economy has shown great resistance in the face of external shocks as a result of its solid macroeconomic foundations, such as:

- Fiscal discipline upheld by legal principles.

- A monetary policy aimed at achieving price stability.

- A well-capitalised financial system, with appropriate regulation and supervision.

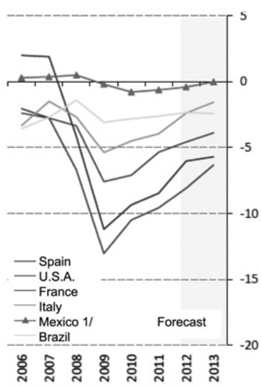
- A flexible exchange-rate scheme, which really allows us, to make adjustments in the real exchange rate by means of fluctuations in the nominal exchange rate, without producing severe impacts on inflation, enabling the national economy to absorb shocks from abroad.

In Mexico, the indicators that refer to public finance have recently been strengthened even more. In Graph Nº 9 one sees how the fiscal balance in Mexico has been practically maintained (this is without including the capital expenditure on PEMEX[2] which is a very profitable investment). Graph Nº 10 shows Mexico's debt-over-GDP ratio, which is a third of the debt over GDP of the advanced countries. A very interesting fact is the one included in Graph Nº 11, where it is possible to see how

2 *Petróleos Mexicanos.*

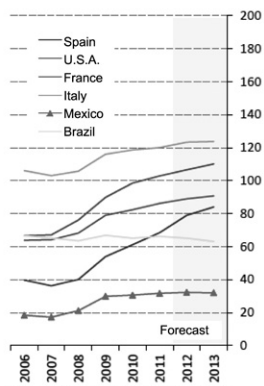
the weighted term of debt in Mexico is already far greater than the weighted term of the debt in the U.S.A. In 1994, the weighted term of Mexican debt was scarcely half a year, while today it is already over seven years, in circumstances where the average term of debt in the U.S.A. has been fluctuating at around five years. That is a very important sign of market confidence in the macroeconomic stability of Mexico and obviously, the Retirement Fund Administrators (AFOREs) have been very important contributors in extending the average term for debt.

Graph Nº 9
Selected Countries
Fiscal Balance
(% of GDP)



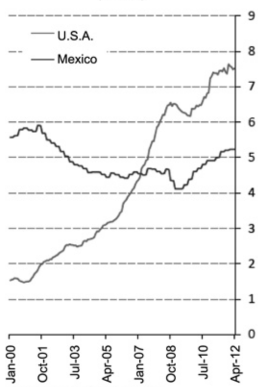
1/ Public Balance without investment in PEMEX.
Source: Fiscal Monitor (IMF) and Ministry of Finance and Public Credit (SHCP).

Graph Nº 10
Selected Countries:
Public Debt
(% of GDP)



Source: Fiscal Monitor (IMF) and Ministry of Finance and Public Credit (SHCP).

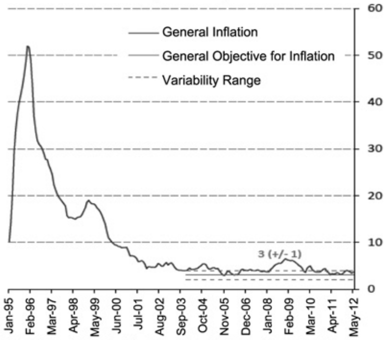
Graph Nº 11
Mexico and USA:
Average Weighted Term
Of Government Bonds
(Years)



Source: Bank of Mexico and Bloomberg.

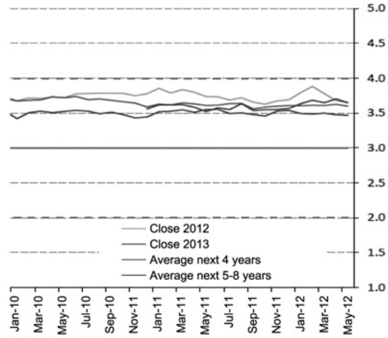
In Graphs Nº 12 and Nº 13 it is possible to see what has been achieved in terms of inflation. For the past several years, inflation has been kept within the Bank of Mexico's target, which is a specific target of 3% with a variation band of plus or minus 1%. Graph Nº 13 shows how inflation expectations have behaved up to terms of over 8 years and also how they are contained within that band of 3% and 4% for three and four years, which also reflects credibility in the Bank of Mexico's monetary policy.

Graph Nº 12
General Inflation 1/
(Annual %)



1/ The inflation of the month of May 2012 refers to the inflation of the first fortnight of that month.
Source: Bank of Mexico and INEGI.

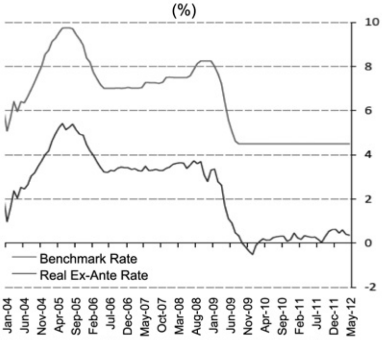
Graph Nº 13
Expectations of General Annual Inflation
(%)



Source: Bank of Mexico Survey.

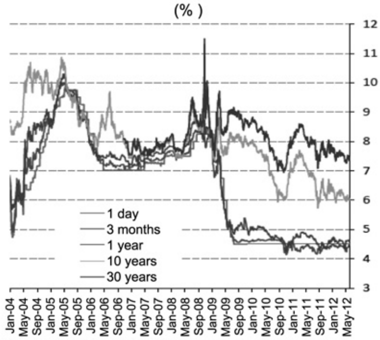
In this stable environment, it has been possible to lower interest rates very considerably. The benchmark rates of the Bank of Mexico, which have been constant for almost three years, are at zero in real terms ex ante, and that has not proved an obstacle to the fall of interest rates at practically all terms, including the very short term. The rates of CETES have been below the Bank of Mexico's benchmark rate (see Graph Nº14 and Nº 15).

Graph Nº 14
Mexico's Benchmark Rate and
Real Short-Term Interest Rate 1/
(%)



1/ Monthly average. The benchmark rate corresponds to the target for the Interbank Interest Rate at 1 day. For calculating the real (ex-ante) interest rate of Mexico, the nominal rate is used (Cetes at 28 days), subtracting the expected inflation at 12 months.
Source: Bank of Mexico.

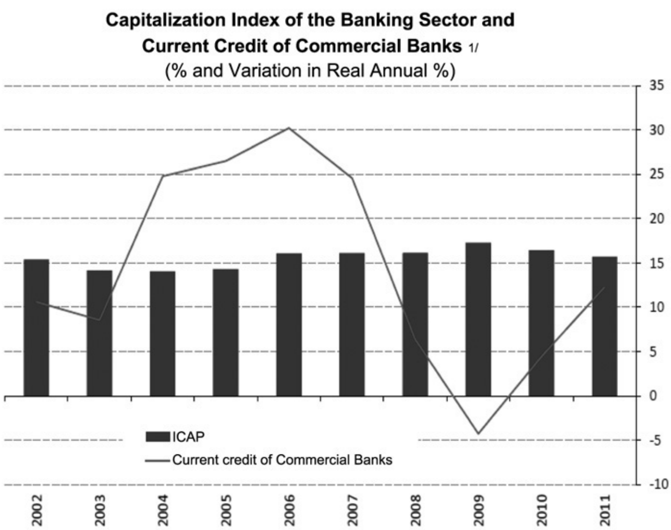
Graph Nº 15
Interest Rates of
Government Securities 2/
(%)



2/ as from 21st January 2008, the interest rate at 1 day corresponds to the target for the Interbank Interest Rate at 1 day.
Source: Bank of Mexico and Complete Price Provider (PIP).

Graph Nº 16 shows the performance of bank capitalization and how credit has been gradually increasing in real terms. Credit in Mexico is currently growing at about 10% in real terms. This is also quite encouraging in the midst of this whole crisis, because the level of capitalization in the Mexican banking sector has not been affected. It is true that there was a considerable credit squeeze, but that was more than anything the result of the prudence of the financial institutions in the face of the great uncertainty that surrounded the Mexican economy after 2008. Here one can see precisely how the growth rates of consumer loans, housing loans and corporate loans are growing at quite reasonable rates and this has been happening with a relatively low level of default.

GRAPH Nº 16

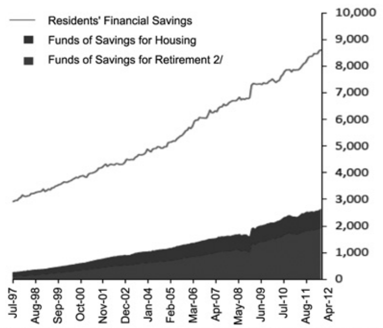


1/ THE CAPITALIZATION INDEX OF THE BANKING SECTOR (ICAP) INCLUDES COMMERCIAL BANKS AND DEVELOPMENT BANKS.
SOURCE: NATIONAL COMMISSION OF BANKING AND SECURITIES (CNVB) AND BANK OF MEXICO.

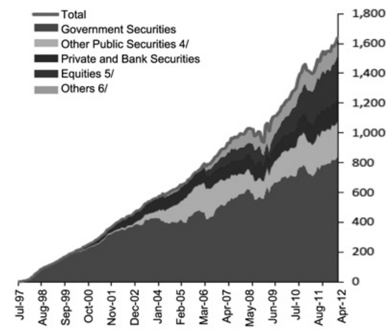
For a country's development it is certainly very important to have financial savings that are adequate and above all, growing, and that is what has been happening in Mexico. Graph Nº 17 shows a breakdown by type of savings. It identifies residents´ financial savings and also savings that are mandatory, originating in the savings funds for retirement and housing. There one can see that that scheme has also been very important in increasing saving in Mexico, and since the Investment Companies

Specialising in Funds for Retirement (SIEFOREs) are also very important purchasers of different securities, they have obviously given the financial market great depth (see Graph Nº 18).

Graph Nº 17
Residents' Financial Savings 1/
(Balances in Thousands of Millions of Pesos of Dec.11)



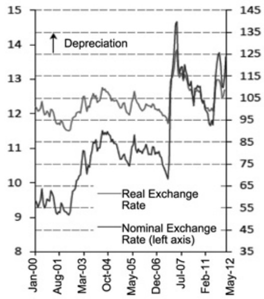
Graph Nº 18
Siefores' Securities Holdings 3/
(Balances in Thousands of Millions of Pesos of Dec.11)



1/ Defined as the M4 of residents plus the SIEFOREs investment in external debt and equities. 2/ In addition to the SIEFOREs securities holdings, includes the pension bond and the deposits of ISSSTE workers in the Bank of Mexico, and the concentrating account of the IMSS workers. 3/ Corresponds to the Basic Siefores included in the definition of Mandatory Savings. 4/ Includes IPAB securities, Share Certificates of Highway Compensation, securities issued by public companies and bodies and by states and municipalities. 5/ Includes Development Capital Certificates (CKDs). 6/ Includes deposits constituted in the Bank of Mexico on behalf of workers, derived from the reform of the ISSSTE Law published in the Official Gazette on 31st March 2007, other instruments placed abroad and in M.E. and Mexican sovereign bonds placed in international markets and denominated in foreign currency (UMS). Source: Bank of Mexico.

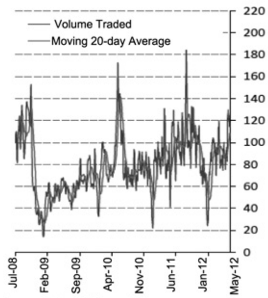
The flexible exchange rate scheme has been a very important factor in all the tools that we have available to confront external shocks. In Graph Nº 18 the distinction is made between nominal exchange rate and real exchange rate. The real exchange rate is one of the most important relative prices in the economy and, among other variables, depends directly on the nominal exchange rate, on exports and on how the flexibility in the nominal exchange rate has been reflected in the flexibilities in the real exchange rate. This is essential in order to be able to absorb external shocks. For example, if Greece, Spain or Portugal had that flexibility today, they would undoubtedly be in a better position to face up to their present crisis.

Graph Nº 19
Exchange Rate vs. U.S. Dollar 1/
(Index Jan.2011 = 100 and Pesos per Dollar)



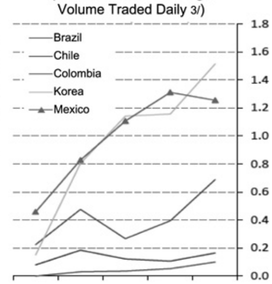
1/ Real exchange rate as of April 2012; nominal exchange rate as of May 2012.
Source: Bank of Mexico.

Graph Nº 20
Volume Traded on the Exchange Market
(Index 01-Jul-2008 = 100)



Source: Bank of Mexico and Reuters.

Graph Nº 21
Selected Currencies: Volume Traded on the Global Exchange Market 2/
(% Distribution of Average Volume Traded Daily 3/)

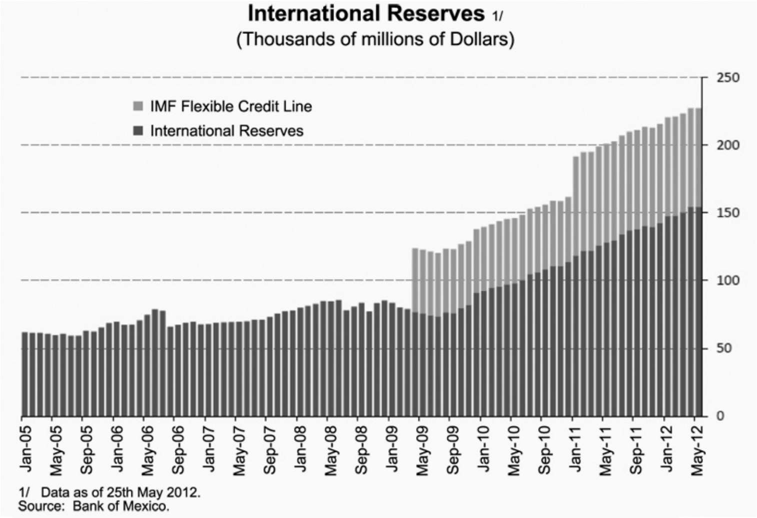


2/ Due to the fact that two currencies are involved in each operation, the sum of the percentages of participation of each currency is 200% instead of 100%.
3/ Data corresponding to the month of April each year.
Source: Quarterly Survey of the BIS.

The exchange market in Mexico is the deepest and most liquid of all Latin America and, following only behind Korea and Singapore, is the market with most depth and volume (See Graphs Nº 20 and Nº 21). This has made it possible for many investors to attempt to cover their positions in moments of volatility by trading in pesos. This has meant that when there is a trend towards appreciation, the peso tends to appreciate more and when there are movements towards depreciation, due to some far-reaching external shock, the peso tends to depreciate somewhat more.

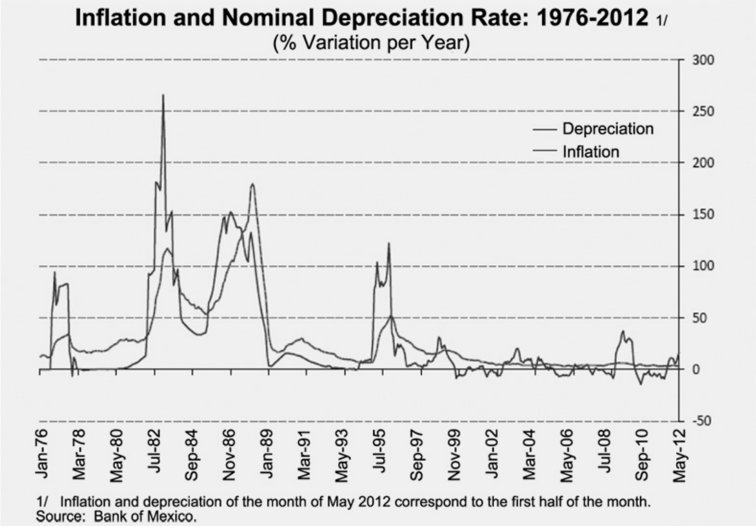
Mexico is quite well-equipped to confront volatility in the event of its being necessary to use resources to stabilise the market. Today it has a reserve of USD 154 thousand million, plus a flexible credit line of USD 75 thousand million with the IMF (see Graph Nº 22). That covers the whole of the country's external debt and the amount is more than double the public debt. This therefore constitutes a very important complement to the country's exchange-rate flexibility.

GRAPH Nº 22



In Graph Nº 23 it shows precisely how the impact of depreciation on inflation has been falling. The reduction in the transference of exchange fluctuations to inflation has increased the degrees of freedom for facing up to external shocks.

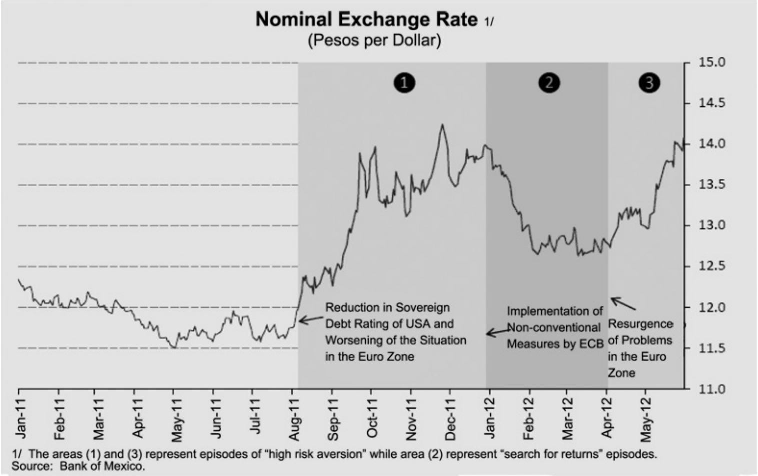
GRAPH Nº 23



Given the high liquidity of the Mexican peso at worldwide level, its market value usually responds quickly to changes in risk aversion in international markets. Since the summer of the year 2011, which is when the credit rating of U.S. debt was lowered and very substantial doubts were expressed regarding the health of Italy, Spain and even the payment of the Euro, the volatility of the markets has increased enormously and this was reflected in a very considerable depreciation of the peso (section 1 of Graph Nº 24).

In section 2 of Graph Nº 24 it is possible to see the appreciation of the peso. That appreciation occurred as a result of actions on the part of the European Central Bank (ECB), that were quite effective, though only temporarily useful, in greatly expanding liquidity. Risk aversion was substantially reduced and that produced a great appreciation of the Mexican peso. However, since April 2012 (section 3 of Graph Nº 24) the stabilisation efforts in Spain have not progressed as much as was desirable and certain adverse political developments have led to greater doubt about the future of Europe, especially the elections which have not been resolved, as in the case of Greece, and to a certain extent in France, and this has generated a process of great uncertainty at international level.

GRAPH Nº 24



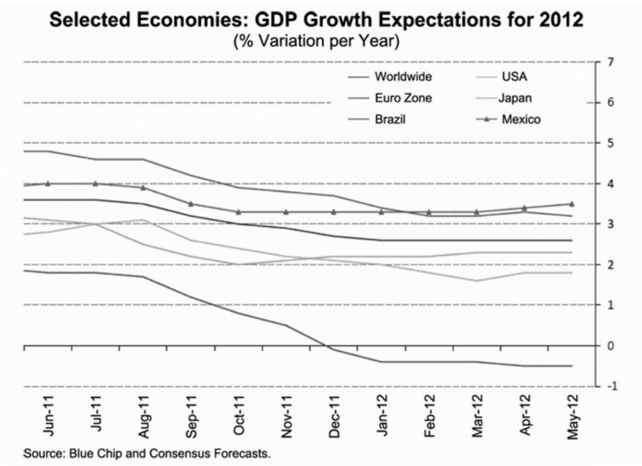
In the mind of many investors, the likelihood of a catastrophic event at international level has increased. What is that catastrophic event? A much greater crisis in the Euro, and that is what has caused resources to be channelled on different occasions into what are called investment refuges or "safe havens", above all the U.S.A. What is happening is that a large proportion of markets have ceased to discriminate between countries; they do not in fact take any notice of the intrinsic strengths of some countries, and mass redeployments take place. That is what produces this exchange-rate volatility that affects practically all countries.

In periods of uncertainty, the peso has shown greater deterioration than other currencies, while in the 'search for returns' episode, it became stronger. In episodes of uncertainty the Mexican peso tends to depreciate a little more and this is precisely because the Mexican market is so liquid that investors who have positions in Colombia or Peru, or even in some other emerging country such as South Africa, tend to hedge themselves in the Mexican market, and that exaggerates or increases the volatility.

In reality, this is a phenomenon that we shall have to learn to live with. A possible solution is to make the market less liquid, perhaps making it more complicated for different investors to participate in the market, but we think that that is a wrong way, which would not lead us to a good result. Above all, we have attempted to introduce clear mechanisms based on rules, so that in very specific situations, especially where there is lack of liquidity, the Bank of Mexico will inject some liquidity into the market. That is what has been done using the following mechanism: if the exchange rate depreciates more than 2 per cent from one day to the next, the Bank of Mexico immediately opens an auction for USD 400 million. That has tended to help us, but we are "believers" in allowing the exchange rate to function as broadly as possible and introducing mechanisms simply to smooth the movements, especially when the markets are not operating fully and when the guarantee that we offer on the stability of the Mexican peso in the medium and long term really depends on the commitment to maintain the country's healthy economic foundations.

That has served Mexico quite well. The country risk has remained very stable, obviously far below that of practically all the European countries and also within the lower levels among emerging countries. This is also reflected in the fact that a relatively good growth rate has been maintained. Graph Nº 25 shows the forecast for the growth in GDP for the year 2012 and it can be seen that the growth in Mexico, around 4%, is much higher than that of the advanced countries and even of several emerging and emblematic countries, such as Brazil, for example.

GRAPH Nº 25



IV. Final Considerations

It might be said that globalisation, the financial integration of the world, has been useful and beneficial, but it has not been cost-free. Above all, with what is going on in Europe, many voices are saying that we should lean much more towards a more nationalistic view. In fact, we have seen that many countries have even fallen into the temptation of taking protectionist measures, limiting the movements of capital, etc. I think that, in reality, in the medium and long term, regressing to closed, inward-looking economies would be a mistake.

It would have an extremely high cost and, for that very reason, I believe that the emphasis should rather be on what countries can do to enable this globalisation and financial integration to keep going, but with larger safety margins. Here action must obviously be taken at local level. My conviction is that the most useful course is to maintain a healthy macroeconomic framework in fiscal, monetary and financial terms, using and influencing greater structural flexibility of the economy, so that it can grow and be competitive. And at international level, many efforts also need to be made to make flows more stable, definitely to give more solvency and solidity to the great international financial institutions and reinforce multilateral bodies such as the IMF and World Bank, which also help to mitigate some of the destabilising phenomena that have appeared in the world.

The external conditions suggest a relatively modest world growth over the next few years. The international conditions will therefore not necessarily be propitious for achieving the growth rate that Mexico needs to reach significantly higher levels of development.

In that context, it is vital to maintain the strength of the macroeconomic foundations in order to strengthen internal sources of growth and continue with the process of structural change in the economy, which calls for on-going, constant efforts.

The final message is that we must continue with our commitment to openness and integration and to benefit from the international, commercial and financial markets, but this must be done with responsibility at both local and international level.

CLOSING REMARKS

I want to thank the Mexican Association of Retirement Fund Administrators (AMAFORE) and its president, Oscar Franco, very specially for the hospitality received and for the gigantic effort involved in organizing this seminar with such a large and distinguished audience.

Within a few hours we shall be returning to our countries and leaving this beautiful country behind. We are taking in our luggage a vast set of challenges that are being faced by our pension systems based on individual funding. However, I believe it was good to have the cathartic experience of requesting an explanation of the European situation, because it has reinforced our conviction that we are on the right track. The unsustainability of the European pension systems as a consequence of the deep demographic changes affecting the world has been made patently obvious in the inability of those systems to provide the benefits that they themselves had claimed as "defined". However, though the international crisis has hit the pay-as-you-go systems very hard, it is also true that the individually-funded systems have been affected, as we have been able to see throughout this session.

With the systems practically reaching maturity, there is concern about what the replacement rate will be, since this depends on yield and contribution density. Although yield has been very good, there is no knowing what level it will reach in the future. At the same time, the replacement rate may well be affected by low contribution density, which is very common in economies like ours, with a high degree of informality. Here we have heard opinions that suggest looking again at retiring ages, contribution amounts and the possibility of boosting voluntary pension saving more effectively on the basis of behavioural economics. There is no doubt that the amount being paid in contributions is insufficient, given the increases that are occurring in life expectancy.

I am convinced that we are going to face deep changes and enormous challenges in the future, and for that very reason it seemed to us that it would be extraordinarily interesting to tackle these issues and highlight the fact that pension reforms must be surrounded by an institutional environment that makes them workable and serious. It was very telling to contrast the case of the Pension Reform in Chile with the case of the Pension Reform in Argentina. It was also important to hear the evidence that Mario Marcel, president of the Presidential Advisory Council for Pension Reform (the Marcel Commission), came to give us on what was involved in the process of reform for the Chilean case: after 30 years in operation, it became necessary to look at what was happening with those workers who would never manage to fund a sufficient pension, due to their degree of informality, lack of contribution density or, simply, their poverty. The procedure adopted by that commission in gathering opinions and structuring a modification speaks of the seriousness with which the process was approached.

Unfortunately, we see certain negative elements on the horizon. Economic crises always produce impatience and also produce ideas that do not necessarily lead in the right direction. For that reason, I hope that this seminar, with all the speeches that we have heard here, has produced concern and some guidance as to how we should continue conducting our processes in order to obtain the best pensions for our workers and greater economic development in our countries.

I hope that all that has been discussed will be useful and that we can improve the way these systems work.

We look forward to seeing you in 2013 on 11th and 12th April in Cartagena de Indias, Colombia, where the next International Seminar and Annual General

Meeting of the International Federation of Pension Fund Administrators (FIAP) will be held.

Thank you very much, and have a safe journey home.

Guillermo Arthur
President FIAP

EARLIER FIAP PUBLICATIONS

EARLIER FIAP PUBLICATIONS

One of the aims of our Federation is to make known the advantages of pension systems based on individual saving and support the governments that wish to adopt them. With this in view, one of our regular activities as a Federation is the organization of seminars and round-tables. As a result of these activities, FIAP has published ten books, which summarize the presentations given at those seminars, and are sure that these have contributed towards improving the literature on this subject. These books are described below:

"Regulación de los Sistemas de Pensiones de Capitalización Individual: Visiones de los Sectores Público y Privado" (Seminar held in Lima, Peru, December 2002). [1 2]

This publication tackles aspects such as the challenges of the new pension systems, the models and priorities of supervision, collection of contributions and management of individual accounts, coverage, regulation and supervision in the area of benefits, price formation in the social security industry, regulation and supervision of marketing and sales, and regulation and supervision of pension fund investments. The authors deal with these subjects from different points of view, which contribute to an enrichment of the debate on the subject of pensions in the countries that have carried out social security reforms, especially in Latin America.

1 *This book is the only one on the list that was published not by FIAP, but by the International Labour Office (ILO). However, it is included on this list because the seminar on the basis of which it was written was organized jointly by the International Association of Pension Fund Supervisory Authorities (AIOS) and FIAP.*

2 *This book is not available in an electronic version on the FIAP website.*

"Pension Reforms: Results and Challenges" (Seminar held in Cancun, Mexico, May 2003).

In this book an analysis is made of the results of the new social security systems, both in Latin America and in Central and Eastern Europe, from the point of view of how they have influenced improvement in pensions and contributed to the growth and economic development of the countries. In order to do this, it reviews the rates of return of the investments of social security resources and matches them with the growth of workers' wages. At the same time, it measures the impact of the reforms on savings and investment, thereby attempting to measure the contribution that they signify for the economic development of the country. There is also an analysis of the main challenges in the social security area for the industry, the regulators and the political system.

"Pension Reforms in Eastern Europe: Experiences and perspectives" (Seminar held in Kiev, Ukraine, May 2004).

This book summarizes the experiences of social security reforms in the countries of Central and Eastern Europe, such as Bulgaria, Croatia, Hungary, Poland, Kazakhstan and Kosovo. Also presented are the main perspectives for reform in Slovakia and Macedonia. The common denominator in all these countries is that they possess individually funded systems in expansion. The book follows with an analysis of the challenges for implementing reforms, in terms of the regulation and supervision of pension funds and their fiscal and economic impact. The book concludes with an analysis of the conditions necessary to ensure the success of the reforms.

"Pension Fund Investment" (Seminar held in Lima, Peru, November 2004).

This book contains a diagnosis of pension fund investment regulation in Latin America. It contains an analysis of the improvements to that regulation, dealing especially with the case of the multi-fund system in Chile, Mexico and Peru. It also looks in depth at the development of the capital markets and analyses the political risks of pension fund investment in the region. Among the most important conclusions to be drawn from the aforementioned subjects are the role of the yield of the investments as a deciding factor in improving pensions and the need for greater diversification, including investment abroad.

"The Strengthening of the New Pension Systems: The Role of each pillar in the Solution of Pension Problems" (Seminar held in Cartagena de Indias, Colombia, May 2005).

This publication analyses reforms to social security systems that have included mandatory individual capitalization/funding systems in their second pillar, in response to the criticisms and objections that are being leveled at them, and analyses future improvements. The role of each pillar within the social security system is highlighted and an in-depth study made of the structure of first pillar programs in Latin America. The key issues of mandatory contribution programs in the second pillar are reviewed and experience in the area of voluntary social security saving (third pillar) is described. One of the most important conclusions arising from the discussion is that the criticisms made of the mandatory individual saving systems are seen to include aspects that, though part of social security, are not the responsibility of the contributory systems, as is the case of coverage.

"Pension Funds Investment Perspectives" (Seminar held in Santiago, Chile, May 2006).

This book discusses which are the best alternatives for pension fund investment. The facts show that 1% of additional yield over the course of the whole working life of a member of a pension fund administrator may result in a pension that is 30% higher. To corroborate this, an in-depth analysis is made in this publication of issues such as the historic performance of the pension funds in Latin America, the regulation and control of investment risks, the best portfolios for social security funds, the characteristics of the multi-fund systems, the strategies for the international diversification of pension funds, the financial impact that occurs in the stage just prior to retiring age, and the importance of corporate governance in pension funds.

"Funded Systems: their contribution towards solving the pension problem" (Seminar held in Varna, Bulgaria, May-June 2007).

In the first instance, this book shows the political economics of pension reforms, taking into account the experience of countries in Central and Eastern Europe and also the pension reforms in Bulgaria and Mexico. Secondly, it analyses the results of the pension reforms for the workers, separating the effects on the labour market and on redistribution of income. An analysis is also included of the workings of the Disability and Survivorship Insurance (DSI) in the Chilean case. Thirdly, it shows how to structure an effective multiple-pillar system in the light of the new Chilean pension reform, the public/private ratio in the pension reform, the design alternatives for non-contributory pension programs (social pensions), and the fiscal effects of the pension reform in Chile. A fourth set of issues analyzed here concerns the investment policies and strategies of the pension funds, experiences and trends in multi-fund systems and regulation and monitoring of investment risk in mandated, defined-contribution systems. Finally the book culminates with a number of different views of the prospects for the pension reforms in Europe.

"Pensions for the Future: Developing Individually Funded Programs" (Seminar held in Lima, Peru, May 2008).

This book analyzes the performance of the new pension systems in Latin America and Central and Eastern Europe, describes the progress of pension reforms in countries that have recently begun to implement them or are about to do it in the near future, and identifies best practices for improving the design of regulations in the individual capitalization programs. It examines issues related to the lessons of pension reforms, investments regulation, supervision models, coverage, pension modes, pension business management, and disability and survivorship insurance in the cases of Argentina, Chile and Mexico. It also discusses the pension reforms in China, Philippines, Romania and New Zealand. It also analyzes the future of pensions in Peru, addressing the issues of pension coverage, quality of social protection, capital markets, and the supervisor´s vision. Finally, the book ends with a discussion on whether the battle of public opinion regarding the pension reform has been won.

"Investments and Payouts in Funded Pension Systems" (Seminar held in Warsaw, Poland, May 2009).

The book is divided into nine chapters. The first four chapters refer to subjects related with the pension accumulation phase, whereas the other five chapters show issues inherent to the payout phase. The first chapter of the book deals with the pension fund investment performance. In the second chapter, the book asks how much financial risk level a funded system may accept, showing the life-cycle risk perspective in the context of pensions. The third chapter shows the close relationship between economic cycles and pension funds. Chapter four shows the current trends in pension fund investments and presents the views of three outstanding speakers on infrastructure investments, thematic investments and Exchange Traded Funds (ETF), respectively. Regarding the pension payout phase, chapter five refers only to the matter of explaining the optimal pension modes in an obligatory pension system. Chapter six analyzes the market annuities of and scheduled withdrawals from the commercial and descriptive angles. Chapter seven contains issues that are of vital importance for an adequate development of the pension market: the keys for success in the annuities market, the challenges involved in the selection of products during the payout phase and an explanation on why the funded pension systems will be better able to face the demographic challenges than the PAYGO systems. The second-to-last chapter deals with the perspectives of the Polish pension system. Finally, the book finishes with chapter nine, a review of the future of mandatory pension funds in Europe and beyond, describing the financial crisis implications for the private pension funds, commenting on the lessons derived from the crisis for the funded pension systems and stating the medium-term challenges to reform the mandatory pension funds in Europe and other industrial countries.

"Developing the Potential of the Individually Funded Pension Systems" (Seminar held in Viña del Mar-Chile, May 2010).

The publication provides the reader with several articles that seek to identify means and instruments whereby pension fund managers can extend the contribution they make to solve the pension problem and, in more general terms, improve the quality of the population's social protection. Papers presented by renowned academics and authorities are featured at the beginning of the book. They address the seminar's subjects with a practical and objective focus aimed at highlighting the characteristics and concrete results of policies, products and organizational and management models that can serve as a reference for innovating and improving the processes and regulations of pension fund managers and regulators.

The book is divided into three parts. The first part, "How can the Coverage of the Individually Funded Programs be Extended?", explores different ways in which the funded programs can extend their coverage to sectors of the population that are not currently engaged in pension saving. The second part, "New Products", explores ways in which the pension industry can use its experience and capacity to advantage to address other social security protection needs of the population. The third part, "The Quest for Excellence", is divided into three chapters. The first, "Pension Information and Education," analyzes the role played by financial education within the context of defined-contribution pension systems from the standpoint of the industry and the supervising agencies. The second chapter, "Ideas for Improving Operational Efficiency," analyzes the organization and process alternatives that enable the operational management and efficiency of the industry to be improved. Finally, the third chapter, "Ideas for improving the impact of investments on local economies," analyzes the investment alternatives available to the pension funds in housing, infrastructure and micro-companies.

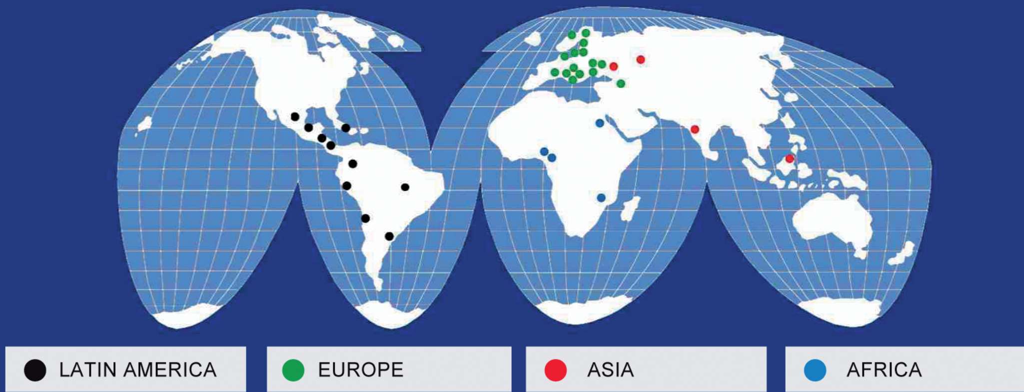
"Advancing in the Strengthening and Consolidation of the Individually-Funded Pension Systems" (Seminar held in Punta Cana-Dominican Republic, May 2011).

This book provides the reader with various studies analyzing different issues related with pension fund investment (best practice in the design of investment policies; impact of pension funds in the development of infrastructure projects and securitization of assets) and the benefits granted in the payout phase (pension options, advantages and disadvantages; replacement rates and adequacy of contributions), and also presents experiences and proposals that enable continued progress to be made in strengthening and consolidating Individually-Funded Pension Systems, after the global financial crisis of recent years. Additionally, the book analyzes, from the points of view of the industry and the international organisations, the topic of implicit and explicit public debt generated by pension systems, its accounting and impact on the creation and development of individually-funded programs, in the light of recent events in Central and Eastern Europe.

For your information, these publications are available in an electronic version on the FIAP website, <http://www.fiap.cl>, in the "FIAP Publications/Books" section. Copies of these publications may be obtained writing to e-mail: <fiap@fiap.cl>.

This book was printed in the workshop of
Imprenta Salesianos S.A.
General Gana 1486
www.imprenta-salesianos.cl
Phone: (56-2) 2 2530 79 14 Fax: (56-2) 2 2530-79 82
Santiago - Chile

COUNTRIES WITH REFORMED PENSION SYSTEMS (1)



Latin America		Europe		Asia		Africa	
Chile	1981	Poland	1999	Kazakhstan	1998	Nigeria	2005
Peru	1993	Sweden	1999	India(*)	2004	Ghana	2010
Colombia	1994	Latvia	2001	Brunei	2010	Egypt(**)	
Uruguay	1996	Bulgaria	2002	Armenia(***)		Malawi(**)	
Mexico	1997	Croatia	2002				
El Salvador	1998	Estonia	2002				
Costa Rica	2000	Kosovo	2002				
Panama(*)	2002	Russian Fed.	2003				
Dominican Republic	2003	Lithuania	2004				
Brazil (*) (**)	2013	Slovak Rep.	2005				
		Macedonia	2006				
		Romania	2008				
		United Kingdom	2012				
		Ukraine(**)					
		Czech Republic(**)					

The year given corresponds in each case to the beginning of mandatory funded pension system's operations.

(1) Information updated to October 31, 2012.

(*) Reform for civil servants.

(**) Reform approved but not yet implemented.

(***) Reform proposed but not yet approved or implemented.

FIAP
FEDERACION INTERNACIONAL DE ADMINISTRADORAS DE FONDOS DE PENSIONES
INTERNATIONAL FEDERATION OF PENSION FUND ADMINISTRATORS

www.fiap.cl