Pension reform in Latin America

Main developments and lessons learnt

Amsterdam, NL

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Outline

I. Background and main features

II. Outstanding results and impacts

III. Recent developments

IV. Main experiences and lessons

I. Background and main features

DB to DC pension reforms in Latin America

		Type of system		
Country	year	unique	complementary	by choice
Chile	1981	●		
Peru	1993			●
Colombia	1994			●
Argentina+	1994			●
Uruguay	1996		●	
Bolivia	1997	●		
Mexico	1997	●		
El Salvador	1998	●		
Costa Rica	2000		●	
Dominican Republic	2003	●		

Source: FIAP
+ Reversed in 2008

Main common features

- Replacement of traditional/“pay-as-you-go”/ DB schemes by DC models
- Mandatory
- Individual accounts
- Fully funded
- Close link between contributions and benefits
- Private management by specialized firms
- Transitional measures (recognition of acquired rights)
- Guarantees (minimum pension and/or rate of return)
- Government regulation and supervision

Multi - pillar models with different approaches

	Chile	Colombia			Mexico	Peru		
Third Pillar	Voluntary contributions with tax incentives	Voluntary contributions with tax incentives			Voluntary contributions with tax incentives	Voluntary contributions without tax incentives		
Second Pillar	Individual accounts, private management	Individual accounts, private management	Choice	Defined benefit, pay-as-you-go; government management	Individual accounts, private management	Individual accounts, private management	Choice	Defined benefit, pay-as-you-go; government management
First Pillar	Non-contributory scheme focused on low-income population	Guaranteed benefits for low income wage earners			Guaranteed benefits for low income wage earners	Subsidies to low-income wage earners to reach minimum pension Non-contributory scheme focused on population under extreme poverty condition		

Source: FIAP.

II. Outstanding results and impacts

Outstanding results

- The main goal of any pension system is to deliver the best possible benefits to its members (usually expressed in terms of a replacement rate)
- In most Latin American countries under DC/individual accounts schemes, it is too early to assess such goal.
- However, it is relevant to analyze the main factors that will affect those replacement rates
- Not being a goal by itself, it is also important to assess the impact of pension reform on financial markets and on the economy as a whole, since the outcome of the reform is closely connected both to the macroeconomic performance and to the specifics of capital, labor and insurance markets, amongst others.

Pension replacemet rates depend on several factors:

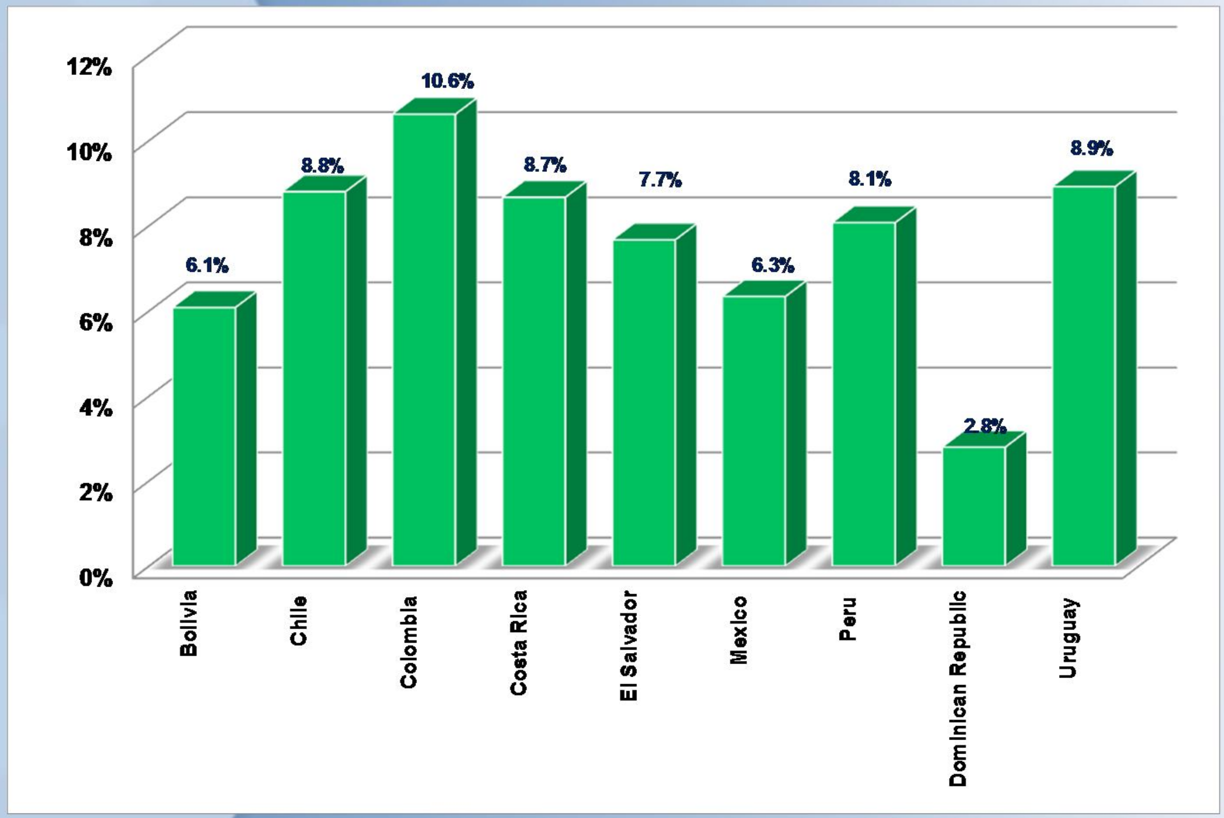
- Return of funds, net of fees and charges
- Contribution “density”
- Contribution rate (as a percentage of wage)
- Retirement age and life expectancy at de-accumulation phase

An efficient fund management is a necessary, but not sufficient condition, to deliver good replacement rates

High real returns will contribute to better pensions

Historical real returns

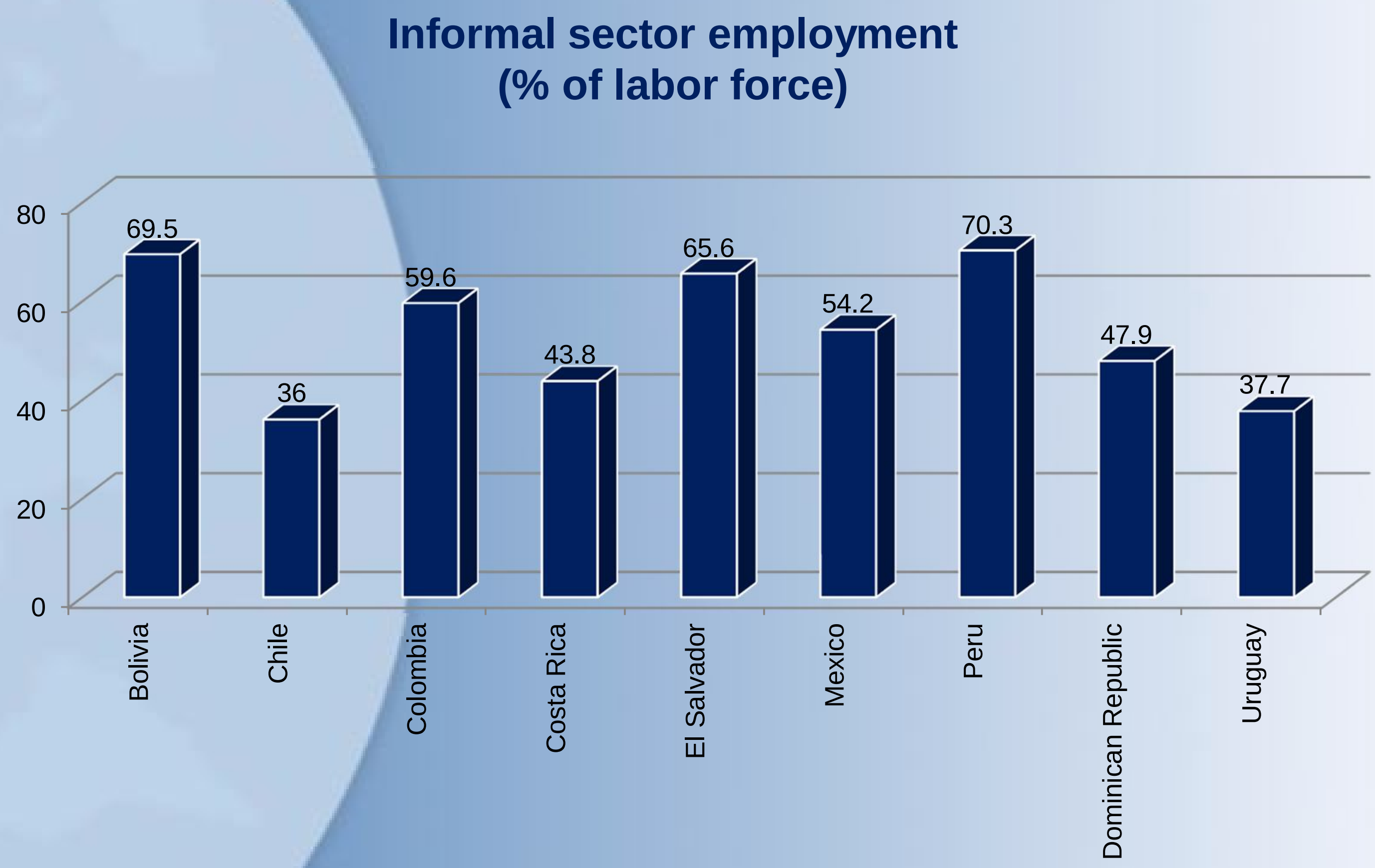
(annual average as of December 2011)



Keener competition and the downward trend of fees have increased net returns

Source: FIAP.

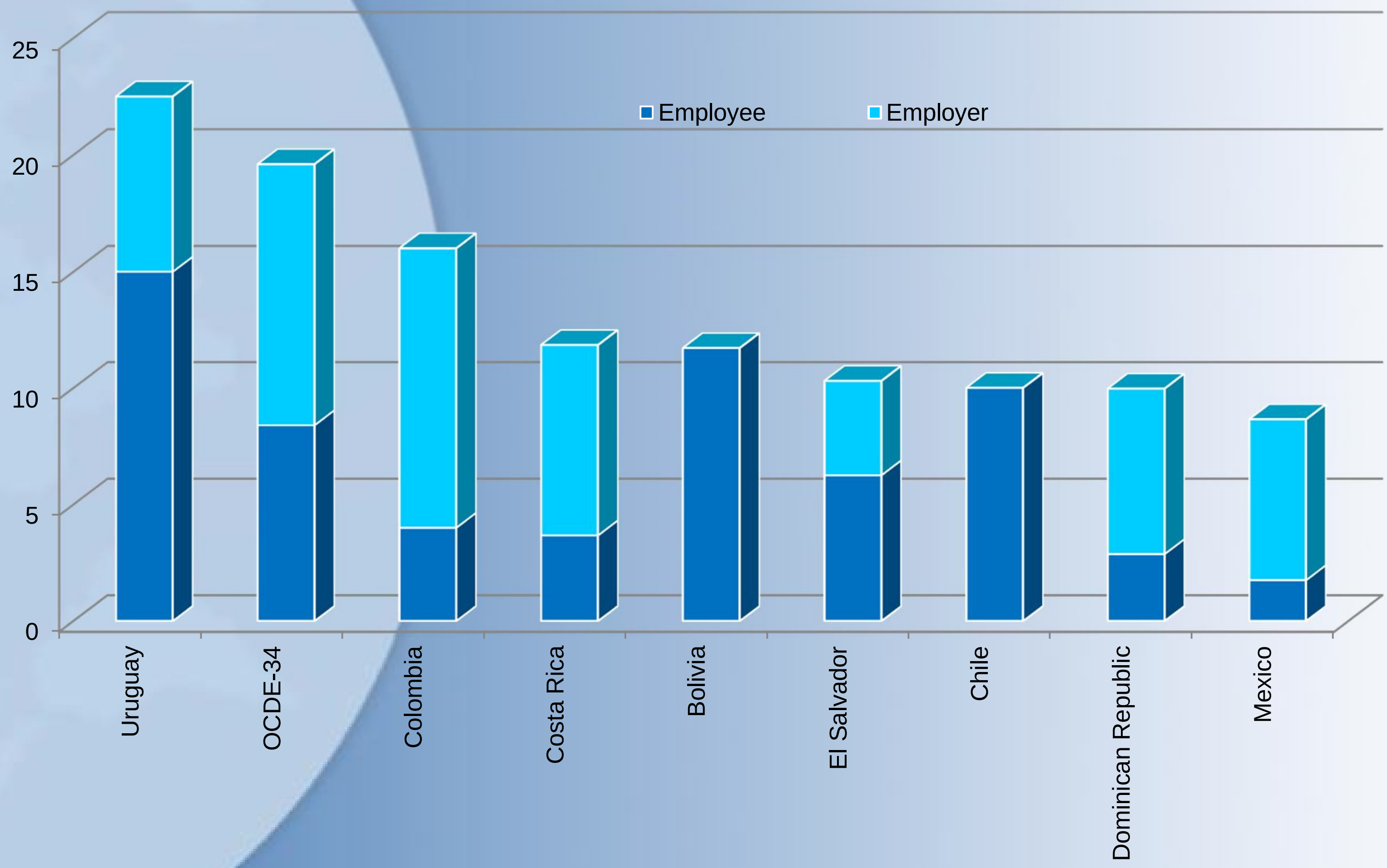
Labor market flaws have had an impact on contribution density



Such imperfections in the labor market need to be faced in order to improve contribution density and, therefore, replacement rates

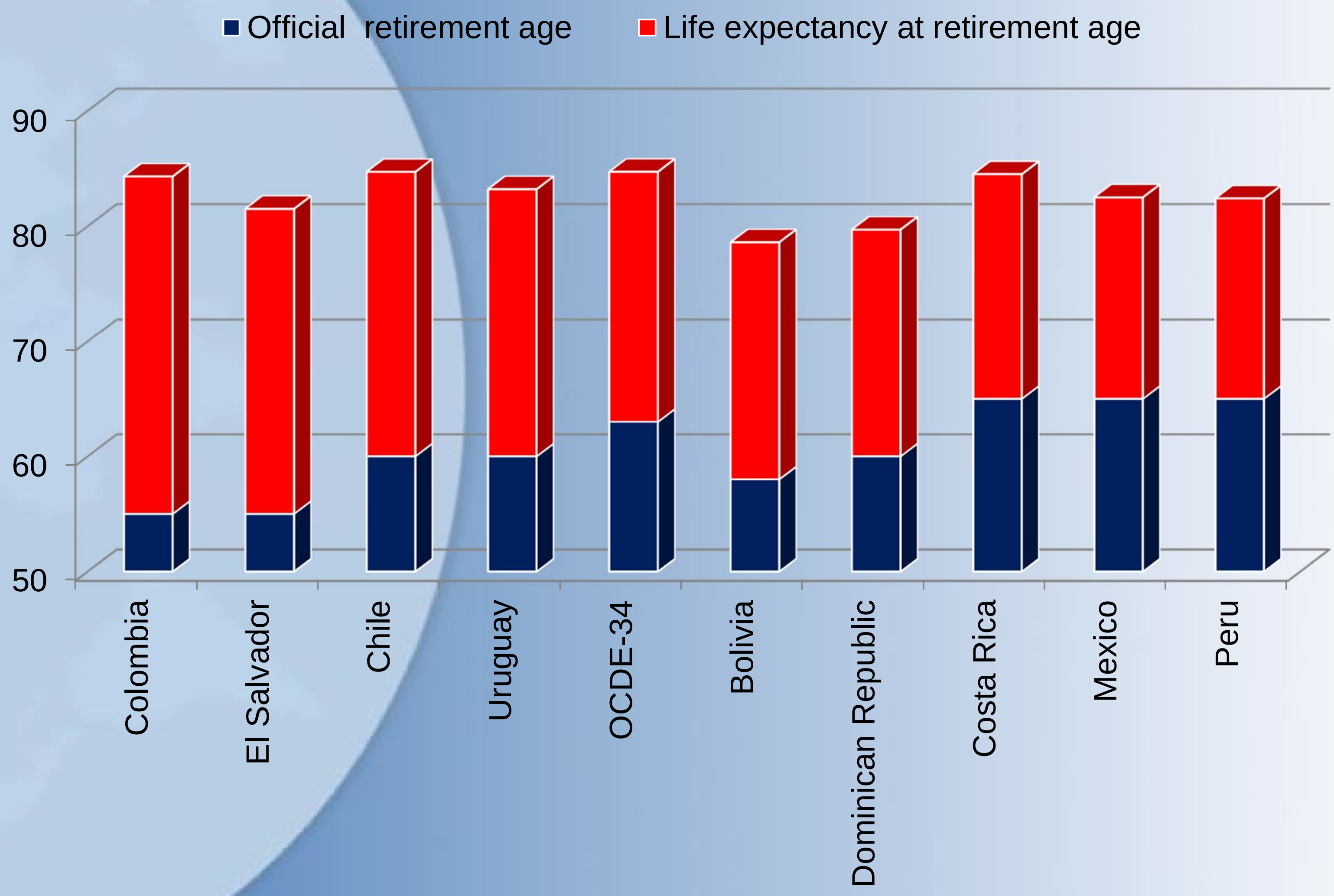
Source: ILO and OECD

Contribution rates are relatively low in most LATAM countries (% of wage)



Source: Pagés-Serra, IDB

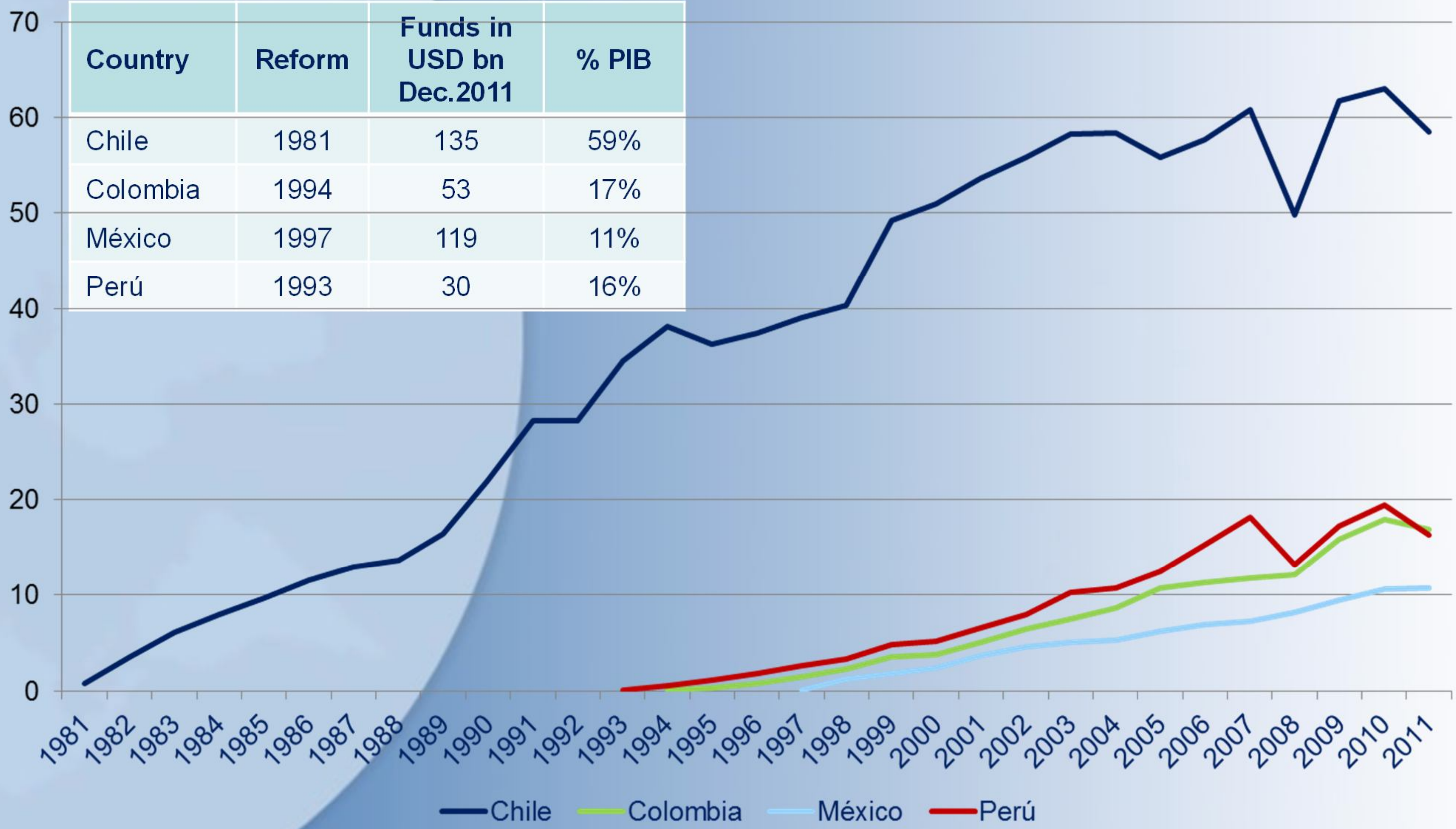
Average legal retirement age is low, with life expectancy similar to OECD levels



Source: Pagés-Serra, IDB

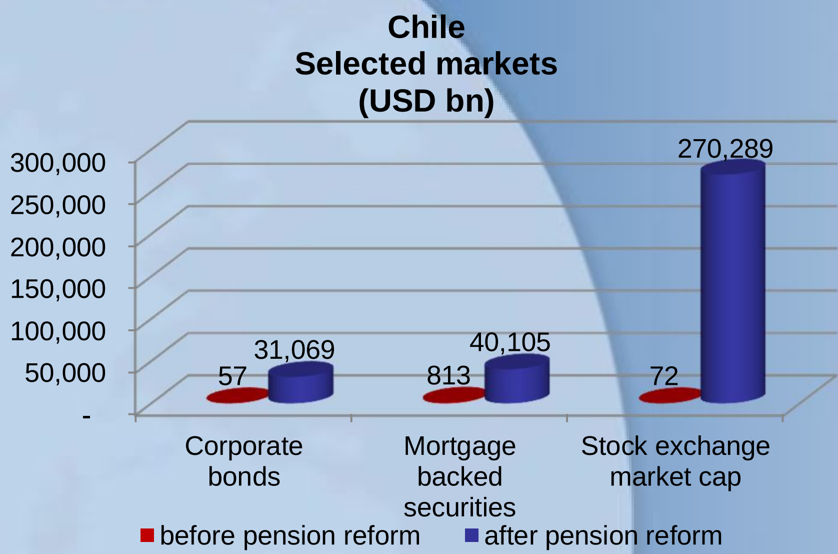
Pension funds in Latin America have gained importance

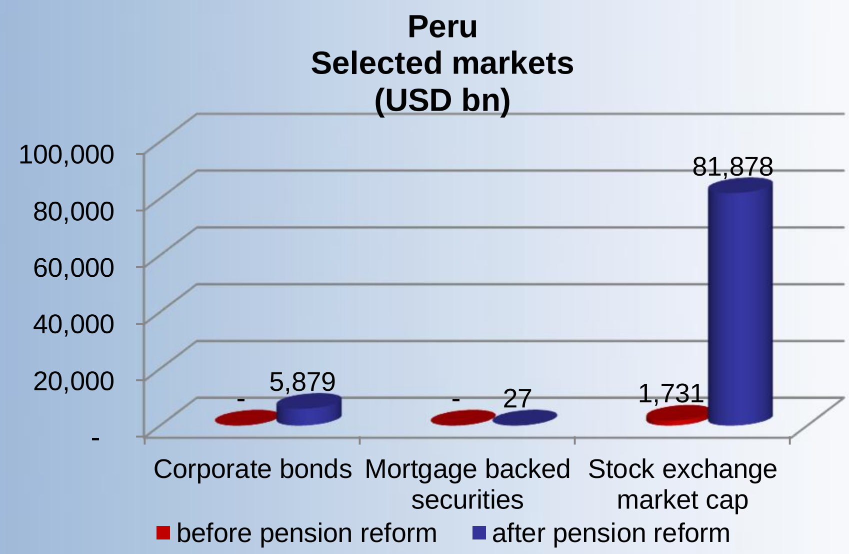
Country	Reform	Funds in USD bn Dec.2011	% PIB
Chile	1981	135	59%
Colombia	1994	53	17%
México	1997	119	11%
Perú	1993	30	16%

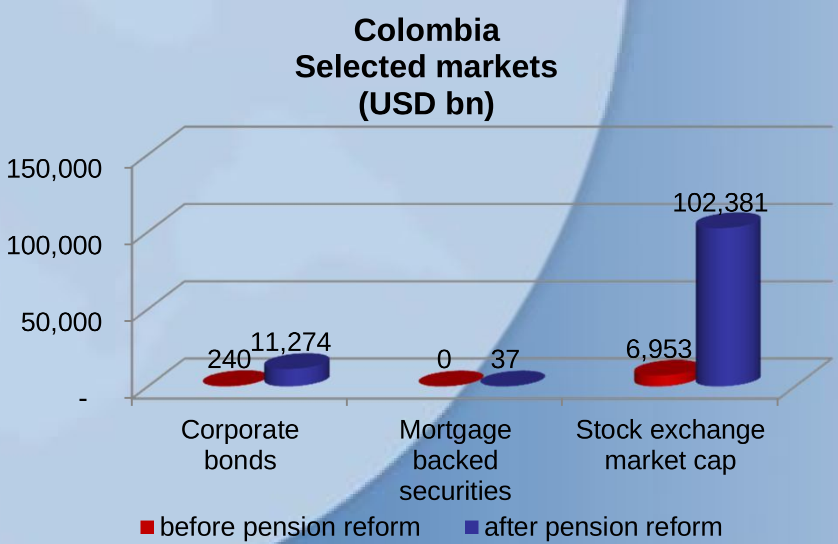


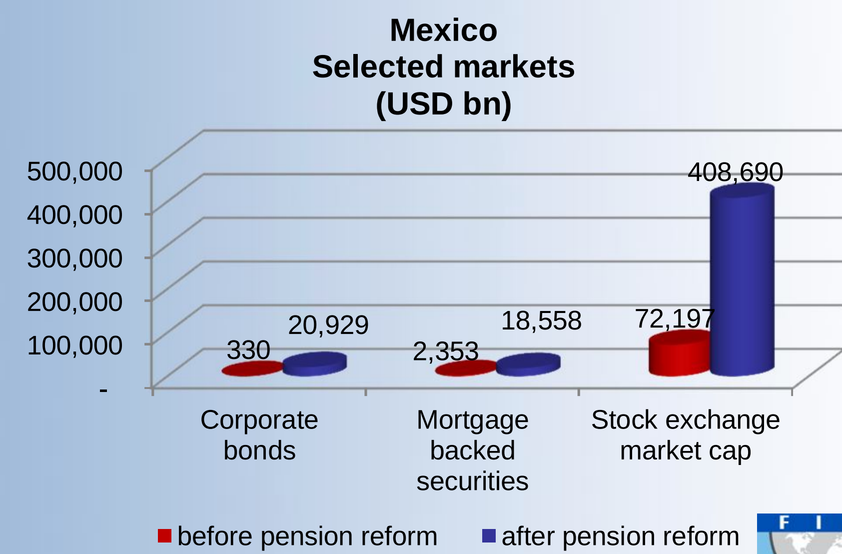
Source: FIAP, with official data.

Pension funds have contributed to the growth and deepening of financial markets









Source: FIAP, with official data

Pension funds are a major source of financing to governments, banks and corporations

Pension funds: share of total December 2011			
Instrument / Country	**Chile**	**México**	**Perú**
Public debt (1)	31,8%	28,3%	13,5%
Banks debt	59,1%	1,2%	2,8%
Corporate bonds	41,0%	47,8%	32,3%
Equity	6,2%	2,4%	7,6%
Time deposits	8,7%	0,0%	13,7%
Mortgage backed securities	5,2%	21,1%	10,4%

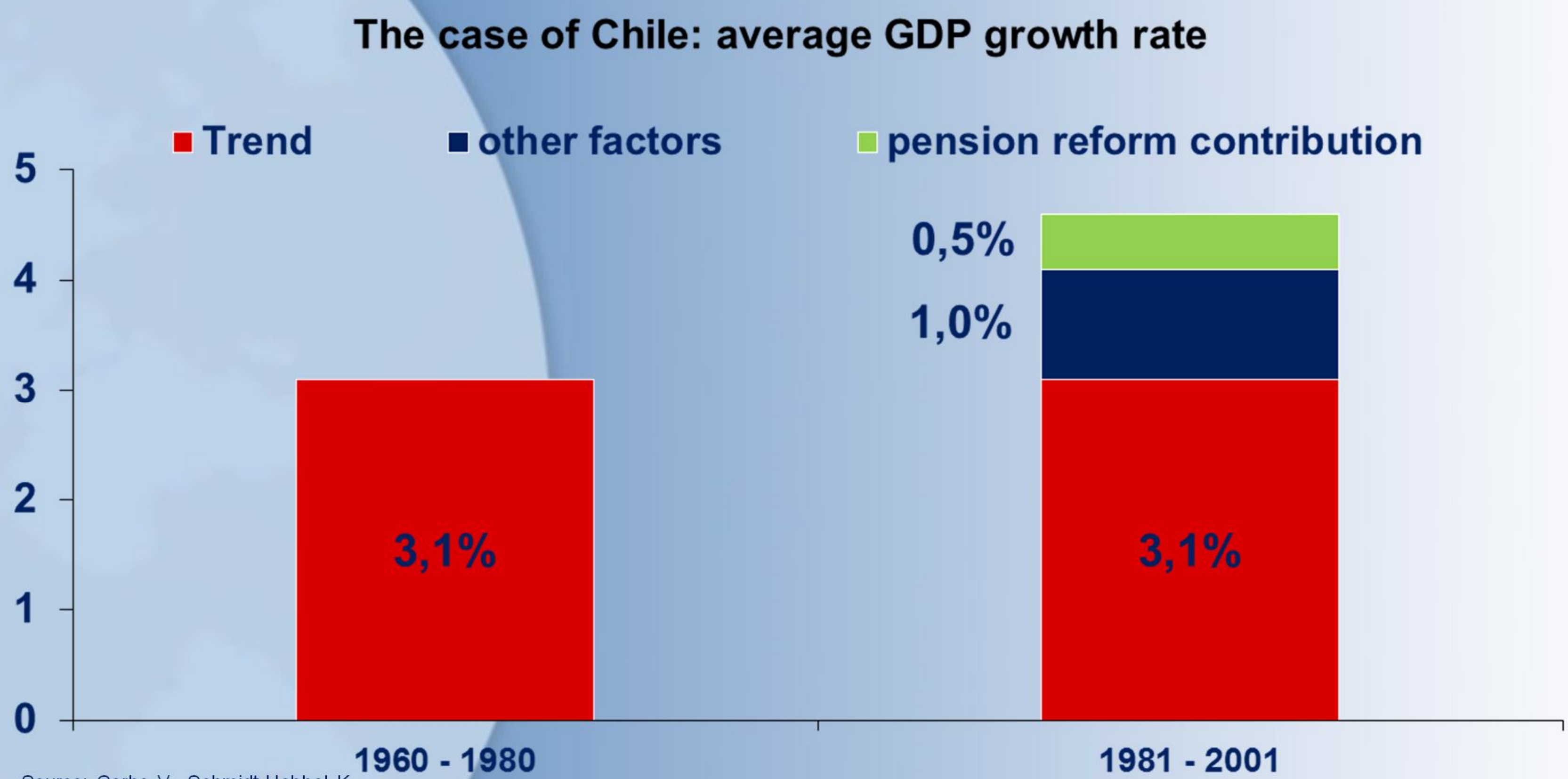
(1) Includes Central Bank debt
Source: FIAP, with official data.

Pension funds have made a relevant contribution to the development of local capital markets and have brought about other positive effects:

i. Increased efficiency in the financial markets, which in turn means:
- Higher long-run returns to investors
- Lower cost of capital for firms
- Higher economic growth

ii. Protection of the economy against the volatility of international capital flows

Empirical evidence shows correlation between pension reform and economic growth



Source: Corbo V., Schmidt-Hebbel K..

Between 1980 and 2001, pension reform in Chile explains:

- 30% of the increase of financial deepening (financial assets-GDP ratio)
- 0.5 percentage points of real GDP growth (4.6% on average)

III. Recent developments

Main areas of recent developments

- **Broadening of population coverage**
  - **Creation / strengthening of non-contributory pillars**
  - **Compulsory contribution for self-employed**
- **Industrial organization**
  - **Bidding of new customers based on price**
  - **Fee reduction / change of strucuture**
- **Asset management**
  - **Broadening of regulation towards more diversification**
  - **Wider choice for customers**
- **Pension sufficiency**
  - **Enhanced tax incentives for voluntary contributions**

Source: FIAP

Cases of recent developments

Area	Chile (2008)	Mexico (2008-12)	Peru (2012)
System pillars	New first, non-contributory, pillar	Re-allocation of subsidy to low income earners	New first, non-contributory, pillar
Coverage	Compulsoty contribution of self-employed		Compulsoty contribution of self-employed (gradual approach)
Industrial organization	Bidding of new customers based on price	Bidding of new customers based on price	Bidding of new customers based on price
Fees	Elimination of fixed fees Splitting of disability/survivors' insurance premium	Unique fee on assets under management; Compulsory annual approval of fees	Structure based on: decreasing fee on contribution; and fee on asset under management (only from new contributions)
Asset management	Broadening of investment regulation	Broadening of investment regulation Multi-fund approach	Broadening of investment regulation Multi-fund approach
Disability and survivors' insurance	Joint bidding Separation men/women		Joint bidding
Voluntrary savings	Increased tax incentives		-
Outsourcing	Measures to facilitate outsourcing		Compulsory use of common infrastructure for specific operations

Souce: FIAP.

IV. Main experiences and lessons

Consistency between principles and policies applied at the macro/micro levels and the pension system

- **There is a close connection between the performance and outcome of pension schemes based on DC/individual accounts and the labor, insurance and capital markets (1)**

- **Imperfections in the operation of those markets may have a strong negative impact on the quality of benefits delivered by the pension system**

(1) This does not mean that those markets need to be well developed for a pension reform to be launched. However, regulations and institutional framework must fulfill certain minimum requirements and, above all, there must be the political will and commitment to undertake the necessary and timely adjustments.

Careful planning of the transition from a traditional/ DB/pay-as-you-go model to a DC/individual accounts system

- This favors the inception and legitimacy of the new system, especially when the previous arrangement delivered benefits whose level was financially unsustainable
- Planning also mitigates the impact of the reform on public deficit and allows to fund its cost, which in turn reduces the likelihood of future reversal of the reform due to fiscal pressure

Adequate integration of the different pillars of the pension system

- Objectives for each one must be clearly defined, thus avoiding competition and conflict
- The design of the DC pillar, especially in terms of rates of contribution, required ages, etc., must be consistent with the desired level of replacement rates
- Continuous monitoring and timely adjustment when contribution densities and life expectancy assumption differ from actual data

Appropriate design of the benefits package

- **Create conditions for a fair conversion of final balances into pension installments and for the stability of pension payments**
- **Anticipate measures to face financial and longevity risks during the de-accumulation phase**
- **Avoid "lump sum" type of benefits, unless specified minimum levels of pension payments are met**

The role of the plan member

- **People have shown low sensitivity to quantifiable attributes (prices and returns)**
- **It is therefore key to encourage financial literacy, through timely, relevant and accessible communication**
- **The involvement of the plan member in decision making, emphasizing property rights, is crucial for the future of DC/individual accounts pension systems**

Some lessons from the global crisis

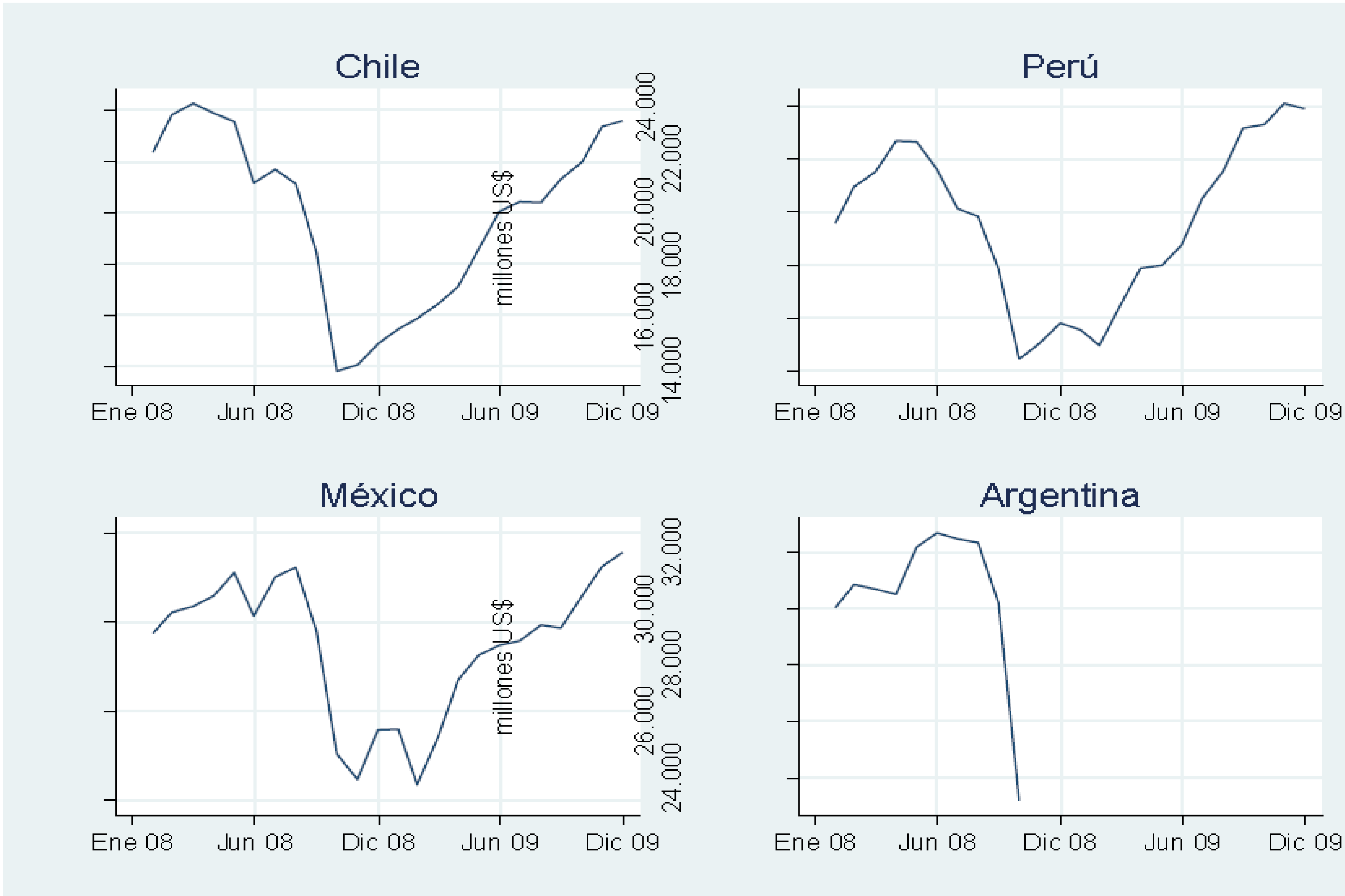
- The impact of the financial crisis on the returns of Latin American pension funds has been lower than expected, and highly **dependent** on the structure of portfolios in each country

- Within one year, the value of pension funds had recovered in most cases.

- Given the long term nature of retirement savings, there is sufficient scope for loss recovery

- However, regulation should specially aim at protecting people who are close to retirement from volatility in the value of portfolios

Pre and post crisis value of pension funds



Source: Mario Marcel C. y Waldo Tapia., IDB

Some lessons from the global crisis

- The multi-fund, life-cycle approach, allows to adjust portfolios according to individual preferences and to reduce exposure to financial volatility
- It is imperative to promote financial literacy, particularly in connection with portfolio choice, in order to avoid rash decisions
- It is also vital to emphasize the long term nature of retirement savings

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