Pension reform in Latin America

Main developments and lessons learnt

Amsterdam, NL
November 15, 2012
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

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Unique</th>
<th>Complementary</th>
<th>By Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>1981</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>1993</td>
<td>●</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>Colombia</td>
<td>1994</td>
<td>●</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>Argentina(^+)</td>
<td>1994</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uruguay</td>
<td>1996</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bolivia</td>
<td>1997</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>1997</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>El Salvador</td>
<td>1998</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costa Rica</td>
<td>2000</td>
<td>●</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>2003</td>
<td>●</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

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 replacement 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

Informal sector employment (% of labor force)

<table>
<thead>
<tr>
<th>Country</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>69.5</td>
</tr>
<tr>
<td>Chile</td>
<td>36.0</td>
</tr>
<tr>
<td>Colombia</td>
<td>59.6</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>43.8</td>
</tr>
<tr>
<td>El Salvador</td>
<td>65.6</td>
</tr>
<tr>
<td>Mexico</td>
<td>54.2</td>
</tr>
<tr>
<td>Peru</td>
<td>70.3</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>47.9</td>
</tr>
<tr>
<td>Uruguay</td>
<td>37.7</td>
</tr>
</tbody>
</table>

Source: ILO and OECD

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Reform</th>
<th>Funds in USD bn Dec.2011</th>
<th>% PIB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile</td>
<td>1981</td>
<td>135</td>
<td>59%</td>
</tr>
<tr>
<td>Colombia</td>
<td>1994</td>
<td>53</td>
<td>17%</td>
</tr>
<tr>
<td>México</td>
<td>1997</td>
<td>119</td>
<td>11%</td>
</tr>
<tr>
<td>Perú</td>
<td>1993</td>
<td>30</td>
<td>16%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Instrument / Country</th>
<th>Chile</th>
<th>México</th>
<th>Perú</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public debt (1)</td>
<td>31,8%</td>
<td>28,3%</td>
<td>13,5%</td>
</tr>
<tr>
<td>Banks debt</td>
<td>59,1%</td>
<td>1,2%</td>
<td>2,8%</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>41,0%</td>
<td>47,8%</td>
<td>32,3%</td>
</tr>
<tr>
<td>Equity</td>
<td>6,2%</td>
<td>2,4%</td>
<td>7,6%</td>
</tr>
<tr>
<td>Time deposits</td>
<td>8,7%</td>
<td>0,0%</td>
<td>13,7%</td>
</tr>
<tr>
<td>Mortgage backed securities</td>
<td>5,2%</td>
<td>21,1%</td>
<td>10,4%</td>
</tr>
</tbody>
</table>

(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

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)

Source: Corbo V., Schmidt-Hebbel K.

The case of Chile: average GDP growth rate
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 structure

- 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

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

Source: 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

Chile

Perú

México

Argentina

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
Pension reform in Latin America
Main developments and lessons learnt

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