PENSION NOTES

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THE IMPORTANCE OF VOLUNTARY PENSIONS SAVINGS AND KEY FACTORS IN ITS DEVELOPMENT[1]

Introduction

In this brief article we review the recent literature on the importance of voluntary pension savings (APV), as a mechanism for improving the pensions of workers, considering demographic changes (increase in life expectancy) and low contribution density. Some key factors for the development of APV, derived from both behavioral economy and the experiences of other countries such as the United States and Chile, are also highlighted. Finally, mention is made of the opportunities available to the Pension Fund Managers (AFPs) for promoting APV and increasing its added value in the industry.

It would be of interest to other countries to explore to what extent the lessons derived from experience and behavioral economics in the voluntary pension savings plans (individual or collective) that complement the pensions of the mandatory individually funded systems can be incorporated.

Context

- In many countries, the total replacement rate (pension/salary ratio) that workers obtain from the pension systems represents an insufficient percentage of the income earned during the years of active life. It can be observed, especially in the case of workers with average or above-average income, that the replacement rates resulting from the sum of social security pensions, is relatively low.

    - According to the OECD Pensions Outlook 2012, for example, in a country like Sweden, a worker earning the average wage receives a pension from the mandatory pension system (public and private) representing 58.4% of his salary. In the case of the United States, the replacement rate for an average worker is estimated to be 39.4%. On average, this indicator amounts to 57.3% of the salary in all the OECD countries.

- Given this scenario, many workers are going to need pensions that are complementary to those provided by the social security systems. Where will these pension increases come from?

[1] Document drawn up by FIAP.

- They would hardly be likely to come from the public systems: demographic pressures and financial crises have forced these systems to reduce benefits and impose more restrictive conditions for accessing them.

- Furthermore, pension amounts in some mandatory individually funded systems may be insufficient (below expectations), due to:
  i) Low contribution densities.
  ii) Growing workers' wage profile, beyond what was initially estimated.
  iii) Increase in life expectancy.
  iv) Insufficient contribution rates.
  v) Existence of maximum ceilings on salaries on which contributions are paid.
  vi) Existence of wage components that are not taxable.

- Reasons i) and ii) are derived from the conditions of the labor market, which fall outside the scope of the pension policy. (In this regard, the pension policy could have a bearing on challenges iii) - vi), i.e., in the logic of the mandatory individually funded systems, the way to improve benefits would be to raise retirement ages, increase contribution rates, increase maximum ceilings on income for mandatory contribution purposes and seek to make 100% of income taxable. Such measures, however, are of a political nature and may face strong resistance.

The importance of voluntary pension savings for increasing pensions

- Given the above, the voluntary pension savings mechanism (APV) is an alternative and indispensable means for improving the pensions of all workers. The APV certainly helps high-income workers to get a pension according to their income. In the case of workers with less saving capacity (low and middle income workers), the APV can help to improve the pension when there are fiscal and tax benefits that promote savings.

- The impact of APV on pensions can be meaningful for increasing the pension obtained from the mandatory system, and the sooner workers start voluntary pension saving, the more significant the effect. According to Iglesias (2010), if a man begins voluntary pension saving at age 30, his total replacement rate increases by 37 percentage points (from 69% of salary without APV to 106% of salary with APV). For women, the replacement rate increases by 32 percentage points with APV (from 59% of the salary without APV, to 91% of salary with APV)[2].

[2] This exercise assumes: (i) Mandatory contribution equal to 10% of the worker's taxable income; (ii) voluntary contribution equal to 5% of the taxable income of the worker; (iii) taxable income of 1,000 Monetary Units (UM); (iv) the worker starts making mandatory contributions at age 25; (v) he retires at age 65; (vi) the contribution density is 80% of working life; (vii) the RV-2004 (Chile) mortality tables are used.

Key factors for the development of APV

- According to Iglesias (2010), Blake (2012) and Utkus (2012), there are at least seven key factors for boosting APV:

  i. ***That pensions obtained by people from the mandatory individually funded systems (as a % of salary), are effectively low***.

  - If the mandatory system were to offer pensions that replace 100% of income, it would be impossible to have a voluntary system of any significant size.

  ii. ***Existence of appropriate incentives***.

  - **Tax benefits for APV**: A necessary condition for the development of APV is that there should be a tax incentive to help "compensate" the lack of liquidity of this type of saving, also serving as an incentive for making it more attractive compared to other forms of saving. The most common regimes allow APV contributions to be non-taxable (whereas withdrawals are taxed; an example of this is the American system of voluntary savings plans - 401 (k)).

  - **State subsidies for APV**: They are justified if the country in question has some non-contributory State-funded pensions program (solidarity pension), since this helps to reduce future costs associated to supporting vulnerable pensioners. In the case of Chile, for example, one can opt not to use the tax benefit when paying in voluntary savings resources (deducting them from the taxable income) and obtaining a State bonus equivalent to 15% of the amount saved by the worker (taxes are paid on the return of these resources at the time the funds are withdrawn - prior to the pension - or according to the tax bracket in which the pension falls).

  iii. ***The APV must have liquidity***

  - In general, especially for young people, engaging in voluntary savings through a mechanism that prevents one from accessing them until retirement age can be a major disincentive.

  - Hence, the APV systems that offer some possibility of early withdrawal of the funds, even at the expense of a penalty or "exit price," are more in demand.

  iv. ***There must be competition between the APV management agencies.***

  - The Chilean experience shows that when different actors are involved in APV management, that very competition helps to expand the market, improve the products offered and reduce prices.

- The existence of agencies that distribute APV through multiple channels contributes to educating workers and making them more sensitive to the product, and therefore to expanding the market.

- However, it is key the existence of common standards among the different agencies competing, regarding the information available to the public in terms of returns (real or nominal rates), the level of fees (it is possible some asymmetry in the way of inform the fees, or can be kind of complex to compare them) and to publish all the information in a centralized manner. Without this uniformity, workers can make bad decisions and competitive asymmetries between the different agencies can arise.

v. ***Employers' Contributions.***

- Employers play an important role in informing workers of the characteristics of the product and thus awakening their interest in it. In this regard, and according to Utkus (2012), it is essential to provide employers within incentives for contributing to an APV account, in order to generate incentives for workers to make this type of voluntary contributions.

- With a collective voluntary savings mechanism, the APV distribution costs for workers are lower (which contributes to the massification of this type of product) and employers can also make contributions to their workers. Such is the case of the Collective Pension Savings plans (APVC) in Chile[3]. Furthermore, according to Blake (2012), this type of mechanism uses **herd behavior** to advantage, to the extent that if several people in a company decide to establish a collective voluntary savings mechanism, it is more likely that others will follow their example.

- Shared APV[4]: In order to increase the monthly contribution of workers to their pension funds, it can be established a voluntary mechanism for workers and mandatory for employers. Those workers who wish to increase their contribution for improving their future pensions can notify the employer that they will make a greater saving. The employer is required by law to contribute the same percentage of increase that makes the worker. In turn, this increased saving, unlike with the APVC, which goes to a different account, goes to the mandatory account, and funds can be used only upon retirement, not before (this happens with APV). This mechanism would be more efficient than the APVC and would preserve individual freedom of people to choose

[3] The APVC in Chile is currently being studied by the authorities to improve it, because the product has had a low demand. The diagnosis of governmental authority is that companies haven´t shown interest in offering this type of savings to their workers, so the idea is to transform it into a product similar to the APV, which has gained popularity. The idea is to have a more liquid AVPC and one of the options is that the new format allows workers to make partial withdrawals of up to 25% of the accumulated balance. According to industry sources also point that is necessary to change some restrictions that exist today, such as the percentage of workers who must be registered and the vesting period (minimum period to stay in a company so that the worker can be the owner of employer contributions) is now defined in 24 months.

[4] Proposal of AFP Habitat in the case of Chile.

their administrator. A more limited approach of this proposal may be to set a more limited percentage of employer contributions, with monthly ceilings (a proportion of the worker´s contribution).

vi. ***Design systems that simplify membership, contributions, investments and withdrawals.***

- **Automatic membership and discount by payroll**: according to Blake (2012), given the fact that individuals have **self-control problems**, they would benefit from a policy of **automatic membership** of APV systems through payroll deductions, with the possibility of withdrawing from the plan if they wish to do so. Thus, the **inertia** of individuals is used to encourage participation in voluntary savings plans. According to Utkus (2012), in the United States the feature of automatic membership of the 401 (k) plans has operated successfully, since it has tripled the rates of participation in such plans[5].

- **Contributions with automatic increases**: also according to Blake (2012), once enrolled, the members of APV plans tend not to alter the contribution rate unless there are automatic annual increases. Once more, the inertia of the workers can be positively used to advantage if, for example, the plan establishes in advance that the contribution rate to the APV plan will increase by a certain percentage each year. According to Utkus (2012), in the United States many companies have successfully introduced this type of design in contributions to 401 (k) plans.

- **Move towards simple and automatic investment schemes**:

  - According to Blake (2012), when individuals are faced with difficult decisions, they resort to "**simplified heuristics**", i.e., they use simple empirical rules, such as choosing the "**default option.**" Therefore, in order to deal with this intrinsic characteristic, it is essential for an APV to have a well-designed, low-cost default fund employing a lifecycle or lifestyle investment strategy that automatically reduces risks as the individual approaches retirement.

  - According to Utkus (2012), the participants in the 401 (k) plans in the United States are increasingly preferring default investment strategies (fixed date investment funds, based on the individual's life cycle) as well as the option of delegating the handling of personalized investments to a third-party professional.

- **Make pension modes more attractive for the portion of savings originating in APV plans**: according to Utkus (2012), allowing lump sum withdrawals from

[5] In the United States about 60% of households near retirement age have a 401 (k) plan. Its main strategy for success, so far, has been active or automatic membership, in which contributors can start withdrawing funds after turning 59 and a half.

the voluntary portion of savings (in the context of mandatory individually funded savings systems), could make APV more attractive.

vii. ***Adequate pension education.***

- The indispensable pension education for raising awareness of the need to save for retirement and inform about the advantages of APV and associated incentives.

- According to Utkus (2012), one of the lessons that can be learnt in terms of communications in this area lies in a change of focus: there must be a switch from an approach based on short term returns on investments to a model of communication based on the life cycle of the worker and the planning of savings for retirement.

- According to Utkus (2012), it is also extremely important to consider the intensive use of available technologies, such as "smart phones," which, for example, could inform workers through an application, and within certain parameters, that they must change their savings strategy in order to generate a certain pension amount at the end of their working lives. One could say that given the general illiteracy of workers regarding pensions and the relatively low average taxable income of workers, the access to these technologies is limited. However, this is an idea that should be present as information technologies will become more massive.

Opportunities for the Pension Fund Managers

- The Pension Fund Managers (AFPs) are in a very favorable position for promoting APV:

  - Due to their direct and ongoing relationship with workers, the AFPs can provide timely information on the level of benefits of the mandatory system and the breaches in individual pension objectives.

  - Their proximity to workers enables the AFPs to disseminate information on the different APV mechanisms and the characteristics of the products at a very low cost. For example, in the case of Chile the AFPs have a comparative advantage over other APV managers authorized by the Superintendency of Securities and Insurance (SVS). Mutual funds, for example, charge fees that are complex to visualize and funds whose administration is far from obtaining a profitability protecting workers' savings. Instead, the AFPs, through Multifunds, deliver a profitability protecting workers' savings and also charge fees that are clear, transparent and considerably lower.

- APV also represents an attractive opportunity for the AFPs. In addition to being a new activity that can add to basic business revenue, the evidence suggests that under competitive conditions with other suppliers, the AFPs can achieve a major market position with this product.

- APV also contributes to closer relationships with clients ("Members") of the AFPs, helping to generate loyalty and allegiance, an effect that is difficult to achieve with mandatory pension savings.

References

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11 de Septiembre 2155, Torre C, Piso 9, Oficina 901, Providencia. Santiago, Chile Phone: (56 - 2) 2 3811723 Fax: (56 - 2) 3812655 2. E-mail: **fiap@fiap.cl.**
Web site: **www.fiap.cl**

Statistical Appendix

Chart No. 1

Volume of Managed Voluntary Pension Savings Funds (Thousands of US$ on each date) - AFP Industry												
Countries / year	**Dec 2001**	**Dec 2002**	**Dec 2003**	**Dec 2004**	**Dec 2005**	**Dec 2006**	**Dec 2007**	**Dec 2008**	**Dec 2009**	**Dec 2010**	**Dec 2011**	**Dec 2012**
Bolivia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bulgaria	60,995	103,726	163,164	226,659	252,106	333,469	509,781	347,573	387,184	381,513	376,234	421,821
Chile (1)	n.a.	495,127	787,311	1,054,369	1,471,986	1,990,057	2,647,688	1,840,749	3,072,985	4,071,729	3,620,127	4,309,110
Colombia	813,775	880,536	1,128,405	1,525,119	2,549,262	2,726,507	3,038,093	2,868,862	3,957,880	5,092,897	5,160,626	6,541,457
Costa Rica (2)	450,348	633,202	723,726	318,639	365,701	441,125	450,730	320,152	305,806	338,386	354,946	367,381
Mexico	154,727	185,598	196,526	179,638	185,144	215,342	230,690	181,420	196,135	342,505	894,887	1,005,887
Panama	n.a.	25,465	34,632	57,519	69,455	82,558	113,400	135,800	161,900	189,000	289,900	290,200
Peru	n.a.	n.a.	n.a.	n.a.	n.a.	128,119	356,179	138,670	202,118	268,423	203,702	230,420
Poland	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,195
The Dominican Republic	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Uruguay	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

(1) Corresponds to savings managed by the AFPs.
(2) The statistics include the funds of the complementary voluntary pension system in colons and dollars.
n.a.*:* Not available
Source: FIAP Members.
Drawn up by: FIAP.

Chart No. 2

Number of Accounts with Voluntary Pension Savings - AFP Industry												
Countries / year	**Dec 2001**	**Dec 2002**	**Dec 2003**	**Dec 2004**	**Dec 2005**	**Dec 2006**	**Dec 2007**	**Dec 2008**	**Dec 2009**	**Dec 2010**	**Dec 2011**	**Dec 2012**
Bolivia	n.a.	n.a.	841,657	893,858	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bulgaria	451,846	484,791	516,148	535,415	549,851	565,782	592,805	608,667	603,105	602,862	600,365	596,833
Chile (1)	n.a.	257,847	265,645	335,997	344,933	389,175	430,764	469,422	517,921	583,004	692,826	797,777
Colombia	109,154	143,603	213,662	231,863	283,886	323,768	340,905	351,874	367,825	372,717	400,127	433,181
Costa Rica (2)	176,092	190,922	n.a.	163,621	167,431	168,011	167,915	168,360	167,972	152,058	151,572	148,467
Mexico	97,344	114,844	132,359	147,376	163,087	167,898	185,363	192,646	n.a.	n.a.	n.a.	n.a.
Panama	7,929	11,002	13,963	17,413	21,507	24,734	24,292	36,151	40,021	48,373	52,735	58,355
Peru	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Poland	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	127,642

The Dominican Republic	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Uruguay	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

(1) Corresponds to the accounts Managed by the AFPs.
(2) The statistics include the funds of the complementary voluntary pension system in colons and dollars.
n.a. = Not available
NA = Not Applicable
Source: FIAP Members.
Drawn up by: FIAP.