Santiago, September 15th, 2016

Mr. Kenneth Murphy

Editor in Chief

Project Syndicate

Dear Mr. Murphy,

We have carefully read the interesting Article of Andrés Velasco about the challenges that the Chilean pension system is facing as a consequence of the increase of life expectancy and the maintenance of pension age for more than 35 years, what have also extended the time period of pension reception. In addition to the latter, interest rates have significantly decreased worldwide.

We agree with most of what was stated in said article. Nevertheless, it called our attention the paragraph that affirms that the problem of pension fund return is aggravated by the high fees charged by the pension fund administrators (AFP). It states that a "commission appointed by the government (Bravo Commission) have recently arrived to the conclusion that administrators have generated high real returns for pension fund investments (an annual real average return of 8.6% for the period 1981-2013), but the increased administration fees reduced returns to approximately 3% real per year for the same period ".

In this regard we would like to confirm that for the abovementioned period the pension funds investment return was indeed high and reached an 8.6% per year above the inflation. However, the calculation of the fees' net return is wrong, as it was also mentioned by some outstanding members of the Bravo Commission.

According to the Law, the mandatory saving administration fee is only charged once at the moment of paying the contributions as a % of the remuneration and is deducted from it and not from the cumulated savings. In other words, every contribution pays a fee only once in exchange for the AFP to administer said contributions and the individual accounts until the workers retire. In fact, a worker that stops paying contributions does not pay fees, but the AFPs continue to administer their individual accounts. For that reason, the calculation of the fees' net profitability using the IRR (Internal Return Rate) methodology should consider the complete labor cycle.

Unfortunately, the methodology used for calculating the abovementioned 3% has not been disseminated. Nevertheless, the limited information available suggests that it has serious methodological errors, one of which is calculating IRR considering only one part of the period in which the AFPs administered the individual funds and invested the affiliates' pension funds and not the worker's whole life, what makes the net profitability to be significantly underestimated.

On the other hand, a company specialized in pension funds, PrimAmérica Consultores, made an estimation of said return based on the IRR methodology using official information from the Office of the Superintendent of Pensions and, of course, including the biases previously explained, since it only considered one part of the labor cycle. It concluded that between 1981 and 2014 the average IRR of the individual accounts was a real annual 5.9% gross of fees and a real annual 4.7% after fees, figures that are significantly higher than those mentioned in the article.

Moreover, this calculation is an average that mixes members with different labor histories, what also implies very different returns among them. By way of example, consider those persons that paid contributions for some period of time, but for different reasons stopped paying and whom the AFP is not charging fees but continue administering their balances in their individual accounts. The fees' net return of these affiliates is higher than those obtained by those who regularly pay their contributions during their labor life and pay fees every time.

Another statement of Mr. Velasco that could lead to inappropriate conclusions is the insinuation that high fees reduce real profitability in 5.6 percentage points, i.e. from an 8.6% to a 3.0%. In this regard, from the information provided by the Office of the Superintendent of Pensions it is concluded that the fees received by the AFPs have been almost a 0.6% of the pension funds during the last five years and are considerably lower than the average fees charged in the pension programs of the OECD countries.

Based on the aforementioned, FIAP is aware of the need of improvement of the second contributive mandatory pillar of the individually-funded accounts in Chile, but improvements should be performed based on a wide technical discussion, analyzing the best proposals for the integral reform of the pension system, in order to warrant it to have a wide coverage, to provide appropriate pensions for the workers, to be fair and financially sustainable.

Sincerely yours,

Guillermo Arthur

President

International Federation of Pension Fund Administrators (FIAP)