FIAP Report on the proposed pension reform in Peru[1]

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In the opinion of the International Federation of Pension Fund Administrators (FIAP), although the proposal has some positive aspects, it recommends some extremely negative changes for the development and stability of the pension system.

Some of the positive aspects we can mention are:

1. **The closing down of the PAYGO system.** The elimination of the PAYGO system, which currently competes with the individually funded system (and fully respecting the rights acquired in the system), puts an end to the inequity and regressive nature of the PAYGO system: individuals who contributed to the PAYGO system for less than 20 years (who tend to be the poorest and least educated) end up without a pension or access to their contributions, while financing the pensions of those who contributed for more than 20 years (who tend to be the ones with higher incomes and higher education).
2. **The abrogation of the law allowing the withdrawal of 95.5% of accumulated balances on retirement, and the limitation of the rules for the use of 25% of the balance of the individual account for the purchase of a first home.** This is intended to restore the necessary link between savings (accumulation phase) and retirement (decumulation phase), thus facilitating the obtainment of a stable and decent income during retirement.
3. **The creation of a first, anti-poverty, non-contributory pillar,** funded with taxes, which would provide a minimum pension by means of a public subsidy, focusing on lower-income members. The amount of the subsidy would decrease as individuals accumulate savings, but the reduction is less than one on one, so that the subsidy does not eliminate the incentive to save.

Despite the aforementioned positive aspects, the reform has some adverse effects that completely distort its purpose.

First of all, it proposes the creation of a centralizing agency, involving the creation of a public or private monopoly solely entrusted with collection, management of accounts and payment of benefits, among other functions. This monopolistic agency entails at least four problems:

[1] The reform proposal was drawn up by the Social Protection Committee (CPS), comprising Alejandro Arrieta, Miguel Jaramillo, Lorraine Prieto, Janice Seinfield, Augusto de la Torre and David Tuesta. The CPS worked for six months and finally delivered an independent technical report to the President of the Republic of Peru, Mr. Pedro Pablo Kuczynski. The Committee received the support and advice of the IDB. the World Bank and the OECD, among other agencies, in drawing up the report.

- **High political risk,** even more so if it is a government agency, because it could use all collected funds for purposes other than pensions.
- **Unnecessary cost increases.** AFP Net already exists in Peru. This is a free system that centralizes the collection process, provides support in enrollment, manages accounts, calculates benefits, and above all, makes the system efficient by using economies of scale to advantage, ultimately resulting in lower commissions. It is also questionable whether this centralizing agency could charge a commission of 0.07% on the balance, as stated in the proposal, due to the complex structure of the investments it must manage, in terms of the relationship with the Investment Portfolio Managers (GCI).
- **Deterioration of the quality of service.** Being a monopoly, it would not have incentives to offer quality service to its users, as it would have an ensured captive demand.
- **Proliferation of financial consulting companies and cases of manipulation and abuse.** The reform proposes implementing the so-called "blind accounts" system, in which members can choose between the different GCIs (there is a default option for those who do not choose) and communicate their choice directly to the centralizing agency, which would maintain direct contact with the GCI. In Sweden, where a similar reform was implemented a few years ago, a parallel industry of financial advice companies has emerged, which, in exchange for a commission, advise workers on portfolio decisions and choosing investment managers. There is great concern in the country regarding possible manipulation and abuse in such advisory services. The Swedish evidence also shows that there are currently more than 700,000 people registered as financial advisors, and that their services are usually used by people with low education and income levels[2]. The Swedish government commissioned a study on the operation of the system and the irregularities that are now occurring[3].

A second negative aspect is the creation of the Investment Portfolio Managers (GCIs). This mainly involves the following five issues:

- **It complicates the investment system of the pension funds.** The fact that the centralizing agency would be responsible for managing the Target Date Funds, while the GCIs would be entrusted with managing the Feeder Funds, complicates the system because the centralizing agency would be permanently giving the GCIs orders for the purchase/sale of the shares of the Feeder Funds, keeping the proportions of the benchmark portfolios of each one of the portfolios constant.
- **The most efficient fund managers per asset type are not sought out.** Each GCI must manage all the feeder funds and asset classes contained in the Benchmark Portfolio (the report proposes 8 to 10 asset classes). Hence, the most efficient fund managers per asset class will not be chosen, which would be much more convenient in terms of costs and returns.

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[2] Source: "Pension Goals and Institutional Arrangements: Reforms DC 2.0 for Latin America"

[3] Source: https://www.ipe.com/news/regulation/cardanos-lundbergh-to-lead-swedish-premium-pension-system-review/10019327.article

- **The GCI incentives are not aligned with the interests of members.** The text does not mention the possibility of incentives/penalties for the GCIs related to their returns compared to the benchmark. Neither does it mention the establishment of reserve funds, which the existing AFPs do have, and which align their interests with those of members.
- **A limited number of GCIs will be selected.** According to the report, 4 to 5 GCIs will suffice for the current size of the Peruvian market, which is clearly arbitrary. There are four AFPs currently operating in Peru, so the Committee's proposal does not appear to advocate the entry of new players into the market.
- **Active vs passive management.** According to the report, there will be different calls for tender for selecting the GCIs, with each one of them exercising different investment strategies - more aggressive versus more passive - with the GCIs with more aggressive investment strategies being able to charge higher commissions. The report does not make it clear how the participation of both strategies within the portfolio would be determined.

Thirdly, the proposal assumes a reduction in commissions, but this is not entirely clear. As estimated by the Committee, commissions on the balance would be 0.67% (the sum of the commissions charged by the CGIs and the centralizing agency). It is worth mentioning that in Chile the commission on the balance is 0.56% (to Dec. 2016), so it is not evident that such a drastic restructuring of the system is necessary for achieving the objectives of reducing the commissions on the balance. It is also worth mentioning that in both Chile and Peru the regulations have established mechanisms for bidding for new members based on the commissions charged, which has enabled reducing them.

Fourthly, the proposal creates the so-called "Committee of Notables". It is a clear risk to the interests of members that pension fund investment portfolios are determined by a Committee of Notables elected by the Government (Ministry of Economy and Finance). There is indeed the risk that this Committee would opt for investments pursuing interests other than those of members. In Latin American history, there is strong evidence that shows that some Governments have acted against the interests of workers, by using the resources of the pension funds to finance fiscal requirements, in many cases with returns lower than market returns (for example, in Argentina, Bolivia and El Salvador).

Finally, the proposal is not the result of a broad consensus between different sectors, and lacks transparency. It was discussed behind closed doors, without a mechanism for the participation of different stakeholders, as provided by pension reform committees in other countries.

Pending Aspects

The proposed reform does not incorporate certain fundamental aspects which must necessarily be considered for the improvement of the pension system.

First of all, the increase in life expectancy at retirement means that the same accumulated savings must be used for paying pensions for a longer period of time, due to which the pension amount is reduced. Life expectancy at retirement has grown steadily since the implementation of the pension systems. According to the Population Division of the United Nations, life expectancy at age 65 in Latin America between 1985 and 2015 has increased on average by 4.15 years for women (from ***15.78 to 19.93 years***, i.e. an increase of 26 per cent) and 3.65 years for the men (from ***13.39 to 17.04*** years, i.e. an increase of 27%). In other words, the average life expectancy for men and women at retirement has risen by just over one year per decade. Considering this reality, any proposed reform must create an **institution that regularly evaluates the key parameters of the system (contribution rate and retirement age), and proposes** the parametric changes necessary for the system, while updating the mortality tables used for calculating pensions, in accordance with current reality.

Second, the reform does not guarantee the expansion of social security coverage. Only 17% of the economically active population (EAP) currently contributes to the pension system (making Peru the country with the lowest rate of contributors in the Pacific Alliance), and only 35% of citizens over 65 are enrolled in any kind of social security system, which is explained by the high levels of informality (more than 70% of the employed population). The proposal requires all Peruvians over the age of 18 to open a savings account in their name, but does not provide effective mechanisms to ensure that such individuals contribute to their pensions.