Executive Summary

Faced with the negative income shock caused by the pandemic, which was felt more strongly by informal workers, support measures have ranged from direct transfers by the State, easing of unemployment insurance, granting of soft loans and employment protection programs, among others. An important fact to mention is that only three countries in the world allowed the withdrawal of savings from the mandatory pension funds: Australia, Chile and Peru.

The non-means tested withdrawal of old age savings funds is an inappropriate public policy, since it can be used to advantage by those workers who have had more stable careers and have contributed regularly, and does not benefit those workers who have not been able to contribute to their individual savings accounts for different reasons (such as, for example, long periods in the informal sector), and even though they contributed at some point, their savings amounts are very low. Likewise, failure to impose requirements for the early withdrawal of mandatory savings generates massive pension savings withdrawals, exacerbating the problem of low pensions and fiscal expenditure.

In Chile, the withdrawals drained pension fund savings in the amount of almost USD 34 billion (approximately 17% of the funds), with worrying effects, such as the fact that more than three million people were left with zero balance in their accounts and about 88% of young members (up to age 25) who withdrew their savings, were left in the same situation. In Peru, withdrawals associated with the four existing mechanisms total more than USD 14 billion (almost 40% of the funds that existed when the first withdrawal of funds was approved), leaving nearly 2.1 million members without funds in their individually funded accounts.

In Chile, withdrawals have resulted in average reductions of 23% in the accumulated balance in personal accounts, translating into a reduction of between 15% and 18% in future pensions for women, and between 10% and 13% for men. In Peru, estimates show a drop of up to 24.5% in accumulated balances in individual accounts, mainly affecting workers close to 40 years of age, who will not have enough time to restore their funds.

In Chile, the fiscal impact of the first withdrawal of funds will be USD 6,002 million (2.5% of GDP) and the impact of the second withdrawal will be USD 2,552 million.
(1.1% of GDP). In addition, the two pension savings withdrawals have an effect on accumulated funds equivalent to lowering the contribution rate by 3.8 percentage points, which cancels out almost two-thirds of the 6-percentage point increase in the contribution rate proposed in the pension reform currently being discussed in Congress.

Seeking to increase savings to improve pensions while reducing such savings through these withdrawals, makes no sense.

Savings withdrawals will necessarily lead to the need to rethink the pension objectives to be achieved with the pension reform, and/or to review the proposed increase in contribution rates, if maintaining pension goals is still a priority. Nonetheless, the danger of the latter is the impact that such increases may have on labor market formality and the coverage of the pension system.

It is concluded that early withdrawals should be a last resort, and if authorized, their design should include means-testing, tax neutrality and mechanisms for replenishing funds, so as not to cause a significant drop in pension amounts.

The measures adopted in Chile and Peru are clearly populist in nature, since they are much appreciated by people who cannot see the future effects on their pensions. This norm contravenes the necessary mandatory nature of all pension systems, to prevent short-term outlooks from affecting the amounts of future pensions.

Introduction

This Note emphasizes the importance of mandatory savings to achieve greater coverage of the contributory programs and higher pension levels, as well as the exposure to risk when said obligation is violated by authorizing early withdrawals of funds. It also analyzes the negative consequences that withdrawals will have, not only on the individually funded systems, but also on pension systems in general and related markets, such as insurance and capital markets; and raises the need to progress gradually to integrate more workers into social security programs that cover different contingencies. The design and effects of the withdrawals, international experiences, and the most relevant conclusions, are highlighted at the end.

I. Importance of mandatory savings solely destined to pensions

International experience shows that the most effective way to achieve broad pension savings coverage is by making it mandatory for workers and employers to contribute. Although this obligation interferes with the decisions that some workers would freely make, it is fully justifiable from a public policy standpoint, because many of them would otherwise not save, or would withdraw their funds if they could, as occurred in Chile and Peru, even though most of them have not suffered significant drops in their income.

As can be seen in Figure 1, there are diverse reasons driving this behavior. One of them is the myopia and preference for present consumption that the vast majority of workers have and the perception of tax on contributions of some of them. This perception has probably changed after withdrawals have shown that the funds are actually the property of members and that they now value individual accounts more. There are other factors that influence the evasion and avoidance of the obligation to contribute, such as the existence of incentives to underreport income to increase non-contributory pension benefits and the benefits granted by other social security programs. Hence the importance of improving the design of these benefits, to ensure that they are adequately complemented by contributory pension benefits.
Mandatory contribution is also important to avoid affecting public policy objectives in pensions and substantially increasing the costs of achieving these objectives for current and future generations (see Figure 2). In pension matters, there is a public interest in preventing individuals and their families from experiencing sharp drops in their standards of living, or falling into poverty on retirement. Thus, when members fail to save enough to finance their pensions, or withdraw their accumulated savings, future generations of workers will pay the bill, as their tax burden will increase and/or the provision of other public goods and services will decrease, due to the necessity to increase the fiscal resources destined to paying the pension benefits of those who made the withdrawals.
II. Consequences of withdrawals for members, the pension system and the macroeconomy

1. Drop in pensions

The main effect of the withdrawals will be a drop in the pension amounts that the individually funded systems will be able to grant. It is estimated that pensions in Chile will drop by up to 18% for members with average salaries, as a result of the first and second withdrawal (see Graph 1). The effects will be greater on the pensions of women and lower-income members, with a drop of up to 26% for those women who are 20 years from retirement and earning the minimum wage. In Peru, estimates show that individual account balances could drop by up to 24.5%, exclusively due to the last withdrawal authorized by Law 31,017 (25% Withdrawal Law due to Covid-19).

Graph 1

Chile: Effect of the first and second withdrawal on the future pensions of active members:
percentage drop in the pensions of members earning an average salary (1)

(1) 4% return on the funds and retirement at the official retirement age are assumed, with contributions starting at age 25; women with average salaries of US$ 1,063 and men US$ 1,193. Exchange rate of CLP 766.69 per US$.


It is estimated that the two withdrawals authorized in Chile are equivalent to almost four percentage points of contribution. Offsetting the negative impact and recovering individual account balances will require between two and six additional years of contributions, with greater effort required by lower-income workers, women and youth.

Savings withdrawals have also entailed a loss of returns for those who made them. For example, in Chile, members who requested the first withdrawal as soon as it was authorized, lost up to 12%, considering only the returns between August 2020 and January 21, 2021.

2. Greater inequity

There will be greater inequity in the contributory system, worsening the situation of the most vulnerable groups of members, which will accentuate the need to adopt policies that protect them from falling into poverty or from experiencing sharp reductions in their standards of living when they reach retirement age.

3. Disincentives to contribute and greater informality

The high percentage of members who will end up without a balance, or experience substantial drops in their funds after withdrawing pension savings, together with
the increase in benefits in non-contributory programs and the greater economic difficulties faced by individuals and companies, will discourage contributions to the AFP system and will encourage greater informality.

4. More dependence on non-contributory pensions and state subsidies

This will increase the pressure to continue increasing non-contributory benefits and expand their coverage, which will reconfigure the multipillar pension system. The relative importance of the solidarity pillar managed and financed by the State will increase, and the amount of self-financed pensions granted by individually funded systems will be reduced, unless the necessary measures are adopted to partially or totally compensate the effects of the withdrawals.

5. Changes in pension fund portfolios and impact on financial markets

The withdrawal of pension savings in Chile and Peru generated uncertainty and greater volatility in the market prices of the most relevant financial instruments, and forced the AFPs to liquidate a large number of assets in a short period of time. The measures adopted by the central banks, the actions implemented by the supervisory agencies and the portfolio management strategy of the AFPs, were fundamental factors in containing this market reaction and the volatility of financial asset prices.

To the extent that withdrawals become repetitive, as is happening in Peru, the impact on the portfolios of pension funds and financial markets will be even greater, because the scope of action of regulators is reduced and because the uncertainty and lower confidence generated by repetitive withdrawals can reduce the national and international investor base, pushing up the risk premiums and financing costs for individuals, companies, financial agencies and the State. According to the Central Bank of Peru, the authorization of repetitive withdrawals will lead to a future financial market with more volatile long-term interest and exchange rates, due to the weakening of the stabilizing role of pension funds in these markets.

In Chile, the frequent fund switches that force the purchase and sale of financial instruments in very short periods of time, alter the investment structures of pension resources, distancing them from those that are more suitable for long-term savings.

6. Negative impacts on the insurance industry

The reduction of the accumulated balances in the individual accounts will reduce the savings that can be used for the different pension modes, including life annuities, and will impact disability and survival insurance costs.

7. Deterioration of the fiscal financial situation

Withdrawals will also increase fiscal expenditure in the pension system and may increase the cost of financing public debt, making it difficult to achieve the fiscal consolidation necessary for the sustainability of public spending required to pay pensions in the non-contributory system in the future.

It is worth mentioning that the withdrawals of funds have improved knowledge of the system and have made it clear to members that their savings in their individual accounts belong to them, resulting in an improvement in the image of the AFPs. This may diminish the tax notion of members regarding contributions, although it does not compensate for all the negative effects of the withdrawals discussed above.
III. Risks for members and the system of withdrawing mandatory pension savings for purposes other than pensions

Withdrawals of mandatory pension savings for purposes other than pensions entail the following risks for members and the system:

1. Greater dependence of workers on non-contributory pensions and state subsidies

The readjustment of the multipillar system will increase the dependence of the pensions obtained by the members on the fiscal financial situation, especially for lower income workers. This is in a context of deterioration in fiscal accounts as a result of the pandemic, reduced economic activity and greater public debt, added to the financial challenges that the pension system will face due to population aging and the greater number of pensioners, which will increase the risks of non-compliance with pension promises in contributory and non-contributory programs based on PAYGO schemes with intergenerational transfers. There is considerable worldwide experience with these types of systems.

2. Vulnerability of the system to proposals for new withdrawals

By violating the sole and exclusive purpose of pension savings, the AFP system is exposed to the possibility of new withdrawals of funds being proposed in the future, due to a prolongation of the effects of Covid-19 and the occurrence of other contingencies. The experience of Peru, a country where several withdrawals have been approved, shows that once withdrawals for purposes other than pensions are allowed, it is difficult to “close the door” to avoid repeating these types of measures, especially when driven by political and ideological motives.

3. Greater risk of future reforms that weaken the pension system

If withdrawals are not a last resort, and if their design and characteristics do not meet means-testing requirements, and if measures are not adopted for compensating withdrawn contributions, pensions will be negatively and substantially affected, weakening the individual accounts contributory system and increasing the risk of future reforms to it.

Withdrawals of pension savings will increase the number of members with zero or low balances in their individual accounts, giving rise to a greater concentration of pension funds in the accounts of higher income workers with more years of contributions, thus discouraging contributions. All of the above will reduce pensions and make the contributory system more vulnerable to reforms that affect its proper development.

IV. Protection against different social contingencies and complementation and integration between different public policies

The non-existence of social security programs with broad coverage to protect workers from the risks of various social contingencies, gives rise to serious consequences for workers who are not protected should they materialize. Furthermore, when problems affect a large number of workers, as in the current pandemic, there are political and civic pressures for implementing programs that can alleviate the financial situation of some workers and their families in the short term, although they were not designed to protect them from current contingencies. This has significant costs, inasmuch as they the defeat the purpose of said programs, as occurred with the authorization of withdrawals from pension funds during the Covid-19 pandemic.

The creation and implementation of the different social security programs must ensure the protection of workers and their families against different contingencies. They must be designed to promote the harmonious development of all programs, minimizing the disincentives for participating
in them. For example, the financial coverage of health benefits usually depends on the income that people declare, which leads to evading or avoiding the declaration of income in formal pension systems.

The financial constraints faced by the countries of our region, which will increase in the coming years as a result of the effects of the pandemic and the economic crisis, limit the possibilities of making rapid progress in broad coverage of the different social programs. However, this does not preclude planning reforms that seek to gradually increase coverage, to the extent that economic conditions will allow it.

In most Latin American countries, systems are structured to preferably cover formal dependent workers. This is clearly insufficient, especially with current trends in labor markets, where workers move between different types of work much more often. Loss of formal employment as a dependent should not lead to loss of social security protection. New policies aimed at universalizing protection must be adopted, incorporating new independent and informal workers who work in sporadic jobs. This requires a good understanding of the functioning of the labor markets of these various types of workers, identifying the factors that prevent or hinder their participation in the system, and designing programs that recognize their realities and contain incentives for them to participate. In this design, experiences and lessons learned by studying behavioral economics and the possibilities offered by existing technology should play a primary role.

Finally, the experience of our countries emphasizes the importance of educating workers regarding the characteristics of existing programs and helping to generate realistic expectations of the benefits they may receive, as well as advising them on the decisions they can take to improve these benefits and reduce the gaps between reality and their aspirations.

V. Behavior and design of withdrawals

1. Behavior

Chile

Due to the pandemic, two pension funds withdrawals were authorized in Chile, the first one in July 2020 and the second one in December of the same year, both for 10% of the savings in the individual account, with a minimum amount of 35 Unidades de Fomento (UF) (USD 1,384) and a maximum amount of 150 UF (USD 5,933).

These minimum and maximum amounts make the 10% inapplicable in many cases. For example, young workers with little savings could withdraw even 100% of their savings in their individual accounts and not reach the minimum amount. Workers close to retirement, on the other hand, can reach the maximum amount withdrawing a percentage much less than 10% of their savings.

All AFP members were able to withdraw funds, without meeting any requirement, and even with tax benefits, since the 1st withdrawal was not subject to tax - whereas pensions are - and only medium/high income was subject to tax in the 2nd withdrawal (people with income greater than 30 Annual Tax Units (USD 2,040 per month).

Figure 3 shows the main results for both withdrawals. As expected, almost all members requested the first withdrawal (more than 10 million people), dropping to 7 million in the second withdrawal, because many people used up their savings in the first withdrawal, and also due to the tax changes (higher incomes paid taxes in the second withdrawal) and due to a recovery of employment. Although the amounts withdrawn in both withdrawals represent 17% of the pension funds, accumulated in up to 40 years, many people withdrew a significant percentage of their savings, due to the minimum amount that could be withdrawn.
Figure 3
Chile: Results of the first and second fund withdrawals

<table>
<thead>
<tr>
<th>First Withdrawal</th>
<th>Second Withdrawal</th>
</tr>
</thead>
<tbody>
<tr>
<td>• USD 20,224 million</td>
<td>• USD 13,030 million</td>
</tr>
<tr>
<td>• 10,232,386 people</td>
<td>• 6,917,988 people</td>
</tr>
<tr>
<td>• Average amount: USD 1,938</td>
<td>• Average amount: USD 1,994</td>
</tr>
<tr>
<td>• 39.3% average balance</td>
<td>• 33.1% average balance</td>
</tr>
</tbody>
</table>

Total pension funds: 17% approx. (*)

Source: In-house based on data published by the Pensions Commission. The date of the data was up to 12/25/2020.

(*) Based on accumulated pension funds as of June, 2020.

Peru

Pension savings withdrawals started several years earlier in Peru, in 2016, with a law that allowed the withdrawal, in a lump sum payment, of 95.5% of the savings of people who were opting for early retirement or retiring at the official retirement age.

Then came the law that allowed withdrawals, at any age, of up to 25% of savings, to buy a first home or pay the mortgage.

In 2020, two Emergency Decrees allowed withdrawals of up to USD 557 on two occasions, for fully unemployed low-wage workers with no recent contributions.

Finally, a law allowed all members to withdraw up to 25% of their pension savings, with a minimum amount of USD 1,200 and a maximum amount of USD 3,600.

The sum of the impact of all the aforementioned laws is a total withdrawal of USD 14,434, equivalent to 39% of the pension funds that existed when the withdrawals started in May 2016.

Graph 2 shows the age distribution of withdrawals in Peru. The 95.5% withdrawal, for which retirement is a requirement, is shown in red. It is the most significant withdrawal by people over 51. The 25% withdrawal due to Covid-19 is shown in light blue. It is the most significant withdrawal by people between 21 and 50. Withdrawals for housing, in dark blue, are concentrated in the 31-60 age bracket, and withdrawals due to Urgency Decrees in the younger age groups (under 21, and 21-30) are shown in yellow and green.
2. Design

Considering myopia and people’s preference for consumption, an adequate design of mandatory savings withdrawals for pensions should consider three characteristics:

(i) **Means-testing**: Whereby only people who need it with some degree of urgency can access the withdrawal. This refers to people who are unemployed or have suffered a significant reduction in their income.

(ii) **Tax Neutrality**: The idea is that at least, or as a minimum, the early withdrawal of funds cannot be accompanied by a tax benefit. It makes no sense to encourage the early withdrawal of pension funds, and allow people who do not need it to do so, since it reduces the value of pensions and increases State spending, as previously mentioned. For countries where contributions are tax-free and pensions are taxed, it is proposed that early withdrawals should be taxable, since those people who lost their job or whose income fell sharply, will not pay a tax very different from the usual, whereas those who have maintained their income and have made withdrawals, will see an increase in their taxes due to the duplication of income, i.e., the salary plus the withdrawal.

(iii) **Replacement**: Since pension savings have a sole, exclusive purpose, people need to understand that withdrawing funds has a negative impact on the future pension amount that they can self-finance. In other words, the withdrawal has a cost; it is not free. Therefore, once the contingency has passed, efforts must be made to achieve the pension that they would have had without withdrawing the funds. To raise awareness, it is proposed that on retirement members must choose the recovery modality, consisting in temporarily increasing the contribution rate, increasing the retirement age, or a combination of both.

Figure 4 evaluates the withdrawals in Chile and Peru, considering the three proposed design characteristics. As can be seen, there is no means-testing of withdrawals in Chile (all members are allowed to withdraw) and in Peru only the withdrawals allowed by the Emergency Decrees are partially means-tested. The 25% Withdrawal Law due to Covid-19 does not involve any means testing.

Withdrawals in Chile have a tax incentive, especially the first one. In Peru withdrawals are tax-free, since pensions in that country are not subject to taxes.

Neither of these countries meet the principle of replacement of withdrawn savings, since no recovery mechanisms have been established so far.
Regarding the poor means-testing of fund withdrawal in Chile, María Cecilia Cifuentes, Executive Director of the Center for Financial Studies of the ESE Business School of the University of Los Andes, says that the National Accounts data by Institutional Sector, recently published by the Central Bank, provide interesting insights on the matter. According to Cifuentes, if we look at the household sector, we can see that compared to the drop in GDP of almost 8% in the first three quarters of 2020, labor and capital income fell at a similar rate, 6.5% in that period, but given that State transfers to households multiplied by almost four times, the drop in income was finally reduced to only 2.6% on average, which does not seem at all dramatic. It also enables affirming that fiscal policy did benefit families.

If we look at only the second and third quarters of 2020, the most acute phase of the pandemic, transfers from the State to households multiplied by almost five times. And what happens if we add the first withdrawal from the pension funds? This is where we have one of the great paradoxes of 2020, since, in the midst of the deepest crisis of the last 38 years, the disposable income of households increased by well over 10% between January and September (see Graph 3). It is evident that, if one sought to counteract a drop in disposable income of less than 3%, it turned out to be not only a very badly focused policy, but also excessive. One must also bear in mind that the increase in disposable income will be even greater when considering the numbers for the fourth quarter of 2020, which include the second withdrawal.
In Cifuentes’ opinion, the above is not the worst. Crises generate temporary damages, which in the long term can be compensated with the lessons learned from them. The pension fund’s withdrawal policies in Chile and Peru have confronted lawmakers with a transitory problem, less serious than what they had proclaimed, generating enormous permanent damage, significantly exacerbating one of the most serious problems they currently face in the region: pensions. According to her, they also transmitted a deeply erroneous message to the population, with an alarmingly short-term outlook: “Any short-term emergency can generate serious permanent damage, preventing the birth of creative thinking, discoveries and great strategies during the crisis.”

Similarly, Giovanna Prialé, Chairman of the Peruvian Association of AFPs, emphasized the importance of examining the Peruvian case, so that other countries do not make the same mistakes. According to Prialé, the political climate is very important because in the end, decisions are no longer of a technical nature, but rather become a kind of convenient excuse for lawmakers looking to find the easiest thing to attack, causing damages that are irrecoverable, because there are no measures in place for returning those funds.

VI. Experiences of other countries

The analysis of pension fund withdrawal experiences worldwide, shows that only three countries allowed the early withdrawal of mandatory pension funds due to Covid-19: Australia, Chile and Peru. It must be pointed out that these are mandatory pension systems, because several countries with voluntary pension systems, in which withdrawals can normally be made by meeting certain requirements, made the withdrawal of pension savings more flexible, or facilitated them, during the pandemic.

It should also be noted that there are Latin American countries where by law, pension fund managers also manage unemployment benefits, either in a single fund (as in Mexico) or in a fund separate from the pension fund (as in Colombia). As with unemployment insurance in Chile, they are not considered as
early withdrawals from pension funds in this analysis.

It is also worth mentioning that the two countries with the pension systems best evaluated by Mercer, the Netherlands and Denmark, did not allow the withdrawal of pension funds due to Covid-19, despite their very abundant assets (over 150% of GDP).

Australia allowed two fund withdrawals for a maximum of USD 7,424 each, but not for all members, but rather means-tested for the unemployed (reduction in working hours greater than 20%) or for those with significant income reduction (self-employed workers with drops in sales greater than 20%). Withdrawals were also subject to taxes.

Graph 4, based on OECD data, shows that Peru and Chile are the countries that allowed the highest early withdrawals from pension funds, as a percentage of total assets of pension plans, due to Covid-19. One must bear in mind that this data is some months old, and does not include, for example, in the case of Chile, the second withdrawal and some delayed first withdrawals.

Graph 4
Value of early withdrawals in selected countries, in 2020
(% of total assets in retirement savings plans at the end-2019)

[Graph showing data for Peru, Chile, Iceland, Australia, Mexico, New Zealand, and Spain]


If we consider the figures updated to December 2020, withdrawals in Chile amount to 17% of its pension funds, and withdrawals in Peru amount to 18%, considering only the withdrawals in 2020 due to Covid-19. Thus, the updated withdrawal amounts for Chile and Peru exceed the limits of the graph, exceeding withdrawals in Australia, the third country that allowed withdrawals from mandatory funds, by more than 10 times. The difference appears to be excessive.

VII. Conclusions

The most significant conclusions are the following:

(i) The obligation to pay in pension contributions is justifiable, because otherwise the majority of workers would not save, or withdraw their funds if they had the option. It also furthers the objectives of public pension policies.

(ii) International experience shows that the most effective way to achieve broad coverage is by making contributions mandatory.
(iii) The main effect of the withdrawals will be a reduction in the pension amounts that the individually funded systems will be able to pay.

(iv) The withdrawals will generate greater inequality in pensions, disincentives to contribute, a readjustment of the pillars of the system and a higher fiscal cost, while increasing the risks for members and the system.

(v) Social security coverage should be gradually increased with a design that integrates and streamlines all the programs.

(vi) The effects of the pandemic on labor income have been significant in Latin America, due to its high rates of informality.

(vii) Support measures for the pandemic have ranged from direct state transfers; easing of unemployment insurance; and delivery of soft loans and employment protection programs.

(viii) If authorized, the early withdrawal of mandatory savings must be exceptional, as a last resort, means-tested and tax neutral, and must be replaced so as not to damage pensions.

(ix) Only three countries in the world allowed the withdrawal of mandatory pension savings due to the pandemic: Australia, Chile and Peru.

(x) Peru and Chile rank first and second in withdrawals as a percentage of total funds, due to an inadequate design of withdrawals.

(xi) In Chile, the fiscal impact of both withdrawals will amount to USD 8,554 million (3.6% of GDP), with an effect equivalent to lowering the contribution rate by 3.8 percentage points, which cancels out more than half of the increase in the contribution rate proposed in the reform.

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