Pension Notes

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What reforms are needed to improve pensions in Latin America?

Federación Internacional
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Executive Summary

World population aging has driven a growing involvement of the individually funded systems in the construction of adequate pensions for workers. It is therefore extremely important to improve the following seven design features:

1.**Improve coverage:** Contributors make up 33.8% of the Economically Active Population (EAP) in Latin America, whereas in OECD countries they are more than double, at 72.1%. Only 1 in 3 workers, on average, are currently contributing in Latin America, a phenomenon directly related to the degree of economic development and labor informality in the region.

Increasing coverage to European levels would entail more than double the number of self-financed pensions in Latin America, on average, with a significant reduction in tax expenditure on non-contributory pensions.

2.**Implement non-contributory pension programs:** Increasing coverage is not feasible in the short term, so it would be necessary to establish and/or enhance well-designed and means-tested non-contributory pension programs to help the elderly who are not entitled to an adequate contributory pension.

3. **Provide them with a technical mechanism that periodically adjusts their parameters:** Contribution rates in OECD countries are double the rates in Latin American countries, and the effective retirement age is also higher. Although life expectancy is growing considerably in Latin American countries, contribution rates and retirement ages have remained constant in all countries, with the sole exception of Mexico. Parameters need to be updated regularly to align with international trends and meet pension adequacy standards.

4. **Improve the returns and safety of pension fund investments:** Considering the significant impact of returns on long-term savings, this is an area that requires ongoing adjustment, considering the relaxation of investment limits and a broader range of eligible instruments, alternative assets, multi-funds and target date funds.

5. **Aggressively promote voluntary pension savings (VPS)**: This is key in a scenario in which mandatory contributions are insufficient for financing adequate pensions. In addition to traditional incentives, such as tax incentives, granting some degree of liquidity to savings and matching contributions, and introducing mechanisms based on the behavioral economy, such as automatic registration or enrollment, automatic and gradual contribution increases, plus a limited number of predetermined options to facilitate the participation of workers, could encourage VPS even more. International experience (USA, New Zealand, Italy, the United Kingdom, Turkey, Lithuania, Poland and Ireland), shows that automatic enrollment in pension schemes has become one of the main levers for boosting voluntary pension savings, thus helping to supplement the sources of retirement income for thousands of workers.

6. **Improve the decumulation stage of the systems,** by establishing pension modalities that conform to the principles of social

security and people's requirements, providing advice to members when selecting pension modalities, implementing an efficient system of consultations and pension amount offers, improving the regulations governing pension calculations, and periodically updating the mortality and life expectancy tables.

7. **Communication and Financial Education on pensions:** To increase pension amounts, workers must be informed of their progress in constructing their future pensions and have sufficient financial education to understand the information they receive from their fund manager. Countries should introduce national financial education strategies for pensions.

FIAP deems it necessary to identify the real causes of low pensions, avoiding the adoption of demagogic or populist measures that end up weakening the pension systems, without resolving the problem of workers' pensions.

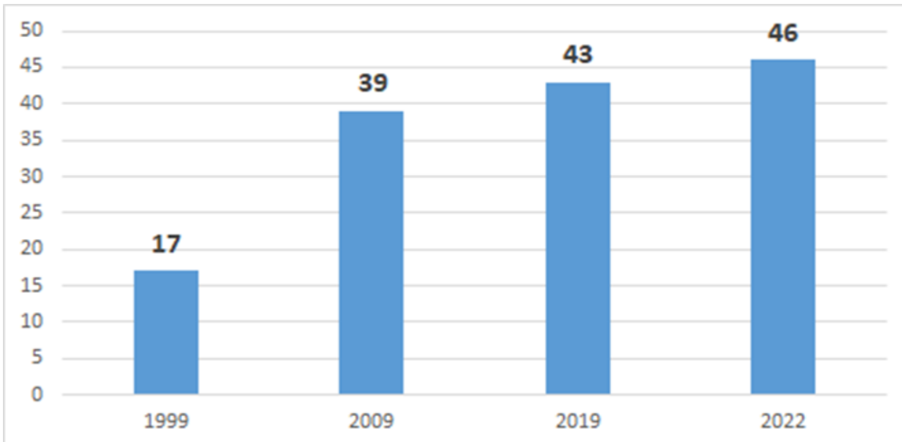
We are convinced that the solution to the problem of contributory pensions is not to expand or return to the PAYGO systems. Such systems are unviable in the long term because, due to population aging, there will be fewer active workers to finance the pensions of senior citizens. In fact, according to United Nations data, the ratio of the population aged 15 to 64, in relation to the population aged 65 or more, will decrease from 7.5 in 2020 to 3.8 in Latin America and the Caribbean by 2050.[1], a drop of 49% in just 30 years, which will be further aggravated by Latin American labor informality, thus considerably underfunding the PAYGO systems and making it impossible for them to provide adequate pensions.

Thus, as shown in the graph below, the number of countries that have incorporated individually funded systems has grown significantly in recent decades.

[1] Source: "Potential support ratio (15-64/65+) by region, subregion and country, 1950-2100 (ratio of population 15-64 per population 65+)", World Population Prospects 2019, United Nations. This refers to lone individually funded systems; individually funded systems competing with PAYGO systems, and individually funded systems as a complement to PAYGO systems.

Graph 1

Countries that have incorporated different types of individually funded systems (1999-2022)



Source: FIAP based on OECD data.

Individually funded systems must be a fundamental part of the construction of adequate pensions, although there is no doubt that their design, parameters and institutional framework require adjustments in the accumulation and decumulation stages. Nonetheless, the need for such adjustments should not be grounds for questioning their structure. On the contrary, improvements must be adopted as a matter of urgency for the ultimate good of workers and public finances.

Hence, the following measures should be included in reforms for improving pensions:

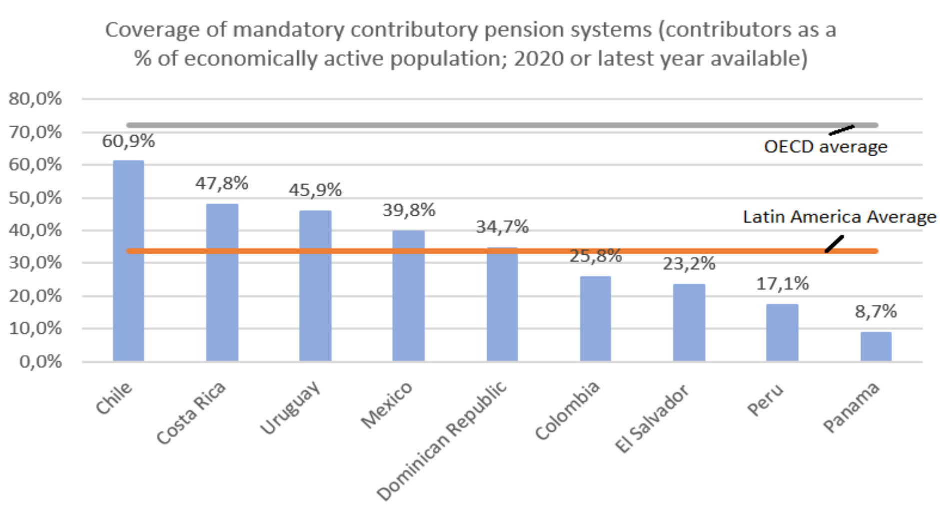
1. Improve Coverage

As shown in Figure 2, 33.8% of the Economically Active Population (EAP) contributes in Latin America, compared to 72.1% (more than double) in OECD countries. This difference is evidence that only 1 in 3 workers, on average, are currently contributing to the pension system in Latin America, a phenomenon directly related to the degree of economic development and informality of the labor markets in the region.

This is a heterogeneous reality, with countries with relatively higher coverage such as Chile, Costa Rica and Uruguay, and others in which this is an even more important challenge, such as Colombia, Peru, and El Salvador, with ratios of between 17% and 26% of EAP.

Increasing coverage to European levels would entail that pension amounts would more than double in Latin America, on average, with a significant reduction in tax expenditure on non-contributory pensions.

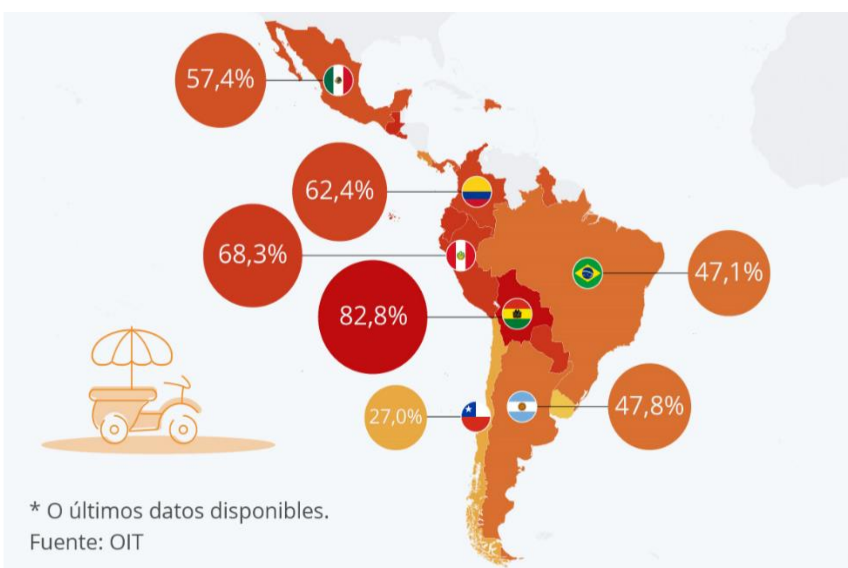
Graph 2.



Source: FIAP and "Pensions at a Glance 2021, OECD".

Experience shows that the most effective way of increasing coverage is to make pension contributions mandatory, or alternatively, establish quasi-mandatory systems (with default enrolment and an opt-out option). In Latin American countries, however, with high levels of informality of even more than 60% (see Figure 3) and high labor recruitment costs, new effective mechanisms must be found for increasing coverage and raising additional funds to finance pensions.

Graph 3.- Labor informality in Latin America – Percentage of employed workers in the informal economy in 2021*



*Or latest year available. Source: ILO.

One of these mechanisms is the incorporation of self-employed workers into the mandatory pension system. Countries such as Uruguay and Chile have made significant progress in this regard.

Pension contribution evasion and avoidance are also important factors in decreasing coverage and collecting contributions, so it is essential to take measures to reduce their effects, such as pension education, reducing labor costs, and enhancing oversight of workers' contributions payments.

To this end, it is also important to review the design and interrelation of existing social programs, to avoid or minimize incentives for evasion and underreporting of taxable income, aimed at improving the benefits received in other social security programs, such as health, for example.

Another alternative to explore for increasing coverage is to link contributions to workers' consumption (pension contributions through consumption), using different mechanisms, such as a percentage of VAT.[2] that is paid into the individual accounts of workers; or through default rules that allocate a part of the consumption to individual savings through technological applications.

Finally, to increase coverage, mainly in more informal sectors, there are the so-called digital micro-pensions. In private pension schemes, workers' contributions are usually deducted from their wages on a monthly basis. However, since low-income groups and workers with irregular income streams are more inclined to make small payments at flexible time intervals, micro-pension applications have recently begun to appear[3], which allow their participants to contribute to their savings accounts in small amounts, in daily and weekly intervals.

2. <u>**Establish non-contributory pension programs**</u>

Improving the pension coverage of contributory programs is undoubtedly the main challenge facing many Latin American countries. However, this cannot be implemented in the short term. This means that well-designed and means-tested non-contributory pension programs will have to be established or enhanced to help senior citizens who are not entitled to an adequate contributory pension and do not have any other income, or who receive a pension deemed insufficient to meet their basic needs in old age. Thus, non-contributory pension amounts should cover at least the poverty line.

According to Bettina Horst (2021)[4] the existence of a non-contributory pillar may eventually lead to less skilled formal workers who are contributing to the social security system to stop working or switch to the informal market, thus ceasing to contribute, especially in the case of low-paid jobs, in which their projected contributory pension in the system is not very different from a basic solidarity pension granted by the State. Thus,

[2] Value Added Tax

[3] An example of this type of application is pinBox Solutions (https://www.pinboxsolutions.com/), a fintech dedicated to the digital inclusion of micro-pensions in Asia, Africa, Latin America and the Caribbean.

[4] https://lyd.org/wpcontent/uploads/2021/10/SIESistemadePensionesSolidarias295-Septiembre2021.pdf,

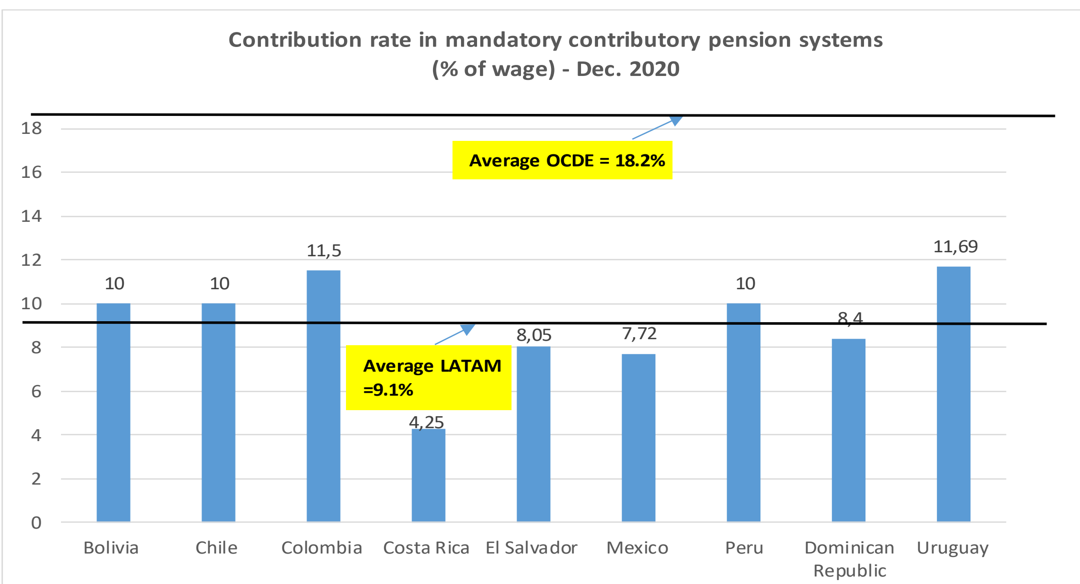
when discussing changes to pensions provided under a non-contributory pillar, one must bear in mind any possible incentives to stop contributing that may be generated and consider them in the final design of this pillar. Furthermore, non-contributory pensions must be financed by general taxes and not by labor taxes, precisely in order not to discourage contributions to contributory pension schemes.

There is currently also a discussion about whether non-contributory pensions should be universal or not. In this regard, in addition to the impact on the incentives to contribute to a pension, the short- and long-term fiscal impact of migrating from a non-contributory means-tested system to a universal non-contributory pension for all those who retire, regardless of their mandatory savings and their socio-economic level, must be considered in the discussion. One must also bear in mind that there will be pressures to increase non-contributory pension amounts, either because the poverty line or the minimum wage increases, and that fiscal spending on these programs will grow due to population aging.

3. **<u>Provide them with a technical mechanism that periodically adjusts their parameters</u> (for example, contribution rate and retirement age)**

The contribution rate of OECD countries is double the rate of Latin American countries (see Figure 4). It is therefore urgent to gradually increase contribution rates to align with international trends and meet pension adequacy requirements.

Graph 4



Source: FIAP and "Pensions at a Glance 2021, OECD".

The average effective retirement age in OECD countries is 63.4 for women and 64.2 for men. In the nine Latin American countries operating individually funded systems, the average effective retirement age is 60.5 for woman and 62.2 for men. Women retire earlier, which is justified as a privilege or special treatment. However, this does not really benefit them in an individual savings system, since they have shorter savings periods and longer life expectancy on retirement compared to men, which means that their average pensions are lower than men's pensions.

According to World Bank data, the average life expectancy at birth in Latin America increased by almost 11 years between 1980 and 2019, while increasing by eight years in the same period, in OECD countries. Increased life expectancy is certainly good news, although it does entail a challenge for traditional PAYGO and individually funded pension systems. In the latter, pension amounts are based on the accumulated savings of individuals throughout their active working lives, interest rates, and their estimated survival time on retirement. If this survival time increases and individuals have not accumulated sufficient savings, because their contribution rates were very low, or because they did not contribute for a sufficient number of years, or because the legal retirement age did not increase with life expectancy, their pension amounts will decrease and will be less than what they would have received if these parameters were better aligned with the pension objectives and the factors that affect the pensions granted by the system.

Given this situation, decision makers would be expected to promote reforms aimed at making the necessary changes in these parameters, in order to increase the pension amounts that workers will receive on retirement. Specifically, public policies would be expected to:

- Raise contribution rates to levels that are consistent with pension objectives.
- Adjust the retirement age to life expectancy and address the challenge of greater longevity.

In recent decades, however, only two countries in the region have made parametric adjustments for increasing pension amounts. Mexico recently carried out a pension reform that gradually increased the contribution rate from 6.5% to 15% of wages, among other aspects, and El Salvador implemented a reform aimed at mitigating the longevity risk of members, by introducing a mechanism to ensure the continuity of pension payments after individual savings have been exhausted (longevity insurance).

In contrast, due to the COVID-19 pandemic, Chile and Peru promoted the depletion of pension savings in the last two years, through massive early withdrawals of pension funds, for use at the discretion of individuals for purposes other than pensions (without means-testing on those who had lost their jobs or experienced a significant reduction in their income).

This is an extremely serious situation in social security terms, as the measure defeats the purpose of improving pensions. Moreover, there were other negative effects identified in the Chilean case, which could potentially be repeated in other countries:

- Workers will have to defer their retirement for about 6 years to recover their pension savings.
- Higher inflation, which is a regressive tax.

- Negative impact for families wanting to access mortgage loans, since dividends have increased due to higher interest rates, shorter loan repayment terms and higher down payments.
- Impact on capital markets due to liquidation of assets to pay authorized disbursements.

To adjust parameters, it is important to define a reference replacement rate, which is not guaranteed, but which one aspires to achieve with parametric adjustments. Longevity risk should also be closely monitored, with pension regulators and providers designing pension modalities that cover this risk, using up-to-date mortality tables and considering future life expectancy increases.

There are two mechanisms for adjusting the parameters of the pension system:

a. <u>Automatic adjustments,</u> such as indexing or adjusting the retirement age in accordance with life expectancy.

b. <u>Legally constitute a Technical Committee</u> endowed with powers and means, to review and adjust the parameters of the system, so that expected pension amounts consistently coincide with a certain replacement rate. For example, in Chile, in order to maintain pension amounts at the same level that could be financed at the beginning of the individually funded system, this body would theoretically have had to set a contribution rate of close to 20% for men and women (if the contribution rate was the only variable to be adjusted). One must also consider the impact of adjustments on the labor market and contribution densities, to determine the graduality of adjustments.

4. <u>Improve the returns and safety of pension fund investments</u>

It is estimated that a difference of one percentage point in the returns of pension funds throughout the accumulation period has an approximately 25% effect on final pension amounts. This demonstrates the importance of finding tools to increase returns, while maintaining limited risk levels. Occupational, financial, economic, demographic, environmental, social and corporate governance (ESG) risks must be considered.

A first effective tool for this purpose would be to relax the investment limits of fund managers and increase the number of eligible instruments; in some countries there are high concentrations of investments in public and/or national securities, due to regulatory restrictions and undeveloped markets. Furthermore, there should be no minimum investment amounts for certain instruments.

Another effective solution that has been proposed is to include alternative assets in the investment portfolios of pension funds. They have higher expected long-term returns than traditional assets (consistent with pension savings) because they have an illiquidity premium and greater complexity, and, in many cases, a negative correlation with traditional assets, improving diversification and investor protection.

Other solutions relate to improving the design of pension multi-funds and default options (with the possibility of fund choice options by members) and introducing *Target Date Funds* (based on the life cycle, with the legislation determining the type of fund corresponding to members, based on their age, with no fund choice options). In multi-funds, predetermined fund changes must be established for those who opt not to choose, or are unable to do so, in line with the purpose of the pension system and the risk levels deemed appropriate during the working lives of workers, or when they retire. Lifecycle investment strategies may be appropriate to encourage members to assume higher levels of investment risk when they are young, and to mitigate the impact of extreme negative outcomes as they approach retirement. People willing to choose their investment strategy should be educated about existing investment options, factors that should be considered in the decision and the expected results of the different investment options.

5. Decisively boost voluntary pension savings (VPS)

Voluntary saving is key in situations where mandatory contributions are insufficient to finance adequate pensions, but it has not been significantly developed in the region, unlike other countries where it has become an important complement to mandatory savings.

If a man starts voluntary pension saving at age 30, his total replacement rate will increase by 37 percentage points, while the replacement rates of women will increase by 32 percentage points.[5]

There are several factors that will determine the effectiveness of public voluntary savings policies. The traditional factors include:

- **Economic incentives to maximize impact on enrollment and contributions**. Tax rules should at least not discourage people from saving for retirement. The design of the incentives must consider the different population subgroups. Middle to upper-income people tend to respond to favorable tax treatment, while low-income people are more likely to respond to matching contributions and state subsidies,
- **Grant some degree of liquidity** to individuals to make early withdrawals from their funds, but with disincentives (for example, payment of taxes with surcharges or partial or total loss of tax incentives), ensuring that this does not end up significantly reducing retirement income,
- **Increase competition** between agencies offering voluntary savings products,
- **In-depth development of social security education**, and

[5] This exercise assumes: mandatory contribution 10%; voluntary contribution 5%; taxable income 1000 MU (monetary units); starting contributions at 25; worker retires at 65; contribution density is 80% of working life.

- **Promote employer** matching contributions, to encourage employees to contribute.

Voluntary pension savings can be stimulated by introducing behavioral economy-based mechanisms in the design of programs, such as:

- **Automatic enrollment**, covering all employees and possibly self-employed workers, as inclusive as possible.
- **Automatic and gradual increase in contributions** over time, which can help members reach appropriate contribution levels throughout their career, and
- **Set a limited number of default** options, which facilitate worker participation.

Based on international experience, automatic enrollment in pension schemes has become one of the main levers for boosting voluntary pension savings. Thus, by 2024, this mechanism will be applied to funded pension savings plans in at least 8 countries (see Figure 5), thus helping to supplement the sources of income for the retirement of thousands of workers.

Graph 5

Application of automatic enrollment internationally

Source: FIAP based on “Best practices and performance of auto-enrollment mechanisms for pension savings” (European Commission) and https://irrationalretirement.com/2021/12/16/what-a-shocker-automatic-enrolment-in-retirement-plans-works-how-it-started-and-how-to-make-it-better/

(*) USA: Since 2017, a wide variety of states have implemented automatic enrollment in their state pension plans. The House of Representatives also recently passed a bill mandating this mechanism for 401-k plans at the federal level (the bill will now be passed on to the Senate).

6. Improve the decumulation stage of systems prior to massive pension payments, for which it is necessary to:

a. **Establish pension modalities that conform to the principles of social security and the requirements of individuals**. In many countries, accumulated balances can be fully or partially withdrawn from individual accounts at the official retirement age, or in advance. This is not consistent with the principles of social security, according to which such balances should be transformed into relatively stable pension flows during the passive stage. On the other hand, the pension modalities available on retirement in most countries are Programmed Withdrawal and Life Annuity. Both alternatives have advantages and disadvantages, and it is commendable that future pensioner can make an informed choice between them. These modalities should also be improved, for example, by attenuating the decreasing programmed withdrawal amounts received, or by incorporating a longevity insurance that operates when the pensioner lives longer than expected.

b. **Provide advice to members when selecting the pension modality**. This decision is complex and may be irrevocable, with important consequences on the pension financed with lifelong savings. Quality, independent advice must be provided.

c. **Implement a consultation and pension amounts offers system, together with measures that increase the transparency**, competitiveness, and solvency of pension providers, ensuring the simplicity of the system.

d. **Improve the regulations governing the calculation of pensions.**

e. **Periodic updating of the mortality tables** and life expectancy, and consideration of special cases, such as terminally ill people, whose life expectancy is clearly different from that of an average pensioner.

7. Communication and Pension Financial Education[6]

To increase pension amounts, workers must be informed of their progress in constructing their future pensions and have sufficient financial education to understand the information they receive from their fund manager.

To this end, the communications sent to members by the fund managers must be clear and simple, with a minimum of technical language, especially when explaining the possible options. It must also be timely and aligned with a purpose. Customized information through online platforms or pension statements should ideally combine all pension sources and include projections to keep members informed and encourage them to take steps to increase the adequacy of their pensions. Projections should focus on potential real levels of retirement income, consider the probabilities of different outcomes, and pass risks on to plan members. Assumptions and methodologies should be fully disclosed. Comparison tools should provide standardized information to enable users to compare performance, costs, investment

[6] Recommendations for the Good Design of Defined Contribution Pension Plans was adopted by the OECD Council on 23 February 2022, on the proposal of the Insurance and Private Pension Committee (IPPC). https://lyd.org/wpcontent/uploads/2021/10/SIESistemadePensionesSolidarias295-Septiembre2021.pdf

allocation, and possibly other features of the plan, such as ESG factors considered in resource investment.

Retirement and pension financial education must also be supported. Countries should have national financial education strategies, including a focus on awareness and knowledge of the importance of saving enough for retirement, the different options available, and pension risks, such as longevity. Financial education is an ongoing process, which must include focused messages that evolve at different stages of life. Authorities should seek to improve people's understanding of how the pension system works and explain pension reforms, as well as their economic justification, through various means, such as communication campaigns.

BOX

Latin American experience shows that the PAYGO systems are regressive and not very supportive

Contrary to the proposals of some sectors to strengthen or return to the PAYGO pension system, for greater solidarity, the Latin American experience clearly shows that these systems have been regressive and unsupportive. First, a high percentage of members who do not meet the minimum requirements reach retirement age and do not receive a pension, losing part or all of their contributions. The vast majority are lower-income, vulnerable and female workers. Consider the examples of the former PAYGO system in Chile, or the PAYGO systems managed by the Office of Social Security Standardization (ONP) in Peru, or the former PAYGO system in El Salvador, in which 50% to 66% of members did not obtain a pension and lost part or all of their savings.

Moreover, an IDB study shows that, in most countries with defined benefit PAYGO systems, subsidies are granted to participants who are able to receive pensions, i.e., the benefits actuarially exceed the contributions made. Such subsidies favor the sectors that least need them, because they grow with the levels of income of individuals, i.e., they are regressive. The most alarming part is that the State must spend considerable resources to finance these subsidies which do not reach people who do not obtain pensions, or who do not participate in the system, because, among other reasons, they are in the informal sector, a very serious phenomenon in our countries.

Queries: International Federation of Pension Fund Administrators (FIAP).
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