



Pension systems in Latam: DC schemes

David Tuesta
BBVA, Chief Economist-Pension Unit

Workshop on Pension System of
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Index

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Section I

The introduction of social policies in Latin America

Section II

Defined contribution schemes in Latin America

Section III

Goals and outcomes

Section IV

Lessons from the Latin American experience

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The introduction of social policies in Latin America

In Latin America, “pay as you go” pension systems were introduced in different periods during the last century.

Pioneering countries:

Uruguay, Argentina, Chile and Brazil
Pension systems were introduced between 1910-1930

Intermediate countries:

Mexico, Peru, Colombia, Bolivia, Ecuador,
Paraguay, Costa Rica y Venezuela
Pension systems were introduced between 1940-1950

Late countries:

El Salvador, Nicaragua, Dominican Republic,
Guatemala, Honduras.
Pension systems were introduced between 1960-1970

The introduction of social policies in Latin America

But pension systems were not effectively managed:

- They offered many benefits with generous payments
- No relation between contributions and pensions
- Unpaid contributions by private and government employers
- Pensions were given in generous amounts without taking into account fiscal sustainability
- Pension parameters such as retirement age, years of contribution, contribution rate and others were not adjusted on time for economic and demographic changes
- Low and negative returns
- Pension funds were used for other activities such as infrastructure, health programs and current government expenses.
- High administrative costs
- Fiscal and political pressure
- Actuarial and financial imbalance

Unsustainable pension systems forced to pursue very realistic parametric changes but mainly new structural changes:

PARAMETRIC CHANGES

Important changes in terms of delaying retirement, increasing contributions, limiting anticipated retirement, incorporating more realistic benefits.

STRUCTURAL CHANGES

The introduction of a mandatory individual savings account systems as an important pillar of the pension systems

Index

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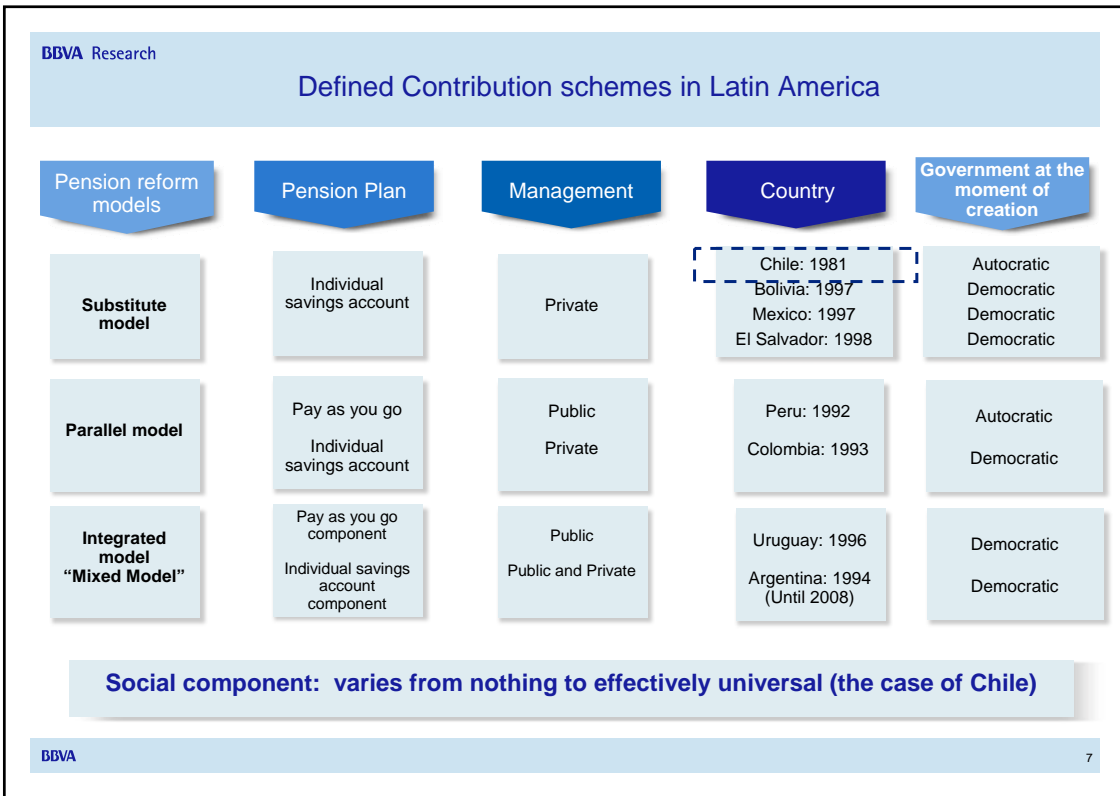
Section I
The introduction of social policies in Latin America

Section II
Defined contribution schemes in Latin America

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July 14th 2010

Section III
Goals and outcomes

Section IV
Lessons from the Latin American experience



Defined Contribution schemes in Latin America

	Social component	Mandatory DB	Mandatory DC	Voluntary DC
Objectives	Social	Redistribution + insurance	Saving + insurance	Saving + insurance
Administration	Government	Government	Private sector	Private sector
Financing regime	National Budget	PAYG or other	Individual capitalization	Individual capitalization
Benefit	Basic pension	Minimum pension	Pension as a function of saving	Pension as a function of saving
Financing	Government	Contributions + Government	Fully-funded	Fully-funded

Defined Contribution schemes in Latin America

DC contribution Scheme in Latin America

Pension Funds companies must collect contributions of its affiliates

Collect contributions

Invest resources in the best portfolios
+
Pension fund fiduciary obligations
+
Corporate governance
+
Custody

Mitigating conflicts of interest and agency problems

Insurance policy for death and labor disability:
An insurance policy that covers affiliated workers (all paying a similar fee).

Better results and Lower costs for Affiliates and Pensions

Contracts:
▪ Insurance companies to pay annuities

Very strict regulation on:

- Risk and return (central risk agency)
- Multifunds regime
- Authorized assets that depend on legal framework given by regulatory institutions
- Capital markets
- Prudent investment decisions
- Investment based on expertise

Defined Contribution schemes in Latin America

Advantages

- One stop shopping arrangement that reduces transaction costs.
- A sense of property rights by establishing individual savings accounts.
- Better expertise and prudent management, considering the historical bad performance of Latin American governments.
- Fiscal consolidation
- Efficient use of resources.
- Increase in national savings and potential GDP.
- Spur capital market development

However, it is important to deepen structural reforms in macroeconomics (labor market reform, capital markets reform, very focused social programs, institutional reforms, etc.) in order to get the best outcomes: coverage, replacement rate and sustainability

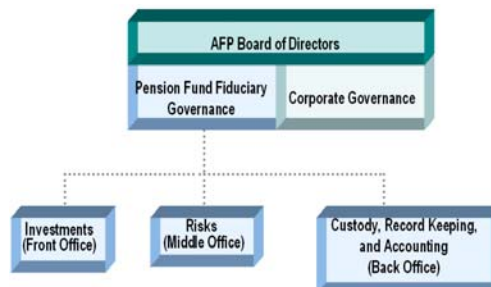
Defined Contribution schemes in Latin America

Pension Funds companies have fiduciary obligations with the funds and must follow best practices in corporate governance and mitigate conflicts of interest

Regulatory mandates

- ➔ Mitigate conflicts of interest and agency problems.
- ➔ Aligns interests with those of the affiliates
- ➔ Responsibilities defined at governing, managerial and operational levels.
- ➔ Fiduciary obligation with the fund
 - ➔ Prudent
 - ➔ Investor
 - ➔ Investment and decision
 - ➔ Specialists professionals

Pension Funds companies implement corporate governance rules according to regulatory requirements



Defined Contribution schemes in Latin America

Asset management: the case of "multifunds" in Chile

Basic characteristics

Type of Fund	US\$ Millions*	% of the Fund
Fund A	25375,8	21,33%
Fund B	24608,6	20,69%
Fund C	50055,9	42,08%
Fund D	14534,7	12,22%
Fund E	4377,1	3,68%

% of Equity

% Maximum	Current	% Minimum
80%	78%	40%
60%	60%	25%
40%	40%	15%
20%	19%	5%
5%	0,5%	-

*dic 2009

The default option

Type of Fund	Women < 35 years and Men < 35 years	Women between 36 and 50 years Men between 36 and 55 years	Women > 51 years and Men > 56 years	Retired workers
A			(-)	(-)
B	default			(-)
C		default		
D			default	default
E				

- Voluntary selection. Fund A is forbidden for people older than 50/55 as well as Funds A and B for retired workers.
- Default option is applied if the worker do not take an option.
- Default and prohibitions are only for the obligatory component.
- People can chose to have two kind of different funds.
- The age- mobility from one fund to another is progressive (20% annually).

Index

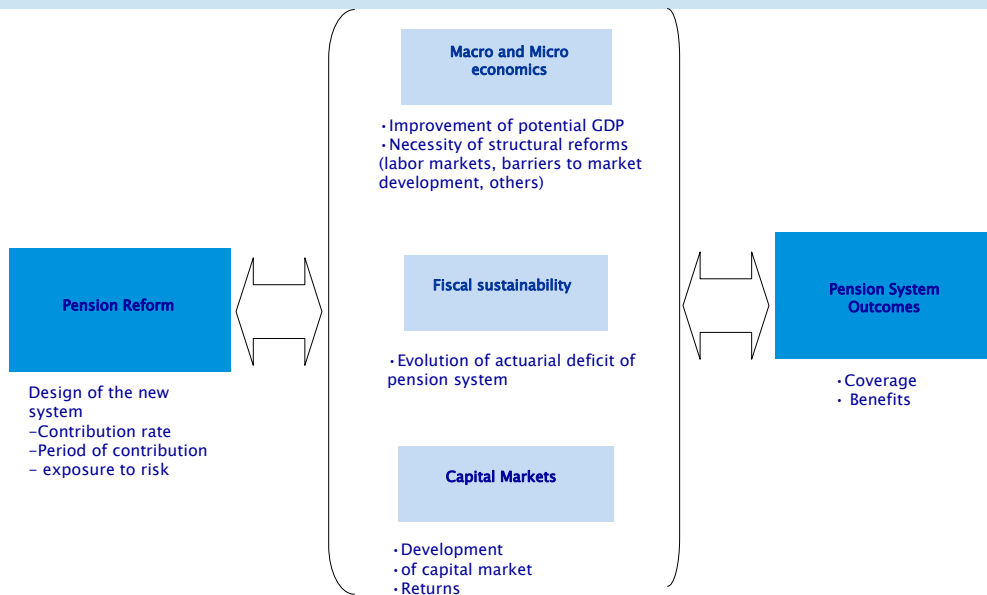
Pension systems in Latam: DC schemes

Section I
The introduction of social policies in Latin AmericaSection II
Defined contribution schemes in Latin America

Workshop on Pension System of China and Latin America CNCB Beijing July 14th 2010

Section III
Goals and outcomesSection IV
Lessons from the Latin American experience

Goals and outcomes: a new pension system and the interaction with other factors



Goals and outcomes: a new pension system and the interaction with other factors

Design of the reform: a pension according to how much you save

Country	Contribution rate		
	The first 10 years	From the beginning of the system	2009
Chile (1986)	10,0	10,0	10,0
Colombia (1994)	9,7	10,2	11,5
México (1997)	8,0	8,0	8,0
Peru (1993)	10,0	8,4	10,0

Macro and microeconomics

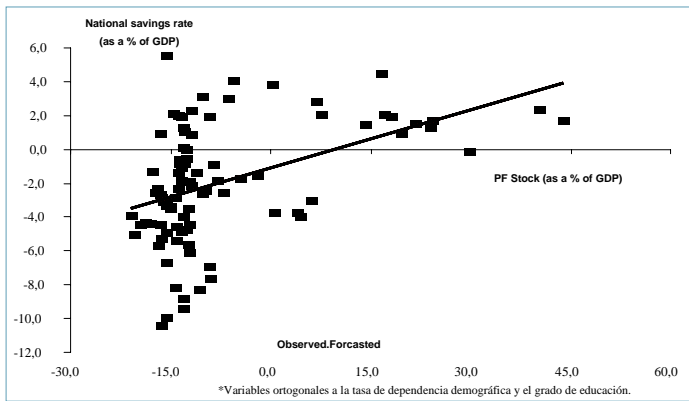
Country	Average GDP %		
	The first 10 years	From the beginning of the system	2008
Chile (1986)	7,9	4,6	3,2
Colombia (1994)	2,6	3,5	2,5
Mexico (1997)	3,2	2,7	1,4
Peru (1993)	4,4	5,4	9,8

A
During the first 10 years Chile experienced a better performance than its peers in the region

B
Growth in Latam has been improving, especially in Peru

Growth is a fundamental factor behind savings and financial market development

Macro and microeconomics



A 10 percent increase in the size of the pension funds has an impact of one tenth in aggregated savings.

Corbo y Schmidt-Hebbel (2003) found that a one percent point increase in pension funds, relative to GDP, has an impact between 1 and 5 points of GDP in savings.

Growth is a fundamental factor behind savings and financial market development

Goals and outcomes: a new pension system and the interaction with other factors

Macro and microeconomics

	Chile	Colombia	Mexico	Peru
Per capita GDP (constant US\$)	10,197	2,954	6,668	2,317
Labor informality (% population not covered by social security)	24%	52%	61%	71%
Labor legislation Protectionism (index)	18	27	41	61
Population of 65 years old and over				
2005	8%	5%	6%	6%
2050	22%	18%	21%	16%

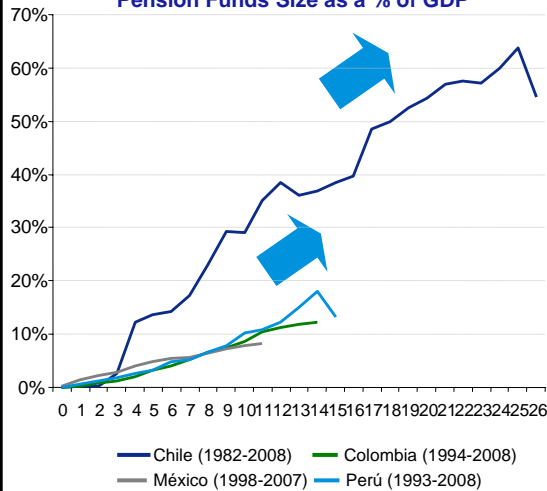
Source: BBVA ERD

Demographics and economic structural variables are the main determinants of the current and future performance of pension schemes

Goals and outcomes: a new pension system and the interaction with other factors

Capital Markets

Pension Funds Size as a % of GDP

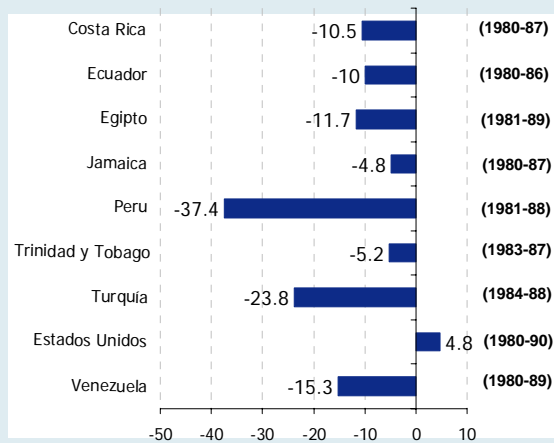


Country	Average return %		
	The first 10 years	From the beginning of the system	2009
Chile (1986)	10,4	9,1	13,4
Colombia (1994)	11,5	10,1	9,3
México (1998)	7,2	7,2	2,5
Perú (1993)	7,2	9,0	12,7

Social policies in Latin America: the introduction of PAYG schemes

Capital Markets

Real return of public pension funds in 1980s

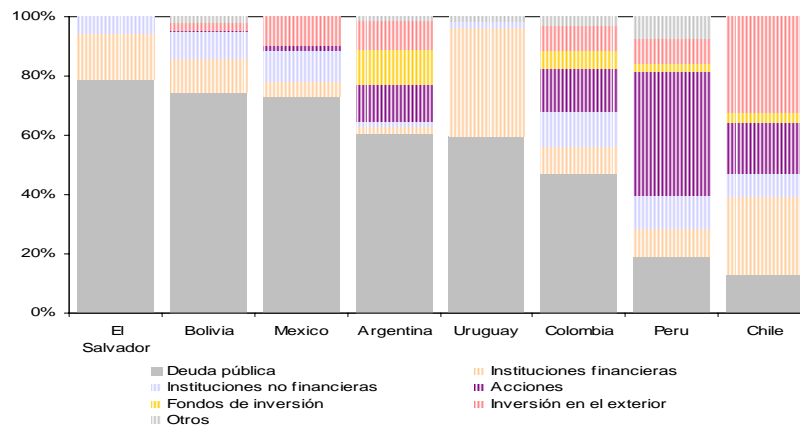


Source: World Bank, 1994: "Envejecimiento sin Crisis"

Goals and outcomes: a new pension system and the interaction with other factors

Capital Markets

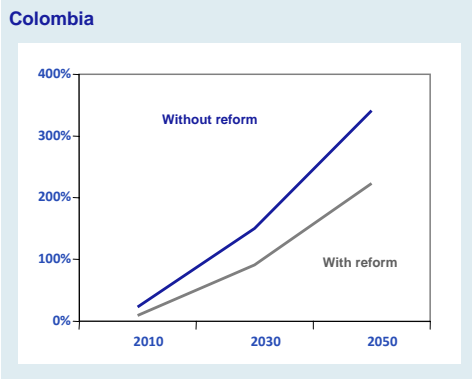
Diversificación del portafolio de Fondos de Pensiones



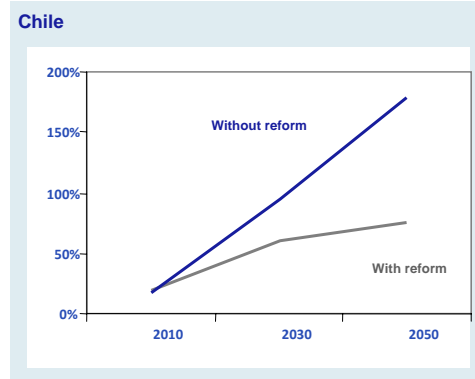
Goals and outcomes: a new pension system and the interaction with other factors

Fiscal sustainability

Estimated pension deficit with and without reform, as a % of GDP



Source: Zvinieni & Packard 2004



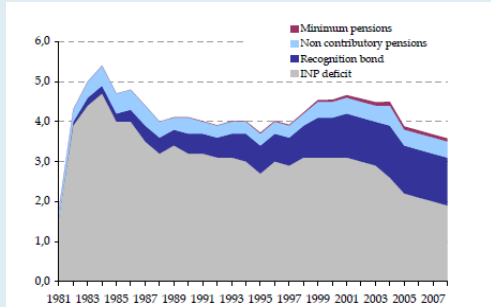
Source: Zvinieni & Packard 2004

The reforms significantly reduced the pension deficit in several countries. The amount depends on the models used and on other reforms.

Goals and outcomes: a new pension system and the interaction with other factors

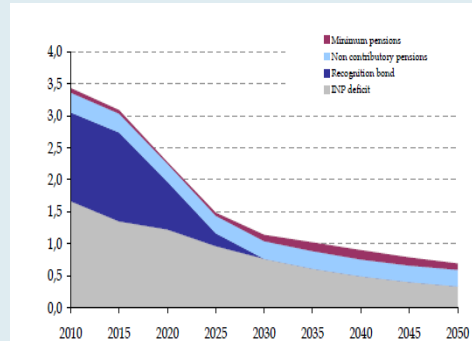
Fiscal sustainability

Transition deficit of the Civil Pension System in Chile 1981-2007 (% of GDP)



Note: Military system would add 1.5 p.p. of GDP on average
Source: Chilean Budget Office, Arenas and Gana (2005), and own elaboration

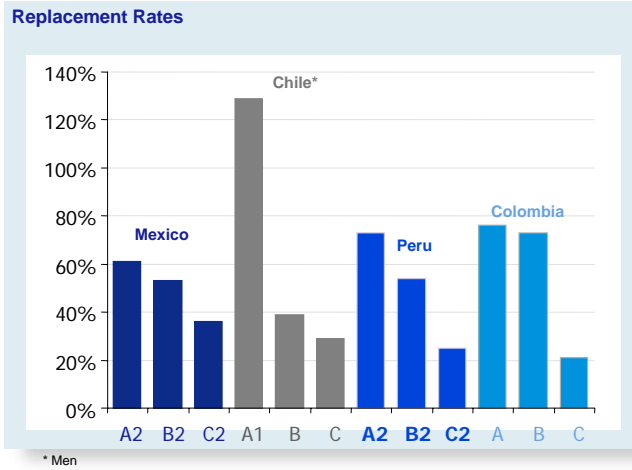
Transition deficit of the Civil Pension System in Chile 2010-2050 (% of GDP)



Source: Favre et al. (2006)

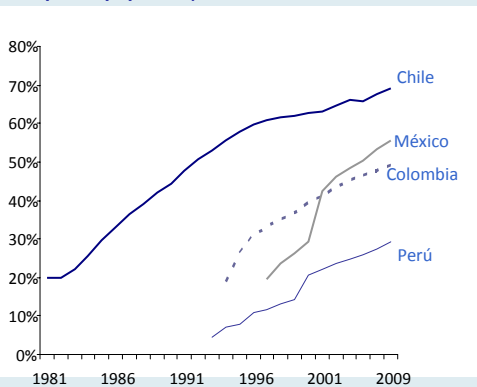
Fiscal sustainability is an important step before pursuing a universal pension scheme as in the case of Chile

Replacement Rates



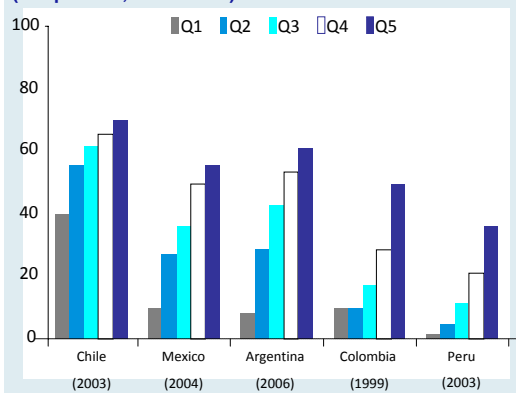
Pension Coverage

EPA coverage evolution (participants/ pop.14-64)



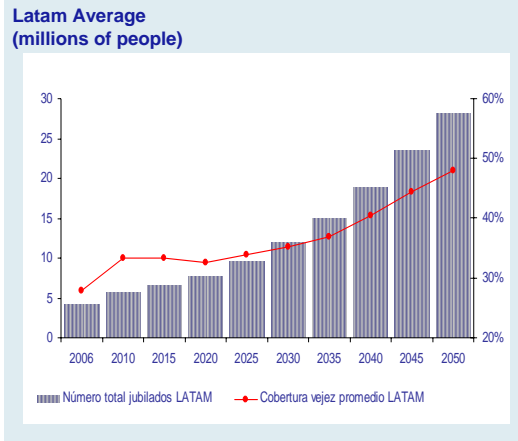
Source: BBVA, FIAP, AIOS, Rolman y Luchetti (2006)

EPA coverage by quintiles (Q1=poorest, Q5=richest)



Goals and outcomes: a new pension system and the interaction with other factors

Pension Coverage



Goals and outcomes: a new pension system and the interaction with other factors

Pension Coverage

Chilean pension system: diagnosis and reform in 2008

Diagnostic

Poverty risk at old-age (coverage)

Low density of contribution among self-employed

Low projected replacement rates for women

Low competition

Law 20.255 (March 2008)

New redistributive pillar (SPS)

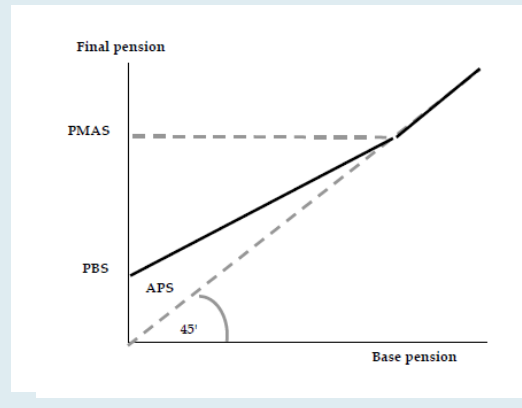
Gradual compulsory contribution / Fiscal advantages (same as dependent)

Public contributions in case of maternity

Auctioning for new affiliates (base on fees) / Join bidding for survivors and disability insurance

Pension Coverage

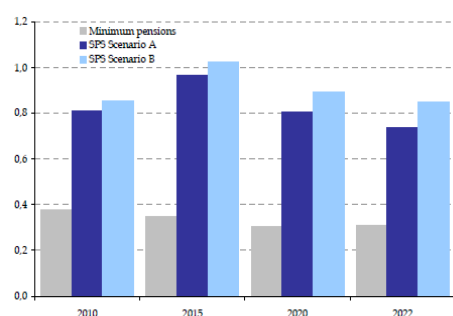
Reformed old age pension system in Chile



Fiscal sustainability is a pre requisite for success

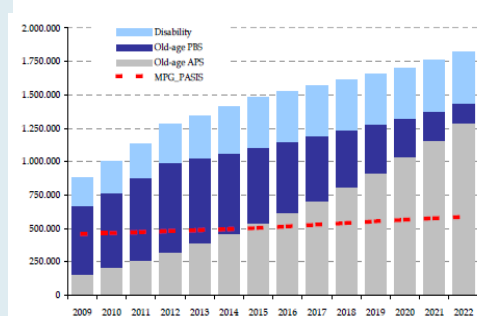
Pension Coverage

Projection of the expenditure of the solidarity pension in Chile (% of GDP)



Source: Favre et al. (2006) and own elaboration

Projection of beneficiaries of the solidarity pension in Chile



Source: Favre et al. (2006) and own elaboration

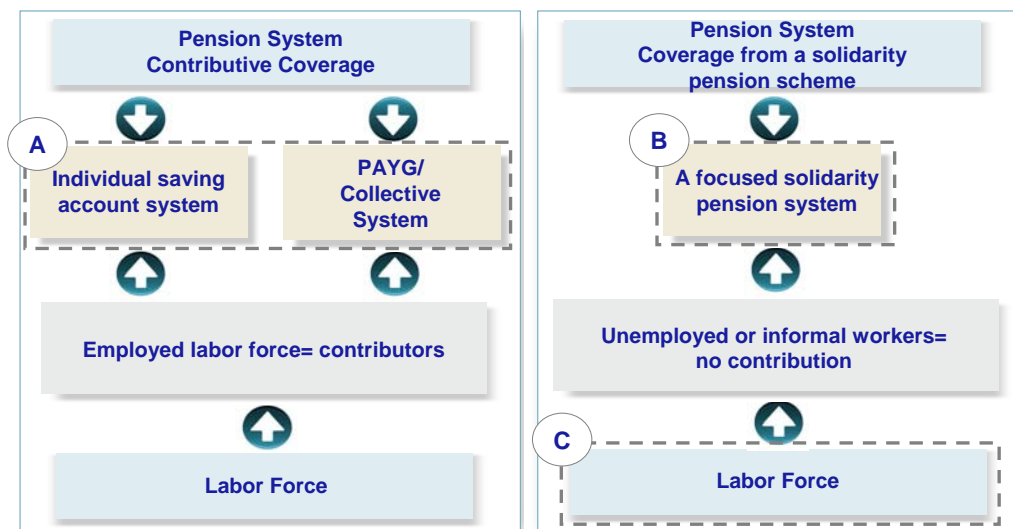
Fiscal sustainability is a pre requisite for success

Index

Pension systems in Latam: DC schemes	Section I	The introduction of social policies in Latin America
	Section II	Defined contribution schemes in Latin America
Workshop on Pension System of China and Latin America CNCB Beijing July 14th 2010	Section III	Goals and outcomes
	Section IV	Lessons from the Latin American experience

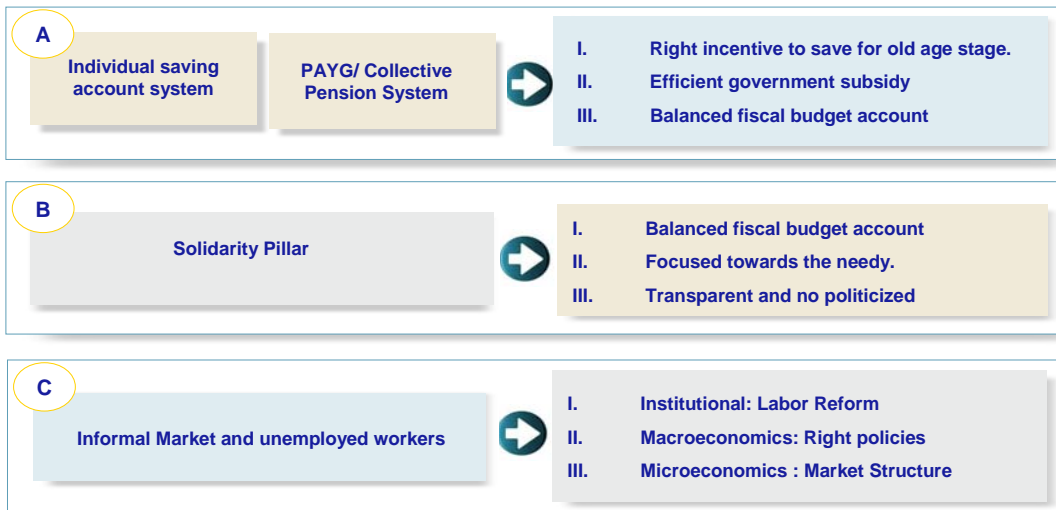
Lessons from the Latin American experience

An ideal system



Lessons from the Latin American experience

Important aspects to take into account



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