Economic Watch

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Economic Analysis

Pensions
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Current trends in pension regulation in Latin America

- **When the first generation of pension reforms in Latin America was undertake, the bulk of the labor force was expected to be covered by the contributory pension system**

  However, the labor market has not evolved as expected, the levels of informality have not fallen significantly and as a result the coverage rate is low and inequitable.

- **To face the coverage problem, Latin American countries have implemented a series of reforms**

  In Chile, for example, the measures included the creation of a solidarity pillar for the poorest people, incentives for involving marginalized segments of the population and for boosting voluntary pensions, among others. In Peru, where a reform is currently being studied, the main challenge is the extension of coverage, and although details are not yet known, the measures appear to be in line with those adopted in Chile. Finally, in Colombia the government has made clear its wish to provide benefits for the poorest people aged over 65, as well as periodic payments to people with who earn less than the minimum wage.

- **The individual capitalization system**

  also went through a number of other reforms such as the adoption of more flexible investment rules, the promotion of competition, the increase of transparency in information, the protection for the financial consumer, and the expansion of financial literacy levels.

The first generation of pension reforms in Latin America was undertaken in 1980. Basically, it consisted of introducing individual capitalization systems. At the time of the reforms employment and the level of formality was expected to increase in line with economic growth[1]. The bulk of the labor force was to be covered by the contributory pension system. The workers would obtain their pensions under this system, with minimum pensions and welfare benefits playing only a residual role, if any. However, the labor market has not evolved as expected. The levels of informality have not fallen significantly and as a result the coverage rate is not at expected levels. When the last reform was introduced in 2008, Chile had one of the best effective coverage rates (contributors/EAP) in the region, at 55% of the EAP (economically active population). Nevertheless, 50% of the pension savers were expected to be without a pension in old age[2] due to their low contribution density. In the cases of Colombia, Peru and Mexico, the aggregate coverage is even lower, at 27%, 16% and 43% respectively of the EAP.

These concerns continue among the governments involved, and are the reason behind a large number of the measures that have been implemented. The first measures aimed at extending coverage were taken in Chile in 2008. They addressed the problem on a number of fronts, by: (i) creating a solidarity pillar for the poorest people; (ii) correcting problems of inequality, as in the case of gender; (iii) increasing the level of pensions for people with a greater capacity to save, by boosting voluntary pensions; and (iv) creating incentives for involving marginalized segments of the population (subsidizing the hiring of young workers and including informal workers into the system).

In the case of Peru, the current regulatory trends are based on a committee created to reform the pension system in October 2011, which has members representing the Central Bank, the Superintendency for Banking, Insurance and Pension Fund Administrators, the Congress of the Republic, the Ministry of Economy and a number of independent academics. This working group was commissioned to present an initial reform proposal in May, which will then be debated by the Congress of the Republic. One of the main challenges that have to be addressed is the extension of coverage. Although details are not yet known, the measures would appear to be in line with those adopted in Chile. They include matching-contribution schemes and obligatory registration for independent workers. However, this upcoming reform will not be the first effort made recently by the government to extend coverage. Since 2011 a non-contributory pension scheme called Pension 65 has been in operation in Peru. It provides a benefit for everyone over the age of 65 who does not receive any other form of state assistance and who is in a situation of poverty.

In Colombia the government has made clear its wish to provide benefits for the poorest people aged over 65, as well as periodic matching payments (beneficios económicos periódicos or BEPs) to people with some capacity to save but who earn less than the minimum wage. These measures can be implemented without a pension reform, and in the case of the BEPs the government has announced that they will be put into practice in the next quarter. It has yet to be seen whether a pension reform in July is feasible, given the full legislative agenda involved in the tax reform process. In the case of Mexico, although there is no formal initiative in place to tackle the problem of coverage, various sectors have voiced concerns about the need to provide universal pension coverage and it has been suggested that a National Pension System should be set up based on individual accounts. Another major challenge in Mexico is to incorporate informal workers (29.2% of the EAP) into the social security system and increase contributions to pension funds, whether by raising the obligatory contribution or creating incentives for voluntary saving through matching-contribution schemes.

To sum up, the labor markets in the four countries under study share similar problems in providing coverage for the whole working population, although to different extents. The coverage is of low quality and distributed unfairly.

1: At the time of the 1993 reform in Colombia, it was estimated that formal work would account for around two thirds of the working population by 2010; in fact, informal work in 2012 accounted for some 60% of the working population.
2: Bernstein et al. (2005) estimates that 50% of pension savers will not manage to accumulate the 20 years of contributions that guarantee a minimum state pension.

In addition, low coverage during the accumulation stage has fiscal effects to the extent that a proportion of the adult population will be left without protection. In some cases, such as Colombia, spending on pensions is already considerable, and transfers from central government for pensions account for around 4% of GDP[3], counting only the pensions in the pay-as-you-go system (around a million people). Similarly, one of the main challenges in Mexico consists in achieving long-term financial and fiscal sustainability for some of the existing public defined-benefit systems[4] and transforming them into defined-contribution systems. This transformation will include a possible transfer of pension funds to the other system.

With respect to the individual saving system, the main reform introduced in the countries in the study since the creation of the capitalization systems has been the multi-fund system, which was introduced in 2002 to Chile, 2005 to Peru, 2005 to Mexico and 2009 to Colombia. This reform above all aims to increase fund returns for each level of risk. The reforms introduced since the creation of the system have consisted of improving individual capitalization by making the investment rules more flexible, promoting competition, transparency in information, protection for the financial consumer and financial literacy. Investment rules have been made more flexible by extending the limits to global equity and foreign currency investment; new investment vehicles have also been incorporated.

In terms of competition, in the case of Chile, for example, the latest reform introduced an auction process for admitting new pension fund administrators (PFAs) and for invalidity and survivor's insurance[5]. With respect to new PFAs, two auctions have been carried out, and a recently created PFA has offered significantly lower fees than the average in the system. In Mexico, fees have fallen significantly, with the fees charged on the balance dropping from 1.8% in 2008 to 1.3% in 2011. Since March 2008 the SAR law only allows fees to be charged on the balance of funds under management; the governing board of CONSAR also has the powers to review and authorize the fees to be charged by the Afores (pension fund administrators) every year. Another important instrument for increasing competition in the private Mexican system is the long-term Net Return Indicator, which compares the performance of the different Afores. This indicator has been modified recently to create incentives for long-term investment horizons for the Afores that are in keeping with the nature of pension savings. In the case of Chile, there is also a four-monthly service quality indicator (ICSA) which measures the level of service of each PFA with respect to the handling of pensions, relations with the pension savers and management of accounts. In Peru, the new reform involves changes to the current fee system, with a reduction in the medium term. Although the final proposal is not yet known, it will probably be along the line of schemes such as those implemented in Chile and Mexico. In the case of Colombia there is a combined ceiling of 3% of the contribution for the management fees and the premium for invalidity and survivor's insurance, and a discussion is underway as to whether these two items should be separated. To sum up, it can be said that there has been much activity in the individual capitalization systems and they have evolved in line with international requirements and standards.

3: A similar figure to the revenues from VAT.
4: State, public university and public-sector company schemes.
5: Similarly, in order to promote competition the administration of invalidity and survivor's insurance was removed from the PFA and is now granted by auction. It is also now the employer who pays the premium.

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