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**Economic Analysis**

## **Reasons to justify fees on assets in the Peruvian private pension sector**



# Summary

**BBVA Research<sup>1</sup>**

Javier Alonso  
Jasmina Bjeletic  
David Tuesta

This paper analyzes the fees collection system in the Peruvian pension system and evaluates switching from fees on flow to fees on assets, which has several advantages. These advantages include the fact that it makes the fees that the pension company charges for the service it provides more transparent by considering the assets being managed (the pension fund), and not the member's salary, as the basis. The paper concludes that, at the moment, the Peruvian private pension system has reached sufficient maturity so as to consider implementing a fee in Individual Account Pension Systems, which would make the system management and supervision process more transparent.

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# 1. Introduction

The design of a system of savings for old age, with a component of individual capitalization and which is privately managed demands the presence of specialist companies in charge of creating value for the funds accumulated. These specialist agencies, called Pension Fund Managers (AFP), according to current regulations, have different roles aimed at providing value to the workers who pay into this savings scheme. These roles include registering the member in the system, managing the fees on contributions into their individual account (which by Law is compulsory for dependent workers) and investing these funds in suitable financial instruments (in accordance with established regulations) to maximize their return, which is subject to a risk criteria. The AFP's duties also include advising the member, for example, when they should change their portfolio profile, as well as other related procedures. The AFP's job is to put the necessary steps in place to help the member to recover his or her recognition bond, which is to be included in the future pensions they will receive. In the depletion or pension payment stage, the AFP is also responsible for providing advice on the different schemes available to the members to receive their pension, pay it (if applicable) or pass it on to the insurance company (if the option chosen by the member so requires).

The foregoing corresponds to a list of some of the roles pension companies fulfill and that are then translated into value for the members. In any market, this value should reflect a given price that the person receiving the service must pay, and it is considered appropriate when the value that the customer gains is sufficiently greater than the price that they must pay for it. In the private pension sector, this price is in the form of fees charged by pension companies, consisting of monetary contributions that the contributors make and to which the AFP is entitled as consideration of the services provided. Due to the nature of this sector, regulation by a specialized agency is required in order to supervise the different areas of the market from a technical perspective. One of their most important roles is that of establishing fees.

In most Latin American countries with a Private Pension System (SPP), the fees charged by the AFP are based on remuneration or salary, which is known as the fees on flow system. In Chile, a pioneer country in the creation of an Individual Capitalization System in 1981, the five AFPs in the pension sector charge fees based on salary, and until 2008, they also charged fixed fees (recently repealed, but effective in the future). The same fees on flow system is used in other countries such as Colombia and Uruguay, while Mexico, the country in the region with the highest number of affiliates and the largest managed fund, has used a single fees on assets since mid-2008. The system in Central and Eastern European countries is mainly fees on contributions made and the balance accumulated in the member's account.

In the particular case of Peru, since the SPP was implemented in 1993, AFP were authorized to charge one of the following types of fees or a combination thereof: (i) fixed fees, (ii) fees on salary and (iii) fees on assets. These companies opted to apply a fee on salary system, which is still used today. Fixed fees were also charged, although this was eliminated in 1996, simplifying the AFP's fees into the aforementioned system. This scheme was used due to the system's immaturity, as there were not sufficient funds available to apply an alternative system, such as fees on assets.

Now, due to the system's maturity, the use of fees on assets could be viable. The possible advantages of this system include the fact that it makes the fees that the pension company charges for its services more transparent by considering the assets being managed (the pension fund) as the basis, not the affiliate's salary. The paper proposes analyzing the fees systems included in the pension fund management sector and comparing the advantages and disadvantages to justify switching to a system based on fees linked to assets under management.

In order to fulfill this goal, the paper is divided into four sections. The first contains a conceptual summary of the different fees systems used in the fund management sector, and looks at the systems used in different countries in the region. To be able to compare the fees charged in different areas, a straightforward common indicator is applied: income from fees as a percentage of the managed fund, bearing in mind that, even through there is a common indicator, there are various factors that determine a direct comparison between the fees charged by fund managers in the different countries analyzed. The second section describes the trend in AFP fees in Peru since the start of the SPP in 1993 to the present day, with an emphasis on the considerable reduction in the percentage of income from fees on assets, which dropped from 9% in 1996 to 1.5% in 2008. The third section goes into a more detailed analysis of the fees on accumulated balance system, identifying the main advantages that justify applying it, as well as the limits that also need to be taken into account. The paper ends with conclusions and recommendations aimed at changing the current fees system, considering the benefits that this change would bring for both sides, i.e. the affiliate (and future pensioner) and the AFP.

## International experience and comparative analysis

In countries with a private pension system, companies in charge of managing the funds saved for retirement charge a fee for managing active balances (balances held by members who make regular contributions) and for the pension payments (there are other services for which they are also authorized to charge fees). Depending on the nature of the system, they may not charge fees for managing inactive balances, and they are under the obligation of applying the same standard fee rates to all members (in some cases rebates for length of membership are allowed). Currently, few countries charge fees on return or fixed fees. The case of Mexico in Latin America is worth mentioning, where fees on funds managed are applied.

The fees charged for managing pension funds are classified into the following types:

- **Fixed Fees:** These fees do not depend on salary level or fund size. It could be said that the main advantage is the fact that members can understand it easily. In Latin America, these fees were allowed and applied in some countries including Chile and Uruguay. According to the International Association of Latin American Pension Fund Supervisors (AIOS-Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones), in Chile, two of the five AFPs applied an average fee of US\$1.1 until September 2008, which is when the latest reform was made to the Chilean system that put an end to this pension option. In Uruguay, only one of the four AFP charged a fixed fee of US\$0.76, which was stopped in October 2008. It must be stressed that in both countries, fees on flow were also charged and are still in force today.
- **Fees on Contributions:** Variable fees that depend on the affiliate's salary and which are charged based on a given proportional rate. Usually, this type of fees is appropriate for systems that have only been in place for a few years and whose volumes to be managed are still small. In the case of compulsory pension funds, since the benefits received are long-term and combined with the low income for some groups and the lack of information regarding the advantages of pension savings, members might see this option as a "cost overrun" which might reduce their incentive to increase their funds managed.
- **Fees on Assets:** Variable fees charged as a percentage of the individual managed funds. This system is more in keeping with the fund manager's management objective. It is also in keeping with the goal of aligning incentives towards maximizing assets under management. As mentioned earlier, Mexico has used this structure since March 2008, and both fees on flow and fees on assets were applied simultaneously. However, the amendments envisaged in the Retirement Savings System Law (SAR-Ley de los Sistemas de Ahorro para el Retiro)<sup>2</sup> eliminated the former in order to allow for the comparison of the prices of the different options offered to workers and to consequently increase the importance attached to rate-of-return in the user's decision process. Bolivia also uses this system, and its two AFP operating in the SPP use both systems, i.e. fees on flow and fees on assets, with the same percentages of 0.5% and 0.21%, respectively.
- **Fees on Return:** Variable fees, where the pension fund manager charges fees based on a percentage of the return on the funds. Until now, this has been used in few countries, which include Kazakhstan and Costa Rica. Although this system encourages competition between managers aimed at improving management by providing more return for the member, it can only work efficiently if the portfolio structure has a long-term focus, rather than one of generating short-term speculative gains. In any case, first the regulator needs to define a benchmark to allow each manager's administration method to be compared. Preliminary steps would also be required to implement it, and it would work better as a complementary scheme to a system in which fees are charged for managing the funds.
- **Fees on Transfer/Exit:** Fees that a manager can charge as a penalty if the member decides to move their pension funds to another manager. These types of fees are justified if we consider that the transfer or exit request represents charges that significantly push up the administration cost for pension companies. Depending on the structure in force, the regulator may allow this cost or not. Fees on withdrawing funds can be fixed or variable depending on the length of membership.

According to an analysis by Tapia and Yermo (2008), different fees systems are used in emerging Latin American and Central European countries, but fees on salary and fees on assets prevail.

As Table 1 shows, in most Latin American countries, AFP charge fees on flow, while, in European countries, a dual system is applied: fees on flow and fees on assets.

2: Amendments to the Retirement Saving Systems Law (SAR-Ley de los Sistemas de Ahorro para el Retiro) entered into force on March 15, 2008.

Table 1

**Fees Structures in Private Pension Systems**

Country	Fixed fees	Fees on contribution	Fees on balance	Fees on return	Transfer/exit fees
<b>Latin American Countries</b>					
Bolivia		x	x		
Colombia		x			x
Chile		x			x
Costa Rica		x		x	
El Salvador		x			
Mexico			x		
Peru		x			
Uruguay		x			
<b>Central and Eastern European Countries</b>					
Bulgaria		x	x		x
Estonia			x		
Hungary		x	x		x
Kazakstan			x	x	
Lithuania		x	x		
Poland		x	x		x
Slovakia					
<b>Other OECD Countries</b>					
Australia	x	x	x		x
Sweden			x		

Source: Tapia, W and J. Yermo (2008)

If we analyze Table 1, seven of the eight countries studied in the region use fees on flow or on contributions. In some countries, the systems vary, and one of the most important being the Mexican system. The Appendices found at the end of the paper, contain a breakdown of the systems used in the most important countries in the region: Chile, Mexico and Colombia.

Table 2 includes statistics on fees that pension companies charge in the eight countries in the region. The limits that the regulator establishes on charging fees are also described.

Table 2

**Private Pension System Fees, 2008**

Country	Fees on contribution	Fees on balance	Fees on return	Fixed fees	Limits
Bolivia	0.5% of salary	0.21%	-	-	0.5% of salary; 0.223% of salary
Colombia	1.59% of salary	-	-	-	3%(a) of salary
Chile	1.73% of salary	-	-	-	-
Costa Rica	3.59% of contributions	-	7.75%	-	4% of contributions; 8% of return
El Salvador	1.5% of salary	-	-	-	3%(a) of salary
Mexico	-	1.69%	-	-	-
Peru (b)	1.95% of salary	-	-	-	-
Uruguay	1.95% of salary	-	-	-	-

(a) A 3% limit, including management fee and insurance fee.

(b) The Peru data is up-to-date as of April 2009, source: Superintendency of Banking, Insurance and Private Pension Funds).

Source: Tapia, W and J. Yermo (2008)

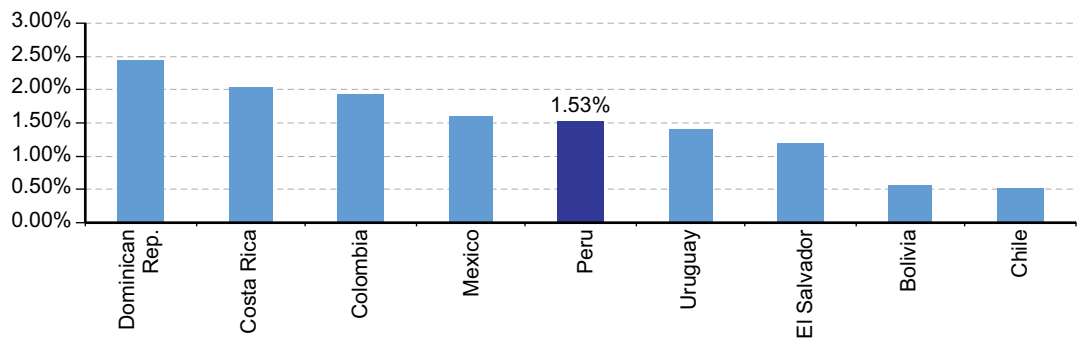
As Table 2 shows, the AFP in Peru charge an average fee of 1.95%. A direct comparison between the fees received in Peru and in other countries in the region would be misleading as the AFP charge different fees and do not necessarily provide the same services in the different Pension Systems. For instance, some countries do not use only one system, fees are regulated, additional fees to the fund manager's fees are charged, etc., which make it even more difficult to conclude which system has the lowest or highest costs depending on the analysis method used.

Tapia and Yermo (2008) agree with these appraisals and they propose a straightforward indicator in their analysis to compare the fees charged in different countries. The quotient of annual income from fees on total funds managed is the indicator used in OECD countries to compare fund management costs. However, it should be pointed out that to compare this ratio among countries, a number of criteria must be taken into account (see below), the most important one being the maturity of the pension system.

Chart 1 shows the percentages of income from fees on assets for a group of countries in the region. The Dominican Republic and Costa Rica have the highest percentages.

Chart 1

**Income from fees as a percentage of total managed funds, 2008**

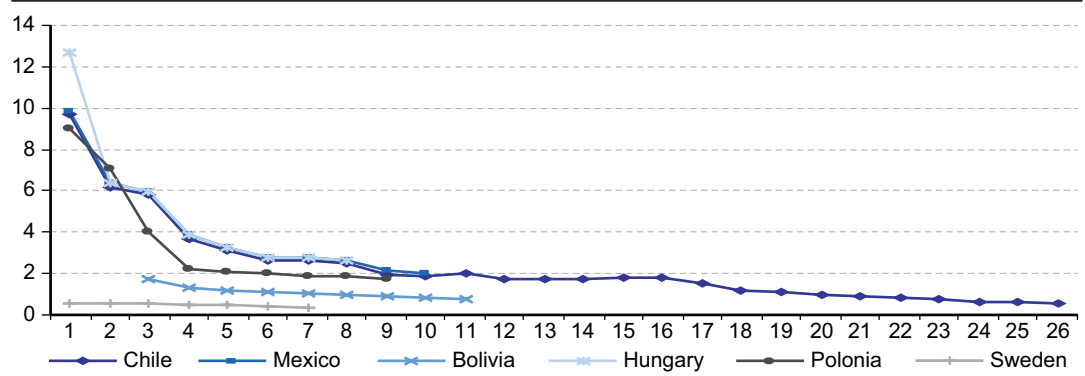


Source: AIOS, December 2008

Chart 2 shows the changes in this ratio for six countries since the start of their respective systems. A comparison reveals that the ratio falls in every one. A more dramatic fall is typical in more immature systems, and the lowest levels are reached in countries with the most mature systems.

Chart 2

**Changes in income from fees as a percentage of total managed funds**



Source: Tapia, W and J. Yermo (2008)

Although there is a common fees indicator, when we attempt to compare this ratio among countries we must remember that this cannot be done directly, as Tapia and Yermo (2008) conclude. This is because any given cost structure has its own specific economic, institutional and regulatory features, as described below.



### a) Economic features

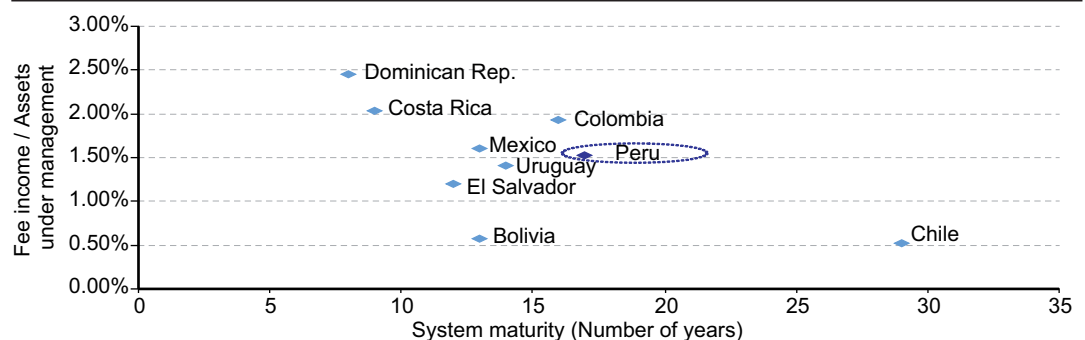
From an economic perspective, the sector is characterized by major economies of scale, in which the volume managed is a key factor. As a result, less mature funds tend to have higher fees than others that have gained more contributors and have therefore built up more funds to be managed, meaning that fixed costs are distributed more evenly.

The longer the system has been running, the lower the ratio of income from fees on funds managed, due to a greater accumulation of funds.

As Chart 3 shows, the oldest system in Latin America, in Chile, has lower fees than other systems in the region. Less mature systems such as those of the Dominican Republic and Costa Rica have the highest rates. However, this does not hold true in every case, as the ratios differ greatly in countries like Colombia and Peru, whose Private Pension Systems have been running for a similar number of years. The ratio in the Colombian SPP is around 2%, while in Peru it is 20% lower, at approximately 1.5%. This difference is not so much due to the fact that in Colombia higher fees on flow are charged than in Peru, but rather because balances managed by pension funds in each country have grown at different rates, due to more flexible financial regulations in Peru which allow investing in different types of assets (bonds and shares), while Colombia is more biased towards fixed-income investment due to regulatory issues. More flexible legislation in Peru has allowed for greater returns, greater assets managed and, therefore, a lower ratio of income from fees as a percentage of total funds.

Chart 3

#### System Maturity and Income from fees as a percentage of total managed funds, 2008



Source: AIOS, December 2008

### b) Institutional features

From an institutional perspective, legal regulations may differ in each country and could push up the managers' fees or mean that they have to assume costs directly. This would happen in certain legal procedures in which the pension company, intervening due to a problem caused by the Government, is obliged to assume legal costs. Procedural costs could also arise in accordance with the legal framework in each country. Along these same lines, we can neither rule out financial nor tax charges that affect the costs indirectly.

As far as Peru is concerned, legal costs make the AFP's job significantly more expensive. To mention just one example, AFP are obliged to take legal action against employers who keep back affiliates' contributions. If they do not take this action, the AFP themselves must make the contributions out of their own money. Also, if the employee did not pay a worker's contribution over various months, the AFP must bring a different legal procedure for each of those months. According to the AFP Association in Peru, at the start of 2009, AFP had opened 375,000 legal procedures for this reason. This represents huge costs in terms of legal fees, attorney fees and bankruptcy proceedings, which the AFP are forced to cover.

### c) Regulatory features

Thirdly, there are specific requirements regarding the different levels of intervention established in the regulations, resulting in a greater or lesser degree of intervention in the assets that companies are being allowed, with consequences regarding the optimum market result for agents in terms of well-being and efficiency.

In this regard, asset allocation also plays an important role when it comes to explaining differences in fees. Investments in fixed-income bonds and instruments are less expensive than investing in shares. The cost of investing abroad or in the local market may also vary. This partly explains the low costs applied in countries such as Bolivia, where the two AFP that operate in the SPP invest around 90% of funds in government bonds.

## 2. Changes in fees in the case of Peru

In December 1992, the Private Pension System (PPS) was set up as an alternative to the Pay-As-You-Go or National Pension System, which was suffering severe financial, economic and actuarial instability.

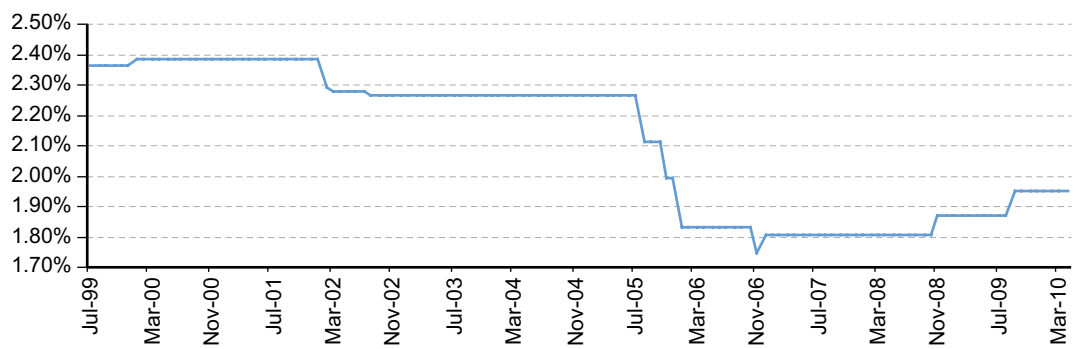
The SPP thus came into being, based on self-financing pensions through the capitalization of individual contributions registered in an Individual Capitalization Account (CCI), which grows each month with new contributions and return on investments in the accumulated fund. AFP manages these accounts, and SPP members must make three types of contributions into their respective AFP:

- Compulsory contribution, which is 10% of the insurable salary.
- Insurance premium, which grants the right to receive disability and survivor benefits and burial expenses. There is a cap on this, the maximum insurable salary, which is published during the first few days of January, April, July and October.
- The fee that member must pay to the AFP to manage their CCI. Each AFP establishes this fee calculated as a percentage of the affiliate's maximum insurable salary. The four AFP' fee percentage fluctuated between 1.75% and 2.30% during 1Q10, with a simple average of 1.95% for the system.

The average fee that the AFP charge has gradually reduced; from around 2.4% in early 2000 to 1.95%<sup>3</sup> at the moment (see Chart 4).

Chart 4

### Changes in fees



Source: Superintendency of Banks, Insurance, and AFPs (SBS); April 2010

The percentage charged to members on their contributions could be brought down further if the number of members who pay into the system were increased. As mentioned earlier, the volume of managed funds is a key factor in reducing costs, given the economies of scale in this sector.

Data shows, however, that although the number of members has risen steadily, the percentage that make regular contributions has not increased at the same rate, making it more difficult to further adjust the fees provisions that the AFP charge. According to SBS figures, over the last few years, the number of members has grown steadily, reaching around 4,513,569 by April 2010. However, the number of contributors (affiliates who make contributions, whether through payments during the month or payments accrued in previous months) was 1,892,183 in that same month. The contribution indicator, which is the percentage of members who make contributions, has remained at around 40% for several years<sup>4</sup>, and is one of the lowest rates in the region.

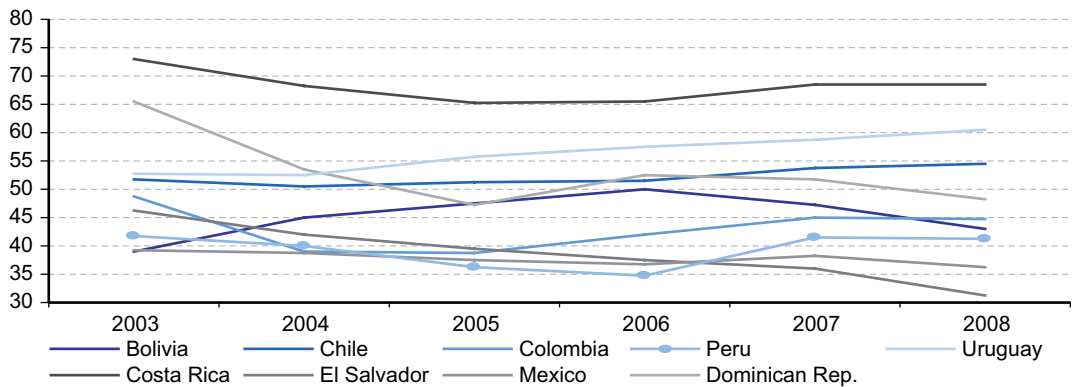
3: 1.91% Weighted Average. This average is weighted in accordance with the number of contributors. The data regarding contributors is two months old.

4: In accordance with SBS data, the contribution indicator average from 1998 to present is 41%.



Chart 5

**Contribution indicator**

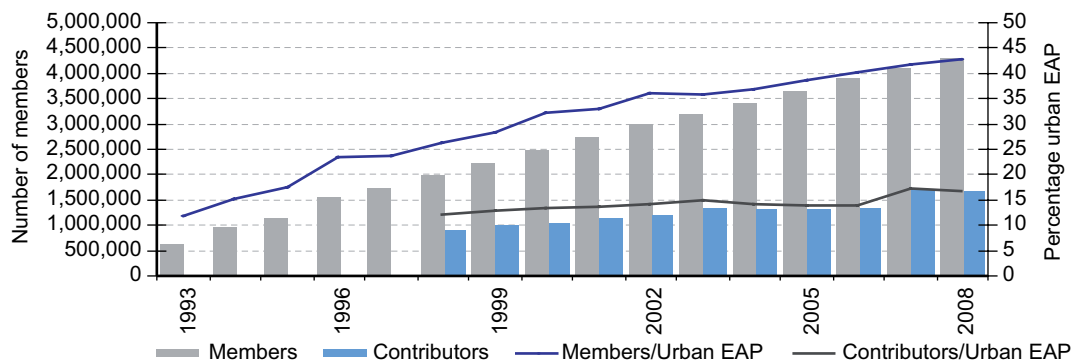


Source: AIOS, June 2009

Other indicators show similar comparisons. While the coverage ratio in Peru (affiliates out of the EAP) rose from 23.5% in 1996 to 43.5% in December 2009, the ratio of contributors out of the EAP is considerably lower. This ratio has not changed much over recent years, which reflects the structural problems that the job market faces in increasing the necessary critical mass (see Chart 6).

Chart 6

**SPP affiliates and contributors**



Source: Superintendency of Banks and Insurance, Spanish National Statistics Institute, Ministry of Employment

The fact that the percentage of contributors out of the EAP has not risen is due to structural flaws in the Peruvian economy and particularly in the job market. These problems include the high level of informal labor, high level of poverty and imbalanced distribution of wealth. Perhaps one of the best examples to summarize the problems regarding employment is informal labor. According to Loayza (2007), 60% of economic activity in Peru is informal labor, with 40% of the work force subcontracted in informal micro-enterprises, and, even counting people who work for larger firms; only 20% of the work force has a pension plan. A major reform was introduced in mid-2008 to include more workers in the pension system<sup>5</sup> the Ley de Promoción y Formalización de la Micro y Pequeña Empresa (Mype), a law designed to promote and formalize micro- and small enterprises and which provides employees in these types of companies with access to benefits such as social security and pensions. Bearing in mind that in Peru micro- and small enterprises represent 54% of the GDP and 62% of the work force, this reform could have a dramatic impact on formalizing employment as it is gradually implemented.

Along the lines of increasing coverage, another issue that needs to be tackled is the registration of freelancers in the Social Security system, who should have similar welfare rights and obligations as dependent workers. Reforms of this nature would have a positive effect on increasing Social Security affiliation.

5: The voluntary Welfare Pension System was set up for workers and leaders of micro-enterprises who were not registered in any Pension System (public or private).

### 3. Reasons that justify fees on assets managed in pension funds

In accordance with Whitehouse's analysis (2001), a comparison between systems based on fees on flow and fees on assets here follows, describing the advantages and limits of each system. The main advantage of fees on flow (the system used by AFP in Peru since the beginning) is that it provides income to meet operating expenses right from the start of the pension activity. On the other hand, fees on assets scheme cannot be used from the beginning because affiliates would not have enough money in their fund to pay the fee. Another advantage of this type of fee is that it allows the member to know the exact amount that they pay (the same effect as charging a fixed fee).

However, there are some drawbacks to the fees on flow system which need to be considered in the final design stages:

- It could discourage contributions since it reduces the worker's available balance.
- It is not adapted to the cost structure, since if this is the only rate charged, then the AFP will look for workers with higher salaries.
- Workers who make contributions incur expenses that those who do not make contributions do not have to pay. Therefore, only active members bear the system's costs. This means that inactive balances are not charged, which increases the cost for contributors.

As regards the aforementioned limits, the Peruvian pension system has already achieved a large volume of managed funds, so members and the system itself could benefit from a change towards a fees system based on funds managed.

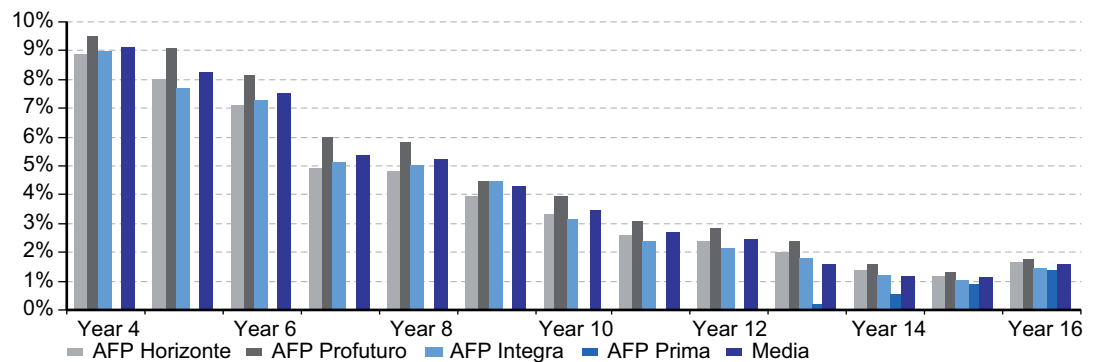
The advantages of implementing a new fee on assets would include:

- The system aligns the AFP's and affiliates' incentives with the aim of creating a larger fund. This is because the fees are directly related to the members' fund assets, which is what the manager's ultimately administrates.
- It encourages contributions: non-contributing members and pensioners would pay a fee in proportion to their fund, and active workers would not be the only ones to bear the pension fund expenses. Affiliates starting out on their career pay fewer costs because their salary is lower. Also, contributors would not see their salary reduced due to their pension manager's costs. Any monthly pension rebate is aimed at increasing the balance of their individual savings account for old age, which is an important incentive for continuing to make contributions.
- It promotes more rate-of-return competition among pension managers: charging a percentage fee on the balance is practically the same as reducing the applied rate-of-return by the same amount, and so each manager's fee would be established in accordance with its ability to generate future rate-of-return.
- The fee calculation and charging process is easier for the pension fund.
- This fees structure is simple, transparent and easily comparable. Priority can be established for the most important variable for the contributor: net rate-of-return on cost, similar to the one used in Mexico, on which their old-age pension will depend.
- The reserve can be replaced by other types of guarantees given the alignment of economic incentives. There will be fewer costs for the system and the entry barriers could even be lowered.
- The fees could be reduced as the funds grow due to more transparent control for the regulator.

A major argument in favor of applying this system is that, over recent years, the fee percentage that AFP charged on the fund has been brought down considerably. In 1996, three years after the system was first implemented, this ratio rose to around 9% of the fund, and by 2008 it had dropped to 1.54% of the managed fund. Although this percentage rose slightly from 2007 onwards (approximately 1%), this is due to the circumstantial effects of the international crisis on pension funds. This argument is well backed by the analysis above which shows that this percentage falls as the system matures.

Chart 7

**Changes in fees as % of assets**



Source: Superintendency of Banks and Insurance, December 2008 Securities National Supervisory Commission, December 2008

## Necessary considerations

However, the implementation of a new fee on assets system must consider factors that could entail disadvantages for some groups or to provide the right incentives for agents involved in the system. A group of affiliates who does not make payments or whose level of contribution discontinuity is high (perhaps due to their options for entering the job market) could, in some cases, result in a smaller managed fund, because the fee would still be charged on the assets that the pension companies manage regardless of whether the member pays contributions or not. Nor must we lose sight of the fact that, under the fees on flow system, workers with a high level of income would already be implicitly paying fees on assets, and, therefore, with the new system they could be charged these same fees twice. The number of members who could benefit or be negatively affected by the variable fees needs to be analyzed closely to establish whether the end result is positive in welfare terms.

If the fee on assets alternative is applied, the possibility of including important clarifications in the regulations regarding the system that is already running in Mexico needs to be studied. These clarifications include: (i) the AFPs' obligation of annually submitting their fees structure for the following year, which the regulator must review and approve or reject (notwithstanding the possibility of requesting a new authorization of fees at any time); (ii) should an AFP breach point (iii), they would have to charge the lowest fee in force in the system until they submit a fees structure; (iv) likewise, should an AFP's proposal be rejected, the AFP must charge the average fee in the system until a new fees structure is submitted; (v) fee increases above the average of the other authorized fees cannot be approved; (vi) the establishing of maximum fee dispersion policies.

## 4. Conclusions

This paper has discussed the reasons for establishing certain fee levels that pension companies charge in defined-contribution systems, especially Pension Fund Managers -AFPs- in Peru. The trend that these fees are following in the sector is compared with the trend in the region and in other countries with similar systems, in order to establish certain behavioral patterns and the possibility of switching from a fees on salary (fees on flow) system to a fees on assets in funds that the AFPs manage (fees on assets).

Generally speaking, there are several advantages of fees on assets system in Peru. Firstly, this system allows the AFP's and affiliates' incentives to be aligned in order to create a large fund. Secondly, it encourages contributions as non-contributing members and pensioners would pay a fee in proportion to their fund, and active workers would not be the only ones to bear the pension fund expenses. Thirdly, it promotes greater rate-of-return competition among pension managers because charging a percentage fee on the balance is practically the same as reducing the applied rate-of-return by the same amount, and so each manager's fee would be established in accordance with their ability to generate future rate-of-return. Fourthly, we also believe that the fees would be easy to calculate and more transparent, and priority could be established for a variable that is important for the contributor: net rate-of-return on cost.

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## 6. Appendices

Because Chile, Mexico and Colombia are the main countries in the region<sup>6</sup> with a private pension system, the structures that the AFP use in those countries to charge fees are described briefly below.

### Chile

In the case of Chile, a pioneer in the field of pensions in Latin America, fees are charged as a percentage of the affiliate's taxable income (in the case of compulsory savings). This method is progressive, because workers with less regular contributions pay fewer fees during their lifetime than members with more regular contributions.

In addition, by 2008 fixed fees were charged, which were discounted from each affiliate's individual capitalization fund. The fixed fees were regressive because, by law, AFP must charge the same fees provision to all of their members, and so the ratio of fees to balances was greater with fewer the assets/contributions. These fixed fees were gradually stopped and only one out of the five AFP in Chile still charged them at the start 2008. The 2008 Pension Reform, which was aimed at boosting competition in the pension sector in order to promote fewer fees for contributors, put an end to fixed fees once and for all due to their regressive nature. It demanded that fees could only be established based on a percentage of the fees and taxable income that gave rise to those contributions.

AFP are also free to set fees charged to members in accordance with the structure established by Law:

- As regards the individual capitalization fund, fees are only charged on the payment of regular contributions.
- The fees are standard for members of the same type. Examples of types of members are: dependent, independent, voluntary and members not entitled to survivor and disability insurance.
- Fees on payment of contributions, called additional contribution, are expressed as a percentage of the salary or taxable income that gives rise to those contributions.
- Until the reform in 2008, fees paid to AFP also financed the cost of survivorship and disability insurance taken out with life insurance companies.
- AFP can charge on temporary retirement income or programmed retirement and they can only be established as a percentage of the assets involved (percentage of the pension).
- AFP used to be able to charge a fixed amount on regular contributions, but the 2008 reform put an end to that.
- The 2008 reform eliminated the possibility of charging fees for the transfer of account assets from another Manager.
- Changes to fees charged must be published 30 days in advance in the case of a rebate or 90 days in advance in the case of an increase, specifying the date on which they will come into force. Information on fees must be sent out with the quarterly statement or individual capitalization fund statement.
- Managers can charge an exit fee to members who move their balances between a same manager's funds more than twice in one year. This is a fixed fee charged to members (it cannot be discounted from the pension fund). No managers charge this fee at the moment.

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6: They have the largest number of registered members and contributors in the region. By December 2008, the number of affiliates was 8,372,475; 8,568,274; and 39,063,971 in Chile, Colombia and Mexico, respectively.



## Mexico

In this country, prior to the SAR Law reforms of June 15, 2007, Retirement Fund Managers (Afores-Administradoras de Fondos para el Retiro) were allowed to charge fees on managing individual accounts for the following:

- On fund assets managed,
- On flows and contributions, or
- A combination of flows and assets.

Due to having different criteria for applying fees, it was difficult to compare these among Afores, and so a method to calculate “equivalent fees” was designed, which allowed the fees on flow and balances that the Afores charged to be compared, converting them all into balances in certain cases. Although the National Commission for the Retirement Saving System (Consar-Comisión Nacional del Sistema de Ahorro para el Retiro) designed the equivalent fee concept as an indicator to compare Afores fees, the indicator was flawed due to representative individual cases and did not manage to avoid confusion.

With the 2007 reforms, which came into effect as of March 2008, the Afores could only charge fees on assets for managing individual balances. Mexico was the only country to use this system. This measure received a warm welcome from members and from the managers. With the changes introduced in 2008, members could find out the exact fees that the Afores were charging and thereby compare the managers more easily. Previously, the dual system had made understanding these fees confusing.

The Afores also benefited from this reform. The new fees system appealed to large Afores with several years on the market because the switch from fees on flow to fees on assets exclusively gave them a more steady income, because contributions are made every two months in Mexico. Also, small or new Afores that depended more heavily on fees on flow had the option of leaving the system or merging with other, larger Afores that had been on the market longer.

It must be stressed that in Mexico the transition period to eliminate fees on flow and switch exclusively to fees on accounts was very brief (around 6 months to give time for the Afores to adjust operationally) and there were no compensation measures for Afores potentially affected by the change.

The reform was sold to the public well from the start, along the lines that the change would align the managers' incentives with the workers' because it was argued that by only applying fees on assets, the Afores would have clearer incentive to increase these assets to their own benefit and to the worker's benefit. Also, to achieve appeal and rate-of-return competition, the net return index (IRN) was introduced as the new indicator to compare the AFORE, which consists of the average nominal rate-of-return for the last 36 months (a long-term rate-of-return proxy) minus the fees on assets in force.

Also, at the start of 2009, another reform package was introduced. Prior to the SAR Law reforms of January 21, 2009, the fees authorized for the Afores entered into force indefinitely. However, with the 2009 reforms, the Afores were placed under the obligation of submitting their fees for approval to the CONSAR Board each year.

The purpose of the latest reforms in 2009 is to bring the fees that the Afores charge for similar services closer into line, and secondly, gradually lower them, as the Law states that fee increases above the average of the other authorized fees cannot be approved. The ultimate aim is for fees to be lowered gradually to help to increase the aforementioned net rate-of-return indicator.

## Colombia

Currently, in Colombia, fees are charged as a percentage of income, which, on average, is 1.58% of the salary from which the contributions are made. The financial reform<sup>7</sup> approved in June 2009 adds a new aspect to the fees on return system. Fees as a percentage of salary are maintained and new fees on return are added. The AFP will not only have to fulfill the minimum rate-of-return equal to inflation, as the Constitutional Court establishes, but will also be rewarded if they manage to make investments that provide them with good return. However, it is still not known exactly how this new structure will work, as this system is still in the early stages of development.

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7: The reform will allow the multifund concept to be created.

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## Contact details

**BBVA Research**  
Paseo Castellana, 81 - 7th floor  
28046 Madrid (Spain)  
Tel.: +34 91 374 60 00 and +34 91 537 70 00  
Fax: +34 91 374 30 25  
[bbvaresearch@grupobbva.com](mailto:bbvaresearch@grupobbva.com)  
[www.bbvarsearch.com](http://www.bbvarsearch.com)