Chilean pension reform: Refining the model after 25 years

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Agenda

1. **Workings of the Chilean model**
2. **Outcomes**
   a. Macroeconomic and financial issues
   b. Social issues: estimated replacement ratios
3. **Reforming the Reform**
   1. Multifunds
   2. SCOMP
   3. Information to affiliates
General aspects of the multipillar Chilean pension system

- **Pillar 1: Old age poverty prevention**
  - Contributory Minimum pension State-guaranteed (20 yr)
  - Non contributory means tested basic pension

- **Pillar 2: Consumption smoothing, mandatory, DC**
  - AFP (accumulation)
  - Life Insurance Companies (LIC, disbursement)

- **Pillar 3: Consumption smoothing, voluntary**
  - AFP
  - LIC, Mutual Funds, brokers, banks
The AFP system in graphical terms

Managed by

Multi Funds Scheme

Government regulates and supervises and provide guarantees

Portfolio A

B

C

D

E

CuprumAFP

HABITAT AFP

PlanVital

Provida AFP

ING AFP SANTA MARIA

Bansander AFP

Multi Funds Scheme

Managed by

Government regulates and supervises and provide guarantees
The minimum pension guarantee

PM

PA

Years contributing 20
Means tested basic pension

Threshold  Poverty score

PA
For this model to work, many reforms in different areas are needed:

pension reform is not a magical potion!

The outcomes in Chile are so because of the persistence of reforms directed in the same orientation for decades.
Macroeconomic impact of pension funds: estimates

<table>
<thead>
<tr>
<th></th>
<th>Med.</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth (average 80-01)</td>
<td>4.6</td>
</tr>
<tr>
<td>Effects of reform:</td>
<td></td>
</tr>
<tr>
<td>Savings + Investment</td>
<td>0.13</td>
</tr>
<tr>
<td>Labour Markets</td>
<td>0.10</td>
</tr>
<tr>
<td>Financial development + TFP</td>
<td>0.20</td>
</tr>
<tr>
<td>Total contribution</td>
<td>0.49</td>
</tr>
</tbody>
</table>

```
<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Not explained</th>
<th>Linked to reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Initial growth&quot;, 1960-80</td>
<td>3.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average growth 1981-2001</td>
<td>0.5</td>
<td>1.0</td>
<td>3.1</td>
</tr>
</tbody>
</table>
```
Pension savings, a history upwards
Pension Funds Return: high return and volatility
Asset diversification has increased over time: all instruments
Asset diversification has increased over time: financial sector
Asset diversification has increased over time: all instruments
Asset diversification has increased over time: Corporate Instruments
## Portfolios in Latin America

### Table

<table>
<thead>
<tr>
<th>País</th>
<th>Total (millones de US$)</th>
<th>Deuda Gubernamental</th>
<th>Instituciones financieras</th>
<th>Instituciones no financieras</th>
<th>Acciones y de inversión</th>
<th>Fdos. Mutuos y de inversión</th>
<th>Emisores extranjeros</th>
<th>Otros</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>16.139</td>
<td>68,9%</td>
<td>3,6%</td>
<td>1,5%</td>
<td>11,8%</td>
<td>2,8%</td>
<td>9,7%</td>
<td>1,7%</td>
</tr>
<tr>
<td>Bolivía</td>
<td>1.493</td>
<td>64,1%</td>
<td>7,3%</td>
<td>16,7%</td>
<td>8,6%</td>
<td>1,7%</td>
<td>1,5%</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>49.690</td>
<td>24,7%</td>
<td>26,3%</td>
<td>7,7%</td>
<td>14,5%</td>
<td>1,9%</td>
<td>23,7%</td>
<td>0,1%</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>305</td>
<td>79,5%</td>
<td>13,8%</td>
<td>5,7%</td>
<td></td>
<td>1,0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>El Salvador</td>
<td>1.572</td>
<td>82,3%</td>
<td>13,2%</td>
<td>4,2%</td>
<td></td>
<td>0,3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>México</td>
<td>35.743</td>
<td>82,3%</td>
<td>4,5%</td>
<td>13,2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Perú</td>
<td>6.311</td>
<td>19,5%</td>
<td>21,4%</td>
<td>12,1%</td>
<td>35,5%</td>
<td>1,0%</td>
<td>8,8%</td>
<td>1,7%</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1.232</td>
<td>69,6%</td>
<td>22,9%</td>
<td>5,8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>112.485</td>
<td>51,0%</td>
<td>15,3%</td>
<td>8,9%</td>
<td>10,2%</td>
<td>1,7%</td>
<td>12,4%</td>
<td>0,4%</td>
</tr>
<tr>
<td>Total S/Chile</td>
<td>62.795</td>
<td>71,8%</td>
<td>6,7%</td>
<td>9,8%</td>
<td>6,8%</td>
<td>0,8%</td>
<td>3,4%</td>
<td>4,2%</td>
</tr>
<tr>
<td>Total S/Chile y Perú</td>
<td>56.484</td>
<td>77,7%</td>
<td>5,0%</td>
<td>9,5%</td>
<td>3,6%</td>
<td>0,8%</td>
<td>2,8%</td>
<td>4,5%</td>
</tr>
</tbody>
</table>

- Chile and Peru are the most diversified portfolios.
But significant challenges remain: Replacement rates as criteria

Longevity, low densities of contribution, excess early retirement, high transaction costs in acquiring annuities lower pensions...

Table 4-5: Average Replacement Rates by Pensioner Category (2020 – 2025)

<table>
<thead>
<tr>
<th></th>
<th>Replacement Rate (1)</th>
<th>Replacement Rate (2)</th>
<th>Replacement Rate (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Last observed wage</td>
<td>Average wage, 3 years before retirement</td>
<td>Average lifetime contributed wage</td>
</tr>
<tr>
<td>All Affiliates</td>
<td>44%</td>
<td>44%</td>
<td>121%</td>
</tr>
<tr>
<td>With pension above MPG (with own fund)</td>
<td>66%</td>
<td>66%</td>
<td>121%</td>
</tr>
<tr>
<td>With more than 10 years contributed</td>
<td>62%</td>
<td>63%</td>
<td>114%</td>
</tr>
</tbody>
</table>

Reforming the reform 1: Multifondos

- At the beginning there was only one portfolio
- Strict regulation on limits
- Minimum relative return
Reforming the reform 1: Multifondos

• Herd behaviour appeared (as always but more than elsewhere)

• Two opposing views on that:
  – minimize likelihood of individual errors of judgement: safety element.
  – as portfolios do not vary, nor do returns. AFPs offered only one portfolio, very similar to each other.
Reforming the reform 1: Multifondos

[Bar chart showing the percentage distribution for each fund (A, B, C, D, E) between Variable Income and Fixed Income.]

Reforming the reform 1: Multifondos

Risk-Return Tradeoff for Type of Pension Fund
(January 2005 – December 2005)
Reforming the reform 1: Multifondos
Intermediation fees while acquiring an annuity

Reforming the reform 2:
SCOMP

Lagos administration put priority to this law
Reforming the reform 2: SCOMP

Average difference between highest and lower offer of annuities
Reforming the reform 3: information to affiliates

• Behavioural economics has found convincing evidence that in saving decisions what prevails is inertia.
• However, no rational choice is possible, even for those that take decisions, without appropriate information

Two major problems remained for 20 years:
1. When there was only one possible portfolio, the benefit of being informed was smaller compared to the cost.
2. The statement was extremely complex, therefore

People received statements but it was useless: desinformation. Surveys suggest:
• 93% of affiliates did not know the price
• 56% declared ignorance of the balance of their personal accounts
• 54% of men and 64% of women declared that they have never changed from one AFP to another
Reforming the reform 3: information to affiliates

Financial statement: comparison of fees

Si durante 12 meses usted cotizara mensualmente por un sueldo de $120,000 la comisión* total anual que pagaría en cada AFP sería:

<table>
<thead>
<tr>
<th>Name of each AFP</th>
<th>Variable fee (% of salary)</th>
<th>Fixed Com.</th>
<th>Total Com. paid</th>
<th>Annual dif. Respect cheapest</th>
</tr>
</thead>
<tbody>
<tr>
<td>AFP</td>
<td>(1)</td>
<td>(2)</td>
<td>(1)+(2)</td>
<td></td>
</tr>
<tr>
<td>2.49</td>
<td>35.856</td>
<td>0</td>
<td>35.856</td>
<td>0</td>
</tr>
<tr>
<td>2.09</td>
<td>30.096</td>
<td>9.480</td>
<td>39.576</td>
<td>3.720</td>
</tr>
<tr>
<td>2.55</td>
<td>36.720</td>
<td>8.280</td>
<td>45.000</td>
<td>9.144</td>
</tr>
<tr>
<td>2.25</td>
<td>32.400</td>
<td>4.680</td>
<td>37.080</td>
<td>1.224</td>
</tr>
<tr>
<td>2.29</td>
<td>32.976</td>
<td>8.340</td>
<td>41.316</td>
<td>5.460</td>
</tr>
<tr>
<td>2.42</td>
<td>34.848</td>
<td>8.280</td>
<td>43.128</td>
<td>7.272</td>
</tr>
</tbody>
</table>

(*) Este cálculo supone que las comisiones no variarían en los próximos 12 meses. Las AFP pueden cambiar las comisiones dando aviso con 90 días de anticipación.

(**) Incluye $10,224 que corresponde al costo anual promedio del seguro de invalidez y sobrevivencia.