

Chapter 2. Finance for Development

Pension reform, capital markets and corporate governance

Latin America leads the developing world in pension reform. Chile launched the process in 1981 with its radical pension reform. Since the early 1990s, that reform has been a model for nine other countries in the region, as well as for a number of countries outside the region, including OECD countries. Amongst Latin America's large countries, only Brazil has not undertaken a similar reform.

These pension reforms involve a transition from unfunded, publicly managed "pay-asyou-go" pension systems to privately managed, fully funded defined-contribution systems of individual accounts for beneficiaries. While some countries have replaced their previous system with the new one, others have introduced it on a voluntary basis.

The reforms pursue several objectives. The most important have been to provide a reliable source of retirement income for workers and to reduce the fiscal drain on governments caused by existing systems. Further objectives, to which this chapter gives particular attention, have been to boost local savings, provide a stable domestic source of development finance and promote the development of local capital markets. The importance of these objectives reflects the fact that many economies in Latin America have long suffered from low domestic savings and financial fragility. These have slowed growth and increased dependence in the region on volatile international capital flows.

The reforms have also sought to rely on competition amongst private interests — notably the pension and insurance companies, which are the institutional investors that manage retirement savings in the new pension systems — to enhance real economic efficiency by channelling savings into more productive uses. The subsequent accumulation of significant amounts of savings in pension funds has drawn attention to the considerable potential for pension funds to induce companies outside the pension sector, in whose equities they may invest, to make significant improvements in the quality of their corporate governance, which would be of major benefit to all stakeholders — including active and retired workers — and to long-term productivity growth in the economy as a whole.

The impacts of pension reforms

Results of the reforms vary amongst countries, in part because the reform was launched much more recently in some countries than in others. In Chile and more recently Peru, pension reform has been accompanied by fiscal consolidation and by increased national saving. In Chile, it has also contributed to financial development — notably by increasing both the role of the stock market and the size of the mortgage bond market — and, together with other reforms, has helped to improve local corporate governance.

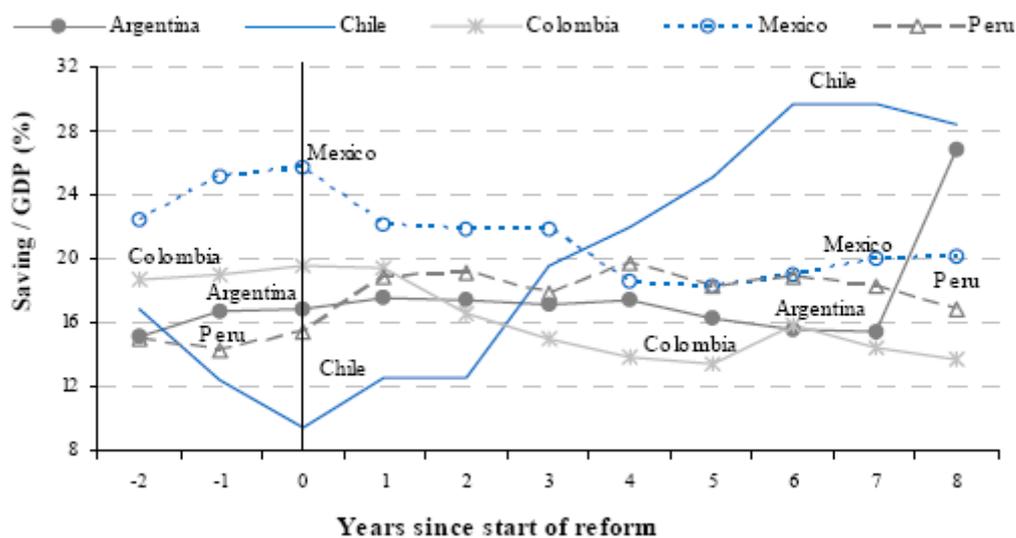
In other countries, the picture is less encouraging. Argentina and Bolivia succumbed to fiscal pressures that weakened their pension-fund systems. In many countries, saving has failed to increase, or even fallen. The impact of pension reform on capital markets has also been constrained by regulations that limit pension funds' investment options and drive them to invest in government debt. As for the expected impact on corporate governance, in most countries, pension funds have yet to become the drivers of improved economy-wide corporate governance that some experts think they may still become.

Analysis of the impact of pension reform on national saving is made difficult in Latin America by the fact that the reform has coincided with other major policy changes that may have had a large impact on saving. In Chile, for example, saving has grown strongly since 1985, after the country recovered from its financial crisis of the first half of the 1980s, but this rise might not have materialised without the important

reforms Chile implemented in other areas of the economy. Figure 2, which gives countries' saving rates during the tenyear period running from two years before to eight years after they launched their pension reform, shows that after the pension reform, besides Chile, only Peru has experienced an increase, albeit small, in national saving as a share of GDP. In Argentina, saving remained virtually unchanged, and in Colombia and Mexico it declined.

Pension reform in Latin America has had considerable impact, on the other hand, on local capital markets. The accumulation of large financial resources by the new pension funds has quickly allowed these funds to gain a dominant position in their domestic financial systems. By the end of 2006, pension-fund assets under management in the region amounted to \$390 billion.

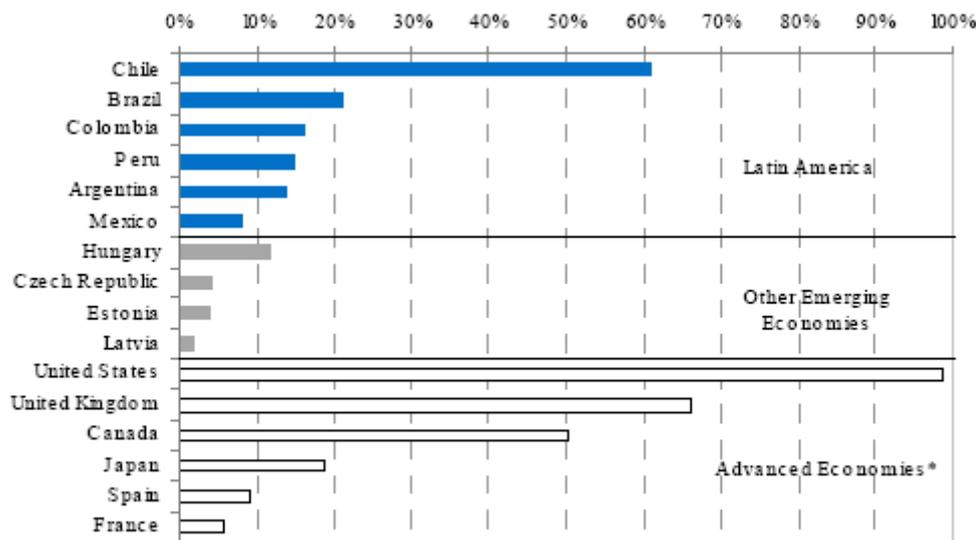
Figure 2. Trends in Gross Domestic Saving as Percentage of GDP



Source: OECD Development Centre (2007); based on World Bank, World Bank Development Indicators (2006) data.
 StatLink <http://dx.doi.org/10.1787/120676251351>

Brazil — which has not followed Chile's route to pension reform but did create voluntary pension funds in the 1970s, of which there are now more than 400 — and Chile have the largest pension-fund industries, accounting for approximately 65 per cent of all pension assets in the region. The early establishment, by regional standards, of pension funds in these two countries, plus the large size of Brazil's economy, explains the large size of these countries' pension industries. Chile has by far the largest pension industry in the region relative to the size of its economy, with assets as of December 2006 worth more than 60 per cent of GDP — a size comparable to those found in OECD countries with well-developed private-pension industries. Brazil's private pension-fund assets, the second largest in the region and now worth about 20 per cent of GDP, have grown more slowly than Chile's primarily because of the voluntary nature of contributions to those funds.

Figure 3. Pension Fund Assets as Percentage of GDP, 2006



Note: (*) 2005

Source: OECD Development Centre (2007); based on OECD Global Pension Statistics database data.

StatLink <http://dx.doi.org/10.1787/120755578734>

Looking ahead

Policy makers throughout the region have moved to ensure better regulation of their pension-fund industries, but significant room for improvement remains both in the regulation and in the governance of these industries. Clearly written mission statements, codes of conduct and mechanisms for enhancing the accountability of pension-fund administrators, for example, could help improve the alignment of incentives amongst members (that is, active and retired workers), sponsors (employers) and administrators (the private companies that manage pension funds), and provide better protection of members' interests.

As governments move to liberalise their restrictions on pension-fund administrators' investment options, the quality of administrators' self-regulation, together with effective governance of pension-fund administrators, will become even more important. This applies especially to the many countries where pension-fund administrators have become entrenched in dominant local-market positions as the largest institutional investors. Greater attention to their governance and self-regulation should also induce a healthy reorientation in their investment strategies towards seeking higher returns from less liquid but potentially profitable and socially necessary investments, for example in housing, infrastructure and innovative technologies.

The probably inevitable high degree of market concentration in strictly regulated, mandatory, funded pension systems further highlights the need for much greater attention to the quality of the governance of pension-fund administrators. Equally important is the potential those administrators have to induce widespread improvement in the quality of governance in the enterprises whose equities they acquire as assets.

Combined, the result of such enhanced governance — of both pension-fund administrators and the corporations in which they invest members' pension monies — should be a far more productive economy-wide use of real capital and human resources. Countries throughout the region would thus enhance national saving and reduce their financial fragility and dependence on volatile international capital markets.

Policy recommendations

To achieve such results, policy makers in different countries would benefit through learning more actively from one another's experiences. Policy makers should exchange their experiences and lessons learned within the frameworks of the OECD Principles of Corporate Governance and the OECD Guidelines for Pension Fund Governance, with the active support of the OECD. Five policy areas deserve particular attention:

First, given that pension-fund assets are likely to continue to grow in Latin America, priority must be given to strengthening local financial-market infrastructure and financial regulatory frameworks.

Second, regulations that hamper a healthy diversification of pension assets should be re-examined with a view to facilitating asset diversification while maintaining high prudential standards. Increasing the share of equities and/or foreign assets allowed in the investment portfolios of pension funds, in countries where current limits on such assets are close to zero, would contribute not only to better pension-fund risk management through enhanced asset diversification but also to reducing the undesirable side-effects of current pension-fund investment patterns on domestic asset prices. And, regarding equities, for pension funds to become active shareholders capable of exercising effective voice in the quality of the governance of the companies in which they invest money, regulators in countries that limit pension funds' equity investment to indexed funds should consider allowing pension funds to buy and sell the shares of individual companies. Any such relaxation of investment limits must be accompanied by effective incentives and tools for asset managers to diligently monitor and be held accountable for the investments of their funds.

Third, policy makers should consider the benefits of allowing pension-fund asset managers the possibility to offer members a diversity of funds in terms of risk-yield profile, which today only Chile, Mexico and Peru allow. In addition to giving individual members a broader range of investment options, such multiple funds enhance the incentive for members to seek information on performance differences amongst fund investments, which may in turn help improve resource allocation.

Fourth, governments must give attention to the high administrative fees and costs that pension funds charge members in some countries. The two principal policy options for addressing this problem are: *i)* to strengthen competitive pressures on funds by liberalizing the market to allow banks, insurance companies and perhaps other financial organizations to compete directly with pension funds for members' contributions; and *ii)* to reduce administrative costs through economies of scale by centralising, for the country as a whole, the collection of members' contributions, record keeping and reporting to members, and reduce administrative fees by limiting incentives for members' costly and inefficient switching between administrators. While the former option relies more on the competitive market mechanism, it requires careful evaluation to avoid exposing workers' pension assets to the excessive risk-taking that may plague the investment and management behaviour of non-specialised financial organisations.

Fifth, the laws and regulations that govern private pension funds need to be revised to strengthen the role and responsibilities of institutional investors as fiduciaries of other people's retirement assets. Transparency and effective rules of communication between fund managers and members are required for the governing bodies of pension funds to act consistently in the best interest of their members. Improved governance of pension funds can in turn greatly enhance the positive impact and simultaneously lower the risk of investment by pension funds in the equity of enterprises active in all sectors of the local economy, as well as internationally. By serving as powerful agents for improved corporate governance throughout their economies, well-governed pension funds can thus also contribute forcefully to long-term real economy-wide productivity growth. Workers, active and retired, and employers alike should benefit significantly.