HIGHLIGHTS

OECD Reviews of Pension Systems

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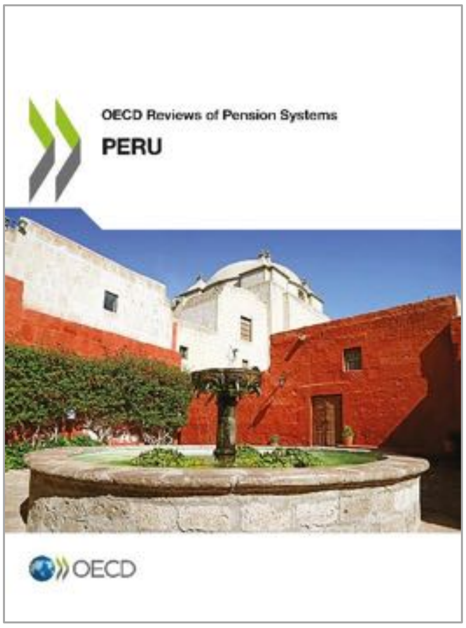

IN THE REVIEW

The current Peruvian pension system

Tackling old-age poverty

Establishing a solid framework for the contributory pension system

Improving the coverage and level of pensions

Optimising the design of the private pension system for the accumulation phase

Optimising the design of the private pension system for the pay-out phase

Trust and confidence in the pension system

Recommendations for the Peruvian pension system

The review is part of a series of country reviews of pension systems. These reviews provide countries with policy options that will help them improve the functioning of their overall pension system. They propose tailored policy options based on the specificities of the national pension system, and on international best practices regarding reforms, design and regulation. This review is the fifth in a series of country reviews of pension systems: Ireland, 2014; Mexico, 2016; Latvia, 2018 and Portugal, 2019.

The Peruvian Pension System has undergone many changes to improve its sustainability over the last several decades. However, there are still significant issues to address to put the Peruvian Pension System in a better position to achieve its objective of ensuring the financial well-being of the elderly.

This booklet presents the main messages from the *OECD Review of Pension Systems in Peru*. The review assesses Peru's pension system in its entirety, looking at both public and private, pay-as-you-go (PAYG) financed and funded pension provisions. It draws on international best practices and the specificities of the Peruvian pension system to propose a set of policy options to improve its functioning and ability to deliver adequate and secure retirement income.

The OECD Review of Pension Systems in Peru provides policy options to help tackle old-age poverty; establish a solid framework for the contributory pension system to meet its objectives; improve the coverage and level of pensions; and, optimise the design and improve the regulation of the funded private pension component. These proposals also aim to improve trust that the pension system and its institutions will work in the best interests of the population to provide a secure retirement income.

The policy proposals in the review should be implemented as a package. All the components work together to balance the different trade-offs. Implementing them separately, in a piecemeal manner, will break the balance and could jeopardise the whole reform. Any reform of the pension system needs to take a long-term vision that goes beyond short-term considerations. Nevertheless, implementation could be gradual taking into account fiscal capacity, institutional capability and labour market developments.

Key issues to address in the Peruvian pension system

Tackle old-age poverty by establishing a non-contributory pension that provides a safety net for all Peruvians in old age

Poverty rates have been declining in Peru, but it remains a much larger problem in rural areas and for the elderly in particular. The programme Pensión 65, that provides a flat-rate benefit for the elderly in extreme poverty, has largely been a success, with 1 in 4 elderly Peruvians now receiving benefits. Nevertheless, benefit levels remain extremely low compared to the level of safety-net benefits provided in OECD countries, even when accounting for the difference in economic development, and only people in extreme poverty are eligible. Furthermore, the benefit level has not been adjusted in nominal terms and has therefore been declining in real terms.

- Increase benefit levels (currently around 9% of average wages) and index them, at least, to inflation to maintain purchasing power.
- Run publicity campaigns to increase people's awareness of the programme and expand its eligibility criteria to reach a larger population to address more than extreme poverty.
- With the expansion of coverage, Pensión 65 benefits may need to change from a flat-rate to a top-up payment to be better integrated with the minimum pension in the contributory system.

Establish a solid framework for the contributory pension system to meet its objectives

The PAYG public and funded private pension components currently operate in parallel, competing against each other rather than building on complementarity. Strict eligibility requirements for the public system mean that individuals unable to achieve twenty years of contributions will receive no benefits from the public system. Individuals switching to the private system will lose access to minimum pension benefits. Furthermore, a lack of coordination among public institutions overseeing the whole pension system has led to pensioners losing contributions.

The main recommendation is to retain the public PAYG and the funded private pension to complement each other, and require that everyone contribute to and receive pensions from both components. While the system could rely primarily on either public or private provision, combining both a mandatory public system and individual capitalisation accounts would result in a more robust pension system that is more resilient to the many risks that can threaten the sustainability and adequacy of retirement income. In addition, retaining both systems would minimise the implementation costs and smooth the transition to the improved new system. The new framework for the complementary public and private pension provision needs to:

- Adhere to the principles of complementarity, accessibility, sustain-ability, and equity.
- Apply the new rules to all new contributions to the system immediately after the reform so as to limit the length of this transition process and the related costs while protecting past entitlements.
- Adjust the public system benefit formula so that the level of benefits that affiliates can expect to receive is linked to the contributions made to the system in order to ensure financial sustainability. Introduce automatic mechanisms to adjust the parameters and benefit levels to the macroeconomic and demographic realities, both in accumulation by linking the accrual of benefits with the macroeconomic situation, and in pay-out by accounting for the length of time that payments are expected to be made.
- Reduce the minimum number of years required to contribute to the PAYG system before being eligible for benefits to improve the accessibility of the system and ensure that most people who contribute to the system can expect to receive benefits in return.
- Establish a minimum level of pension that increases with the number of years of contributions so that individuals can see merit in continuing to contribute. Coordinate the minimum pension benefit with the increased safety-net Pensión 65.
- Remove duplication of disability and survivor pension benefits. Benefits may continue to be provided by the public and private system for their respective portion of retirement benefits. For those in risky occupations, competition between the public and private sector should be removed for SCTR insurance.
- Create a centralised platform to collect contributions and manage information collection for both the public and the private components of the pensions system, and capitalise on the efficiency gains brought with the existing AFPnet platform. This will facilitate the access to timely and accurate data on the pension system and make the processes to share information more flexible and adaptable to ad-hoc needs.

Improve the coverage of the system and the level of pensions

Coverage of the contributory pension system is low by international standards, at around 55% of the working age population. High levels of informal employment, relatively low contributions, low contribution densities, and the possibility of withdrawing assets before the legal retirement age explain the low levels of pension benefits. Over 70% of the workforce is in informal employment, and individuals affiliated to the private system contribute less than half of the years in which they have an account. Currently, individuals can withdraw 25% of their assets before retirement for the purchase of a first home, and retire from the age of 50/55 for females/males if eligible for early retirement. These factors result in a replacement rate that is around 35-40% of final salary in the best case scenario, and only 15-20% in more realistic scenario.

- Subsidise the social security contributions of low-income workers. This would reduce the costs for informal workers - the majority of whom have low income - to become formal.
- Provide incentives workers to voluntarily save for retirement, particularly informal workers. In order to ensure that low-income individuals benefit from these incentives, consider implementing a flat subsidy or matching contributions that are paid directly into the affiliate's account. Such incentives could be linked to contribution density to encourage more frequent contributions. These incentives could also be implemented to encourage additional contributions beyond the mandatory level for formal workers.
- Nudge individuals to save for retirement in addition to the other measures by, for example, introducing as well automatic enrolment and using other insights from behavioural economics such as simplification of the processes and improved communication.
- Consider reintroducing the requirement that independent workers contribute to the system, while allowing for a flexible contribution schedule and innovative collection mechanisms such as through utility bills.

- Increase the mandatory contribution rate. This increase could be gradual and linked to wage increases to prevent an immediate reduction in nominal wages. However, this implies that during the transition period there will be people with different contribution rates. Alternatively, or in parallel, additional contributions could come from the employer.
- Limit the early withdrawal of assets from pension accounts. Early withdrawals for the purchase of a home could be limited to voluntary contributions, but any matching contributions or subsidies provided on these contributions would need to be removed to avoid adverse incentives to game the system.
- Limit access to early retirement. First, eliminate the gender gap in the early retirement age. While the legal retirement age is the same for both genders, there remains a difference of five years for early retirement, which puts women at a disadvantage in retirement given their lower average wages and higher life expectancies. Secondly, make the criteria for early retirement more restrictive for those who are able to continue working. Also, impose minimum income requirements, and adjust benefits downward in an actuarially fair manner to reflect the longer expected time in retirement.

Optimise the design and improve the regulation of the private funded system

Recent measures such as the introduction of the tender mechanism have generated cost reductions and improved competition, but further improvements are necessary to promote better investment outcomes for individuals and to ensure that their best interests are of paramount importance.

- Adapt the default investment strategy to provide a more optimal lifecycle approach by gradually de-risking the investment rather than doing so immediately when individuals reach the specified age. Furthermore, individuals could be allowed to invest different sources of pension savings into different funds and providers in order to better diversify their risk exposure according to their preferences.
- Introduce independent investment benchmarks to assess the performance of the AFPs and improve comparability.

- Introduce a performance-based fee structure, where providers receive more fees if the funds outperform the market, to better align the incentives of the fund managers with the interest of the affiliates. The independent performance benchmarks could be relied upon to this effect.
- Align the fees charged on voluntary contributions with those for mandatory contributions. The fees charged for voluntary contributions remain significantly higher than those for mandatory contributions on average. These high fees may act as a disincentive for individuals, especially those in informal occupations, to contribute voluntarily to the pension system. It also means that individuals who do decide to save more are getting much less out of their additional savings than they would otherwise.
- Eliminate the minimum guaranteed return. Alternative mechanisms exist to achieve the objectives of the minimum return, namely independent benchmarks to judge investment performance and more direct targets around investment volatility.
- Improve and standardise the disclosure and reporting of AFPs' cost and fees to encourage better cost control. The resulting transparency can increase competitive pressure on providers as affiliates can more easily compare the fees they are paying and change providers if they choose. In addition, more providers themselves to better understand all the costs they incur, allowing them to take action to reduce these costs.
- Limit how often individuals can change funds and providers to prevent negative consequences such as excessive marketing expenditure or market instability related to frequent switching.
- Provide the centralised platform managing the contributions and information collection with a mandate to enforce the payment of contributions. AFPs are currently responsible for this, but they do not have the mechanisms to carry out this responsibility effectively.

The option to take 95.5% of assets as a lump sum at retirement has undermined the role of the pension system to provide a regular stream of income in retirement. Short of removing this option, policy makers should implement measures to encourage people to have a pension in retirement. The options they have to take their accumulated assets need to be aligned with the pension system's objective of ensuring people's financial well-being throughout their retirement.

- Require a minimum level of income in retirement to be able to take a lump sum. This minimum could be met through a combination of both the public and private components, and set at a level such as the minimum pension for the contributory system.
- Maintain tax incentives and matching contributions (when introduced) aimed at encouraging saving for retirement only when people buy into a regular stream of income at retirement. People taking lump sums should be able to take only their contributions and returns, but not the incentives received.
- Discourage taking a lump-sum through incentives linked to health coverage. Those retiring early should be required to pay a higher contribution from their lump-sum to account for the longer time to be covered by EsSalud or not allowed to take a lump-sum at all.
- Continue to simplify and standardise the pay-out options. The alternative options for pay-present a risk of confusion and choice overload.
- Ensure the continued security of benefits by regularly reviewing assumptions (e.g. mortality tables) and establishing a procedure to protect annuitants in the case of insolvency of the insurer.
- Extend the deferral period for deferred annuities to increase the amount of income that the deferred annuity will provide. The current annuity purchased with 50% of accumulated assets and a deferral period of five years will result in a significantly lower income than pensioners could otherwise obtain.

Improve trust and confidence in the pension system

There is a lack of trust in the pension system. The population does not fully understand how the pension system works and how contributing to the system will benefit them financially in old age. In addition, there is a perception that the public and private institutions involved do not operate in people's best interest.

- Promote knowledge of how the pension system works. More Peruvians expect to rely on Pensión 65 in retirement than the contributory pension system, demonstrating a significant lack of understanding of the benefits that the system can provide. Education about the pension system should be incorporated into the financial literacy programmes in schools. For adults, public awareness campaigns should be used to educate the public and encourage them to save into the system.
- Improve confidence in the financial institutions of the pension system by establishing a centralised platform as the main point of contact for affiliates. This would help to mitigate the public's perception of who is responsible for errors, and minimise the opportunity for procedural failures.
- Ensure the effectiveness of the rules in place requiring AFPs to avoid and/or manage the potential conflicts of interest they may face.
- Compensate individuals for any contributions that have been misdirected.
- Strengthen the independence and enforcement power of the SBS to show the public that the institutions operating within the pension system are subject to the rules in place and that failing to act in the best interests of the people may carry risks.
- Establish an independent committee of experts that will be responsible for the implementation of the reform in an objective in a gradual manner. They should ensure that the pension reform achieves its long-term view of creating a sustainable pension system.

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