The Chilean Pension System: 1981-1997 *

Thank you very much. I've been invited to speak about the Chilean experience, which we may say is the purest case of private fully-funded management system among all the alternatives we have been discussing today. As it was mentioned before, many countries are introducing fully-funded schemes or a fully-funded pillar in a broader system. In such a context a revision of the lessons from the Chilean experience are useful.

I have prepared this presentation organized in the following four points.

First, I will give a brief description of the system; second, I will go through a very quick comparison of the capitalization fully-funded scheme versus the pay as you go system with the corresponding advantages and disadvantages of each system. Third, I will go over the evolution of the system with some quantitative performance over the first 16 years of the system which started in 1981. Finally, I will expose some lessons we can extract from this experience.

I. A description of the system

The system is a define-contribution scheme with individual capitalization accounts, in which there are private companies, called "Administradora de Fondos de Pensiones", or "A.F.P.", who receive worker's funds. The employers, who retain 10% of their employee's salary for this purpose, deposit these funds in the individual accounts. Workers have the right to choose every moment the fund manager that manages their funds.

Pensions are based on the funds that are accumulated in the worker´s account at retirement age, which is 65 and 60 years old for men and women respectively.

The benefits are of three types: pension, disability and survivorship benefits.

At the retirement age insured people can choose between two modalities. Pensioners can either contract with their fund manager a phased withdrawal scheme

* * Patricio Arrau, Partner, Gerens Consulting. Conference on Pension systems, Rome, Italy, March 1998.

according to the value of their funds or they can withdraw in one act all their funds and hire an annuity pension in an insurance company. In the first case, the workers must face the longevity's risk, so that if they live more than the mortality table's average, they might run out of funds. By the contrary, in the annuity pension's case, they transfer that risk to the insurance company.

There is also an early retirement benefit. If any person has accumulated enough funds in his account (enough to get a pension that is at least 50% of what his salary over the last 10 years was, and if his pension is grater than 110% of the minimum wage), then the worker can retire having any age.

As I mentioned, anyone may move from one A.F.P. to another. A.F.Ps manage the fund as a different and separated networth from the old A.F.P's networth or capital.

The A.F.Ps are forced to keep at least 1% of the their own capital in the form of a liquid asset to back up a minimum return for the fund. In the fund´s return is below some minimum A.F.Ps must use this asset to guarantee this minimum return.

Competition among A.F.P.s is supposed to lie on the commission fees charged to the workers, as well as in the return of their funds. However, competition is a very hard matter in this system as we will see later.

AFPs charge a flat monthly fee (around 25 cents of a dollar) to every worker for the deposit, along with a variable fee (around 3% of the monthly salary) to finance the operating costs the fund managers have. As they are obliged to hire in the insurance market the disability and survivorship benefit, which is around 0.6% of the worker's salary, only the 2.4% remains for the A.F.P. to cover other costs.

Finally, the state's role in the system applies to: regulation, supervision and redistribution policies. There is a superintendancy of fund managers which controls, regulates and supervises very closely the AFPs. Because there is an incentive to risk-taking, the authority controls the portfolios very strictly. It establishes requirements of risk classification and limits the amount of the funds that can be invested in different instruments (no more than 40% of any fund in shares, no more than 45% in government bonds, no more than 12% in foreign instruments and so on).

There are also restrictions which keep the A.F.Ps from having more than 7% of the equity of any particular company. The idea here is that fund managers must be passive investors in companies. There is also a very strict regulation on conflicts of interest.

In relation to redistribution policies, the state provides a minimum pension for all insured that has 20 or more years of contributions during the working-life period. If the amount of fund accumulated in his account is not enough to get a minimum pension, the government would pay out this difference. Still the system is too young to measure the contingent liability associated to this commitment.

II. A comparison between the two systems

The capitalization system is supposed to have less distortions in the labor market. This is so because the contribution should be seen by workers as part of their salary instead of being perceived as a payroll tax as is the case in the pay as you go system. However, this is likely to be the case for people close to retirement age, but not the case for young people.

Another good advantage of the new system is that it promotes capital market development. In Chile there is a lot of empirical evidence that shows that private capital markets institutions have developed enormously since 1981, when the A.F.P. system was created.

The administration costs in the capitalization scheme is very high compared to the pay-as-you-go system. In Chile, the annual cost per worker is a bit over 3% of the salary (30% of the 10% deposit or contribution rate). This is a large amount. I will return to this point later, although I must point out that it is very difficult to compare administration costs across countries. There are scale as well as quality problems to do the comparison and many pay-as-you-go systems don't account correctly all the costs and profits. In the case of US for instance, all the collection activity is done by the IRS and not by the social security system.

The risks faced by beneficiaries have different nature in capitalization schemes. In the capitalization scheme there is the volatility of investments and the longevity risk. On the other hand, in many pay-as-you-go schemes the risk beneficiaries face emerges frequently when inflation liquidates the amount of pensions. However, there is certain consensus that the capitalization system is riskier.

The capitalization system has the very good advantage of generating grater insulation from the political system. Under the pay-as-you-go scheme, much pressure emerges over the social security system to increase benefits, creating large fiscal deficits, and therefore, generating macroeconomic instability. There is very little scope for distribution policy under the capitalization scheme because of the link between contributions and benefits. By the contrary, the pay-as-you-go system opens the possibility of different replacement rates and other type of intra-generational distribution. Keep in mind that if a country is planning to shift to a capitalization system and is now using the pay-as-you-go system as a redistribution policy, it will be necessary to think of how the distribution or safety net will be replaced. I will not talk about these two issues because a previous speaker already did it.

Many people think that the fully-funded system creates more capital accumulation, but at least during the transition that is not true. The accumulation of funds in the capital market is just the mirror image of a transitional fiscal deficit. I'm glad to hear from the IMF representative that they now consider this fiscal deficit of a different nature when they analyze countries. In fact it should be considered the payment of contingent accumulated pension debt, which will decrease over the time as people in the old system is dying away.

III. The Evolution of the System:

The coverage has increased in the system from 52% to 65%. This 65% is a little below than what it was in the old system overall. The difference corresponds to independent people who are not contributing to the new system.

I would like to show you a chart that compares the affiliates and contributors to the A.F.Ps. Affiliates are people who have registered themselves once in an AFP (today they may be unemployed or could be independent people). In fact, many independent people register for only one contribution in the new system, so they can have access to the health system. They keep paying just the health insurance but do not value the deposit in the AFP. That is the reason that explains that the ratio of contributors to affiliates has been going down. This actually shows people do not value very much the contributions as part of their salary or as a good saving device, and therefore the arguments in favor of low labor market distortions is somewhat weakened.

Pension funds have been increasing very sharply since 1981 to 29 billion dollars today (around 40% of GDP). This percentage of GPD should keep increasing up to 80% by the second decade of next century, as the system reaches its regime.

I want to show now the portfolio investments by pension funds. Notice that the first five the system had only three type of instruments: government certificates, time deposits, and mortgage-backed securities. At that time the government was very strict in not allowing the A.F.Ps to buy any share or any corporate instrument. This helped to consolidate the system as it is necessary to slowly create the institutions and gradually flexibilize what A.F.Ps can do. So, since 1986 they are allowed to invest in shares and company bonds. In the last period they have been investing in these instruments as much as they can. Foreign investments are also very limited, as the government feared foreign capital flows. Only three years ago A.F.Ps were allowed to invest up to 12% of funds abroad. Anyhow, fund managers have not used this advantage because of the existence of good domestic investments and high domestic interest rates.

Pension funds have had high but volatile return. On average, they have paid 11% a year over all these 16 years in real terms, in spite of the low return over the last three years due to poor stock market performance. In 1994 the price earning ratio in Chile was very high (around 20) but during 1995-1997 the Chilean stock market suffered a strong correction downward, which affected the funds' return. Nevertheless, after the Asian crisis (in October and November) pension funds suffered another correction downward. This situation is expected to change by the end of the year, turning the return back to a positive value.

If you are kind enough to give me a few more minutes, I would like to show you a darker side of the system, which is due to the difficulties of competition in this system. People have been switching too much among A.F.Ps, specially since 1990. From around 400.000 persons who switched A.F.P. in the beginning of the nineties, this figure increased to 1.600.000 in 1997; that is from around from 10% of total affiliates to around 30%). Moreover, half of the people who moved in the last year had remained less than one year in the old AFP. We should conclude something is working badly today with the incentives to stay. If you look at this phenomenon in more detail, you realize that the government made a huge effort to promote entry and competition among A.F.Ps beginning 1990. Many new AFPs came in making a grate effort to capture workers from other A.F.Ps. To succeed in doing it, their strategy was to hire as many sale agents as they could, who received good commissions for persuading people to move into the new A.F.P. The more agents the A.F.Ps hired, the more trapped they became in a prisoner's dilemma. They had to spend a lot of money and the system increased considerably administration costs and commission fees to affiliates. Finally, this situation exploded this year and the government decided to put limitations to the transfer capability of workers. This is a paradox because the system is suppose to work with competition to capture workers as the only way to control commission fees (price of the service).

IV. Lessons from Chilean's Experience:

To conclude, let me stress the corrections we must put in the agenda.

First, to reduce the high administration costs and to promote a good competition among A.F.Ps, we must emulate some aspects of the occupational pension schemes of UK, US and other countries.

One solution is instead of giving each worker the responsibility of deciding which A.F.P. to choose, to transfer this activity to the employers, who should make group decisions with more information.

Another measure that becomes necessary is to control the commercial practices through some regulation as there is much incentives to capture people by fraudulent means. A very common problem that is now being controlled was that sometimes many sale agents registered changes without having got the signature of the worker who is being transferred.

Also it is necessary to change the commission structure: the flat lump-sum commission that was 25 cents should be around 2 dollars, and the variable percentage commission which is 3% should be around 1.5%, according to the cost structure of the system.

A second aspect to improve the system is the need to reduce the risk tha beneficiaries face. For instance, a person near the retirement is obliged to keep his pension funds in a long term investment, with many shares, which may be affected just before the retirement, loosing a large part of his pension value. For instance, people who went to retirement last June got a better pension than those who went to retirement last December (having had the same amount of funds) only because the Asian crisis wiped up part of the value. For this reason, the authorities have been pushing for a second low-risk fund with only fixed term investments. In general, it is necessary to flexibilize portfolio limits and the number of funds that each A.F.P can manage at the same time.