The first generation of reforms and their implementation in Latin America

David Tuesta
Head Economist for Pension Schemes
Research Department BBVA

150 años adelante.

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Pension system evolution in Latin America

In Latin America, “pay as you go” pension systems were introduced in different periods during the last century.

Pioneering countries:
Uruguay, Argentina, Chile and Brazil
Pension systems were introduced between 1910-1930

Intermediate countries:
México, Perú, Colombia, Bolivia, Ecuador, Paraguay, Costa Rica y Venezuela
Pension systems were introduced between 1940-1950

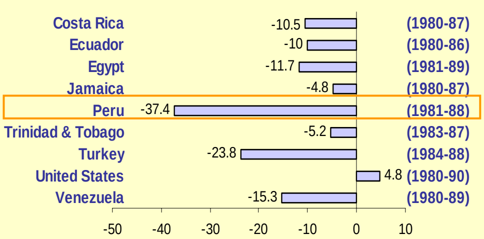
Late countries:
El Salvador, Nicaragua, Dominican Republic, Guatemala, Honduras.
Pension systems were introduced between 1960-1970

Unsustainability of “pay as you go” pension systems

- High benefits with generous payments
- No relation between contributions and pensions
- Unpaid contributions by private and government employers
- Fiscal unsustainability
- Pension parameters such us retirement age, years of contribution, contribution rate and others were not adjusted on time for economic and demographic changes

- Low and negative returns
- Pension funds were used for other activities such us health programs and current government expenses
- High administrative costs
- Political and social pressures
- Actuarial and financial imbalances

Real return of public pension funds in 1980s



Source: World Bank (1994)

Unsustainability of "pay as you go" pension systems

Urgent changes were needed. Two alternatives:

PARAMETRIC CHANGES

Confront crisis by only changing some parameters (delay retirement, increase contributions, limits to anticipated retirement, etc.)

OR

STRUCTURAL CHANGES

Completely reform pension systems, by reducing presence of PAYG frameworks, and implementing individual savings account systems.

Latin American governments chose a structural change

Previous situation: one pillar

Only one mandatory pillar:
PAYG system administrated by government with fiscal constraints and no fund accumulation

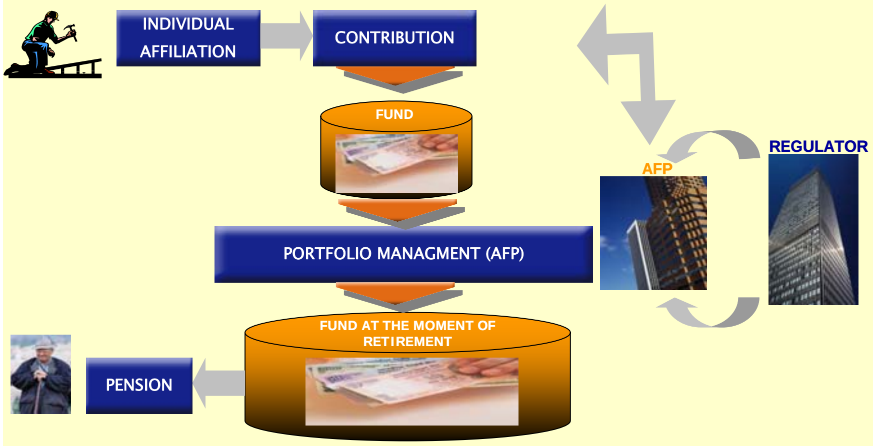
Current situation: two pillars

	Pillar 1 Mandatory	Pillar 2 Mandatory
Objectives	Redistribution + insurance	Saving + insurance
Administration	Government	Private sector
Financing regime	PAYG or other	Individual capitalization
Benefit	Minimum pension or defined benefit	Pension as a function of saving
Financing	Contributions + Government	Fully-funded

Administrated by AFP with separation of assets between pension fund and the AFP company

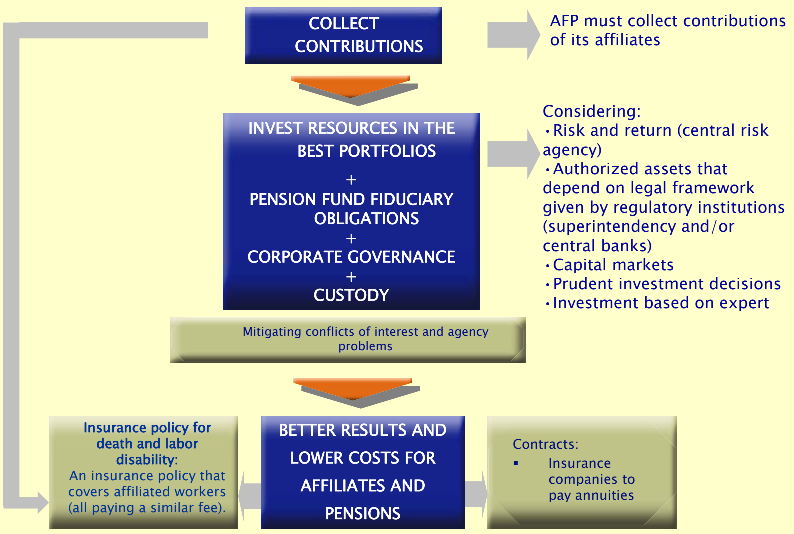
Combination of pillars depended on each country prefferences, but mostly of them chose to implement Pillar 2

Private pension system scheme and AFP´s work



- Different normative requirements can fit this general mechanism

AFPs are not only portfolio managers. They also are collectors of contributions and have responsibilities with affiliates



Private pension system: key characteristics

- **Contributions:**
  Each worker keeps an individual savings account with his contributions
  Property of workers
  Mostly mandatory for dependent workers
- **Financial regime:**
  Individual Capitalization
- **Accountability:**
  Legal and financial accounting separation between Pension Funds and AFP Company
- **Institutions:**
  Management by specialized institutions (AFP)
  It strives for efficiency and competition
- **Freedom for workers:**
  To choose and change AFP

The Government maintains responsibility for the system by assuming its subsidiary and regulatory role

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Benefits and some considerations about the private pension system adopted in Latin America

ADVANTAGES

- One stop shopping arrangement that reduces transaction costs.
- A sense of property rights by establishing individual savings accounts.
- Better expertise and prudent management, considering the historical bad performance of Latin American governments.
- Fiscal consolidation
- Efficient use of resources.
- Increase in national savings and potential GDP.
- Spur capital market development

WARNINGS

- How the framework is designed is important.
- Structural reforms are needed in order to get a full advantage from the system in the long run.
- The system alone does not solve the problem of coverage, especially in countries with bad income distribution, poverty and high informality.
- Therefore, responsible economic policies and well designed social programs are needed to overcome short-term pitfalls

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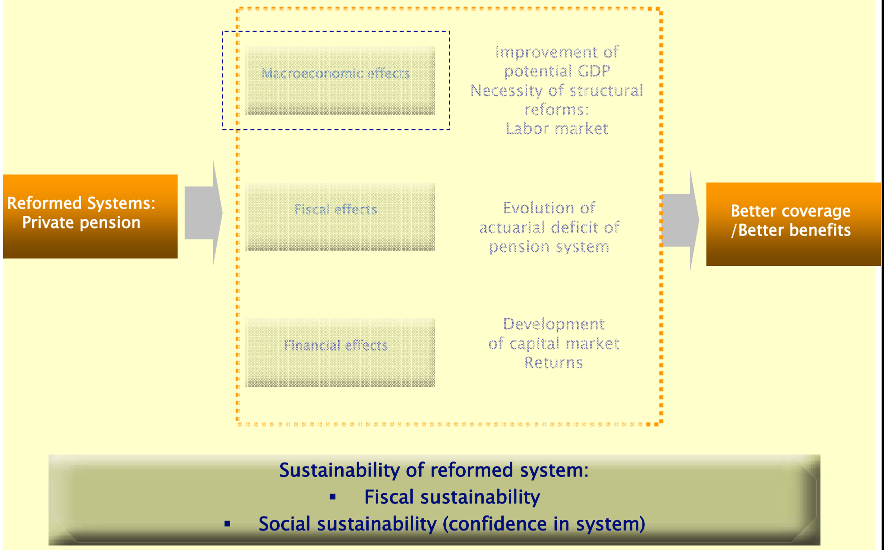
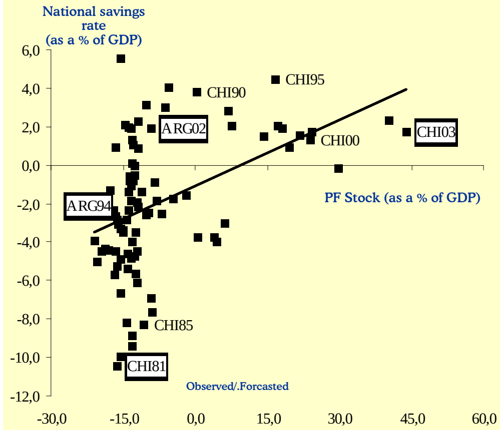
Long run impacts and sustainability of private pension system depends on these factors

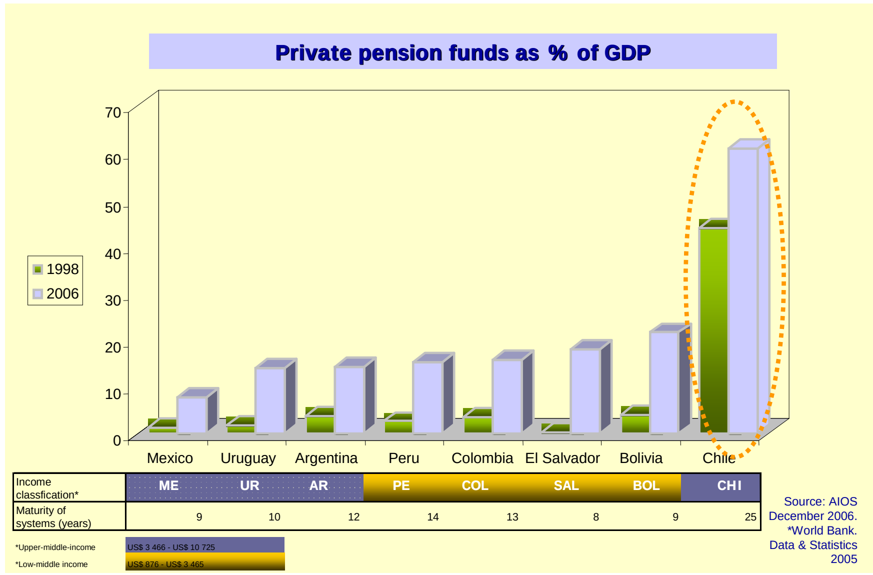


Private pension systems have produced important effects in national savings. It will continue…



- A 10 % increase in pension fund stocks increases the national savings rate by 0.4%.
- According to Corbo and Schmidt-Hebbel (2003), the Chilean experience shows an increase in national savings rate between 1 and 5 % of GDP.

Private pension systems have produced important effects in national savings. It will continue…



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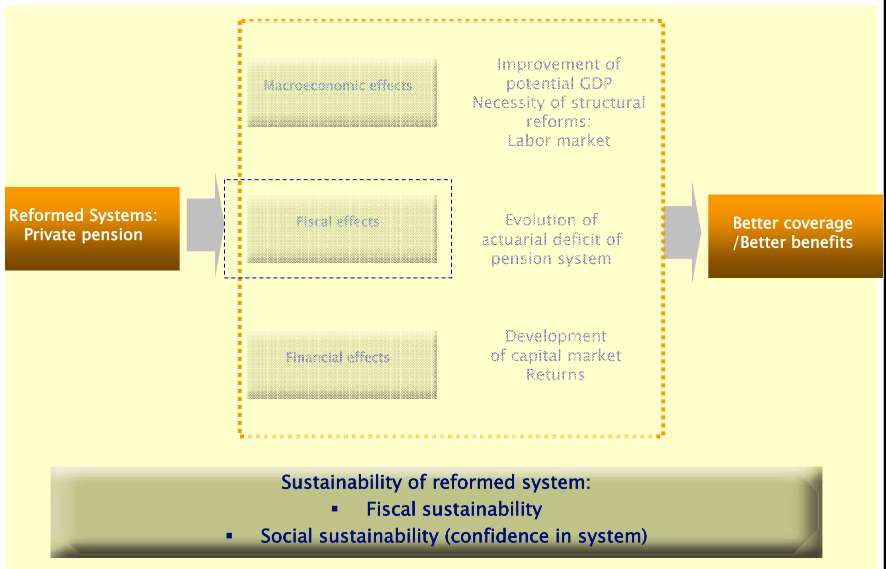
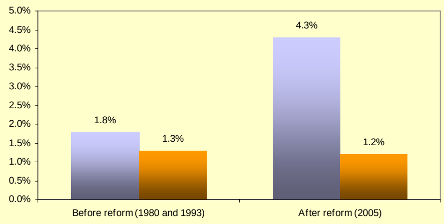


Fiscal results before and after pension reform

Pension reforms have had effects in fiscal cost. But the timing depends on the model adopted

Chilean and Peruvian cases

Deficit pension expenses as a percentage of GDP*



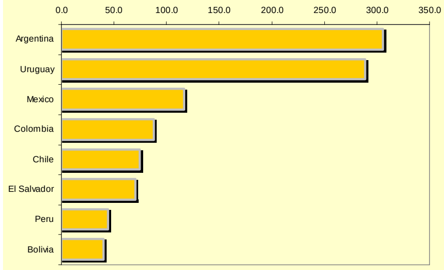
*GDP 2005

*It considers deficit of civil pension system covered by governments

Source: Carmelo Mesa Lago (2000), Alberto Arenas (2005), MMM 2008-2010, MEF (2004) Informe de los sistemas de pensiones en Peru

Fiscal cost of pension debt

in present value as a percentage of GDP



Source: J. Bravo and A. Uthoff, CEPAL "Social Protection" 2006 and Carmelo Mesa Lago.

Forecasting has been made in different years and does not consider the same discount rate for every country (available information)

Updated in the case of Mexico (it considers transition cost). Source BBVA

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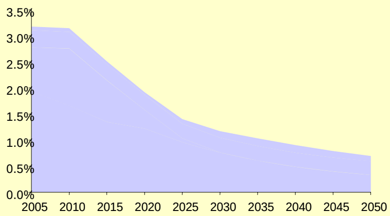
A private system alone does not solve fiscal constraints completely

The cost of Chile

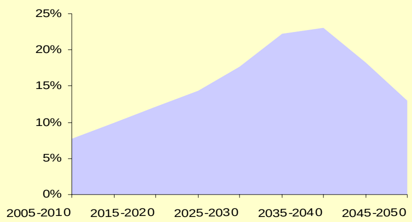


In the long run, Chile will reduce fiscal cost of pension system because of:

- a more realistic fiscal adjustment before the reform.
- mechanisms to finance the previsional debt of the old system (recognition bonds).

A contrasting situation is facing by Mexico.

The cost of Mexico



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Long run effects and sustainability of private pension system depends on these factors

Reformed Systems: Private pension

Macroeconomic effects

Improvement of potential GDP
Necessity of structural reforms:
Labor market

Fiscal effects

Evolution of actuarial deficit of pension system

Financial effects

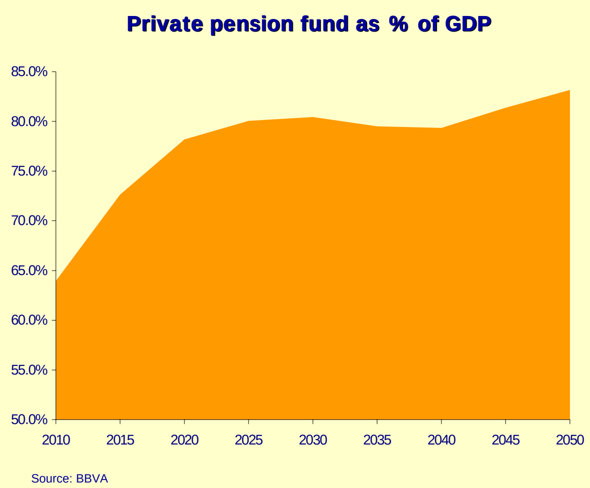
Development of capital market
Returns

Better coverage /Better benefits

Sustainability of reformed system:

- Fiscal sustainability
- Social sustainability (confidence in system)

Evolution of pension fund in the case of Chile and its effect in capital market

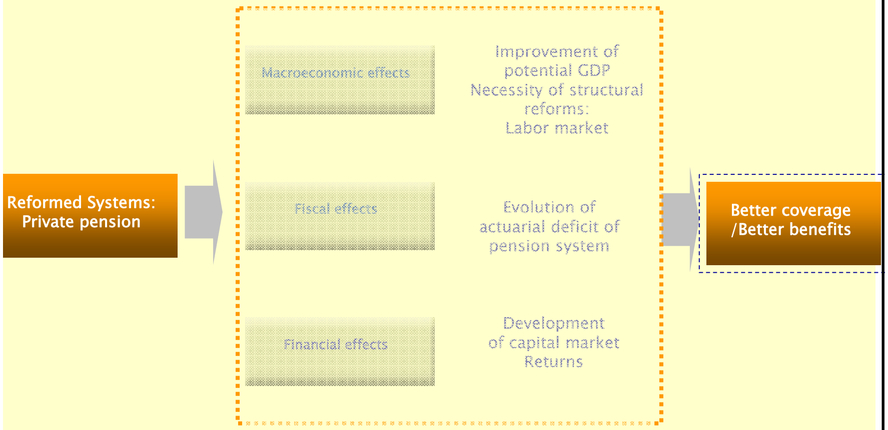


Pension fund will continue increasing 20p. in the next 15th years

Capital market can not increase in the same way.

AFP investments represent 30% of banking deposits (which have low return)

Long run effects and sustainability of private pension system depends on these factors



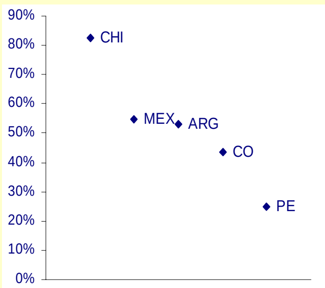
Sustainability of reformed system:

- Fiscal sustainability
- Social sustainability (confidence in system)

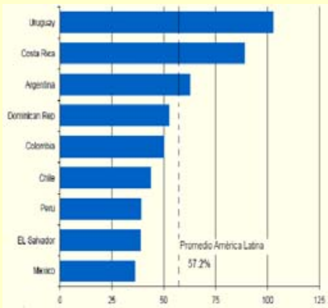
Coverage and Benefits

The current situation can be summarized with two indicators:

Coverage
Affiliates/Pop 14-64



Replacement rates



¿What can we do to improve coverage and pension?

COVERAGE

- Labor market reforms
- Fiscal reform to reduce informality
- Guarantee a minimum pension and/or non- contributive pensions
- Contribution incentives for independent workers
- Flexible plans for independent and informal workers

AND

PENSION

- Portfolio returns
- Increase contribution rate
- Improve contribution density
- Administration costs

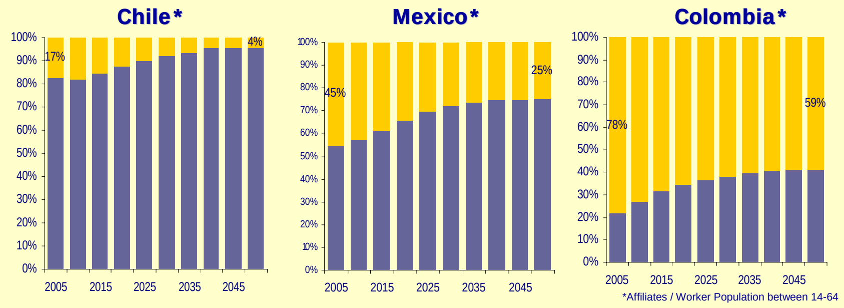
Private pension system actions:

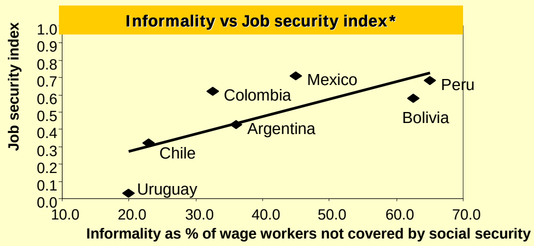
Government actions (economic policy):

Responsibilities

Sustainability of reformed system = Government + Private pension system

Governments must implement extra private pension actions. For example reduce informality



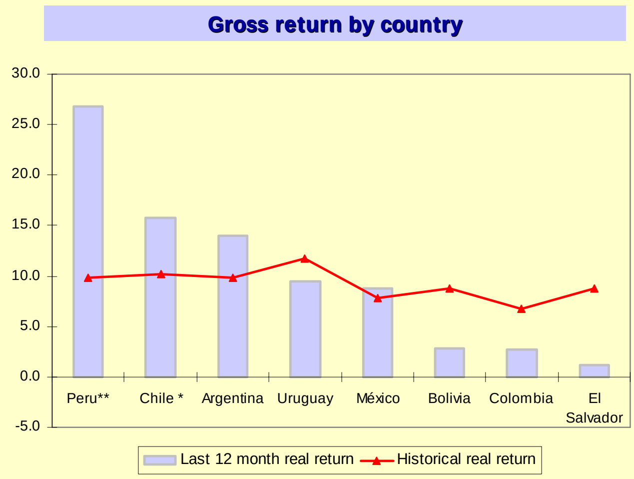


For example, labor market rigidity is one of the main aspects that explains informality and therefore, limits coverage

Source: Djankov et al. (2003) y BID (2004)

*Values close to 1 show more protection

Portfolio returns: a key factor for better benefits

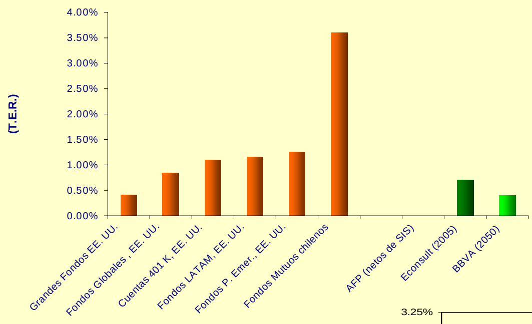


Additional 1% portfolio return increases pension level between 24% – 30%

Source: AIOS December 2006

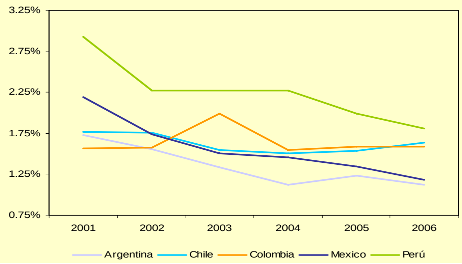
*It considers C fund. **It considers fund called "Mixed"

Administrative costs



An international comparison shows that administrative costs in the case of Chile are not expensive

....and the maturity of the system will produce lower the costs* for affiliates



* As percentage of wages

Conclusions

- There is not just one pension reform model. The choice depends on fiscal cost, maturity of the system and the preferences of the society.
- As a whole, pension reform in Latin America has been successful in increasing national savings, reducing fiscal costs, increasing portfolio returns and developing capital markets. These achievements are very important as a pre-requisite to spur better coverage in the long run.
- At the same time, responsible economic policies and well-designed social programs are needed in order to face short-term difficulties.

Challenges

- ➢ Improve coverage
- ➢ Continue reducing fiscal costs, specially in countries with high costs
- ➢ Improve contribution density
- ➢ Help to design a labor market reform that contributes to improve coverage of independent and informal workers
- ➢ More research on solidarity mechanisms

BBVA

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