INTERNATIONAL CENTRE FOR PENSION MANAGEMENT

Outsider’s View on the Chilean Pension System

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This report is prepared for the ICPM Discussion Forum in Santiago, Chile taking place from October 21 to 24, 2018 by a group of international pension experts under the Research Committee of ICPM. The report is based on 18 informal interviews of key stake holders of the Chilean pension system primarily conducted on a fact-finding tour to Chile from August 28 to 30, 2018.

The working group acknowledges the work put in by many people to analyse the dilemmas in the Chilean pension system and to propose solutions. The objective of the report is to provide an “outsider’s view” on these dilemmas in the hope that this will make a constructive contribution to these efforts.

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Background

The structure[1] of the Chilean pension system was created in the early eighties. The main features of the system are:

- *Solidarity Pillar*. The solidarity pillar provides a means-tested, minimum pension funded over the public budget delivering up to USD 160 a month to persons without own means. Persons with own pensions exceeding USD 460 will normally not receive anything. Current public spending[2] is 0.7% of GDP.
- *Individual accounts*. The core system is a DC system of individual accounts with a mandatory contribution rate of 10%. Assets are managed by specially mandated Pension Fund Administration companies (AFPs) and the system provides seamless, well-developed decumulation options at retirement.
- *Strong governance*: The system is extensively regulated, with regulation efficiently enforced by an independent supervisor, and there are no indications of abuse or misconduct.

On these grounds, the Chilean pension system has for many years been a model system to many developing countries and earned a 'B' ranking in the Melbourne Mercer Global Pension Index (MMI) among peers like Canada and Sweden.

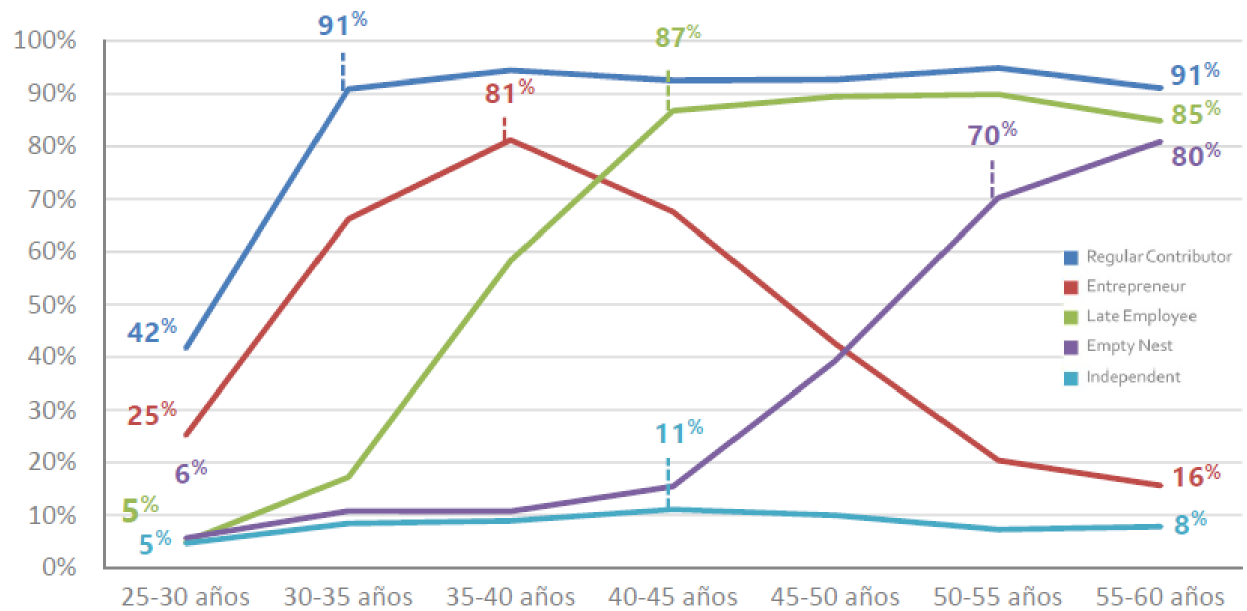
Weaknesses

Yet, large groups of the Chilean population are very dissatisfied with the system. This came to its most vivid expression in 2016-17 where more than 2 million Chileans protested in a series of demonstrations across the country.

The anger is driven by widespread disappointment of the pension outcome of the individual-account system which by many is expected to deliver a 70% replacement rate – but the majority of Chileans receive much less. The actual replacement rate[3] is more like 35-40%, on average.

[1] See *Summary of the Chilean Pension System* by the working group.
[2] *Final Report*, Bravo Commission, 2015.
[3] *Pensions at a Glance*, 2017, OECD.

FIGURE 1: CONTRIBUTION PROFILES OF *HABITAT* 60+ MEMBERS



Source: AFP Habitat, Contribution History for Affiliates Older Than 60 Years, March 2018

Figure 1 shows the density of contributions, i.e. the average number of months per year a contribution was made, over the working lives of members of AFP Habitat older than 60 years. The analysis identifies five characteristic groups of contributors with the following profiles (fraction of members in parenthesis):

Regular Contributor (29%): Start to contribute around age 30 and continue to do so through the entire working life.

Entrepreneur (13%): Contribute early in career and then stop around age 40.

Late Employee (15%): Enter the labor market late but then contribute regularly.

Empty Nest (13%): Enter labor market very late and contribute fairly regularly.

Independent (30%): Infrequent and few contributions over working life.

The analysis shows that a minority of about 30% of the members of Habitat have contributed consistently their entire working life while another 30% make very little contributions (less than 1 month a year). The other 40% contribute part of the time but not enough to accrue the money they would need to generate a sufficient replacement rate.

THE CHILEAN PENSION CRISIS

If the DC system is to deliver adequate replacement ratios it is imperative that members make *regular* contributions. This is not the reality for most members leaving a sizeable gap between the pension outcome that Chileans *expect* and the pension they *receive*. This is the core of the Chilean pension crisis.

The problem is exacerbated by a contribution rate (10%) and a retirement age that are both low by international comparison. The retirement age in the individual account system is 60 for women and 65 for men, which makes the problem for women even more acute.

In terms of delivery, the Chilean pension crisis can therefore be summed up as:

a) Lack of persistence in contributions;

b) Low contribution rate; and

c) Retirement age is fixed despite significant increases in life expectancy.

The population is directing its frustration at the AFPs. The AFPs are private for-profit companies mandated to manage individual accounts. These commercial master trust vehicles are responsible for the management of the DC system (administration and investment).

The fact that groups having consistently contributed to the system obtain reasonable replacement rates indicates that the system – from a technical point of view – was well designed at its origin although parameters are now outdated. Historically[2], the individual account system has delivered 8.6% in average return.

Four Observations

The underlying reasons for the Chilean pension crisis are well-known and have been thoroughly analyzed by academics and were the subject of two presidential commissions, the Marcel Commission (2006) and the Bravo Commission (2015).

Cutting to the bone, the structural challenges of the Chilean pension system can be summed up in the following two observations:

- The parameters of the system are outdated; and
- The pension system is a poor fit to the labor market.

The purpose of any pension system should be to provide secure and affordable retirement incomes to everyone – a view that the majority of stakeholders supports. Negotiating pension reform is a difficult and slowly moving process that eventually will require all parties to compromise to reach a successful outcome. Still, the Chilean debate has not yet reached a consensus on the exact, tangible objectives to be met by a reformed pension system, and, hence, not succeeded on a reform.

On the lack of consensus, the working group has made the following two observations:

- The individual account system lacks legitimacy; and
- There is a piece missing in the design.

THE PARAMETERS OF THE SYSTEM ARE OUTDATED

From a technical point of view the Chilean pension system is well designed and works as intended delivering replacement ratios as expected for groups with full contribution histories. The success relies on high historical returns which exceed current long-term investment return expectations.

All else being equal, lower investment returns directly translates into higher contribution requirements. The mandatory contribution rate of 10% is low by international comparison. In most other countries, contribution rates of 15-20% is typically needed to deliver replacement rates of 60-80%. This reinforces the point that contribution rates will have to drift higher in Chile if one hope to reach a 70% replacement ratio.

In addition, the positive trend of people living longer also applies to Chile adding further pressure on replacement ratios as the length of time in retirement increases. The need to increase retirement ages is therefore as necessary, and undoubtedly as unpopular, in Chile as in many other countries.

Some other parameters also appear out of line from an outsider's perspective: The default investment profile, which is set by law, prescribes a rather conservative risk level at most ages.

In addition, there is a high degree of switching between investment portfolios by members, fuelled by independent investment advisors. This, together with the need for individual accounts to be transferable within a few days between AFPs prevents sizeable allocation to illiquid asset classes. This goes against the global trend to increase the exposure to alternative and private assets.

THE PENSION SYSTEM IS A POOR FIT TO THE LABOR MARKET

Formally, there is a mandatory contribution of 10% of salary to the individual account system, that is set by law. This is only enforced efficiently in the formal part of the Chilean labor market whereas there are many options to evade contributing for informal (independent) workers.

The informal labor market is a sizeable element of the Chilean economy and most Chileans spend part of their careers as independent workers. Most middle-class Chileans therefore save too little – knowingly or unknowingly – and have done so for a long time. The result is that large groups of Chile's middle class are left with an inadequate pension that will not provide a standard of living similar to their working lives. This will persist for a long time even once contribution rates are lifted.

Whether the lack of regular contributions is the responsibility of the state or the individual is ultimately a political issue; but, problems in the individual account system will have to be cleaned up in the solidarity pillar, as happens in countries elsewhere.

The challenges of an informal labor market are not unique to Chile. It is a growing challenge in many developed economies and should be addressed explicitly. It is globally considered best practice *not* to leave the decision to save to the individual. Instead, contribution rates are usually enforced either through legislation or negotiated in the labor market.

THE INDIVIDUAL ACCOUNT SYSTEM LACKS LEGITIMACY

The Chilean economy is to a large degree structured as a free-market economy where the state provides basic coverage on public goods, but premium services are left to private enterprise and individual choice. This goes for health care, education and the pension system.

Pension legislation aims at creating a level playing field for pension providers to create a competitive market and drive costs down. To ensure competition, regulation details asset composition, transition/liquidation times, cost structure etc.

Legislation itself comes out of a parliament that seems divided on the objective and structure of the pension system itself. There is no independent institution to act in the best interest of the members of the system; leaving the individual-account system without a sponsor to whole-heartedly support the system.

From an international perspective, pension institutions are typically linked directly to worker's interests through a public entity or the labor market: Pension funds are often directly owned or associated with employer or labor organizations – and member representation in the pension provider is strong and, sometimes, mandated.

In the Chilean pension system, member representation in the pension providers is weak. Some AFPs have established consultation committees where members are heard but these have very limited power over how assets are managed and – as private companies – clients are not represented on the board.

AFPs have improved member communication significantly in recent years. This is both necessary and helpful, but as private for-profit companies they cannot provide the same legitimacy to the system as an independent institution would do.

In the light of the necessity of reform the lack of legitimacy adds to the challenges. Pension reform has proven a bitter pill to swallow in any country embarking on such effort. If, on top of this, necessary changes are met with distrust and rejection, political courage easily fails, severely diminishing the chance of a successful outcome.

From an outsider's perspective, trust in the Chilean pension system could be materially improved by creating an independent institution empowered to represent and act on behalf of members of the pension system.

Outsider's View on the Chilean Pension System

THERE IS A PIECE MISSING IN THE DESIGN

In the classic definition of the World Bank, Pillar 1 provides poverty protection whereas Pillar 2 provides income substitution.

At first sight the Chilean pension system fits these definitions: The PBS (old-age basic solidarity pension) and the APS (Solidarity Pension) together provide a means-tested, minimum retirement income (Pillar 1) financed over the public budget; the individual-account system provides an income-based pension plan on top of this (Pillar 2).

In other words, Pillar 1 provides protection to some, Pillar 2 to others, but the combination leaves large groups without adequate retirement income … and it is difficult to fill this gap.

Although the content of Pillar 1 and Pillar 2 are clearly defined, they do not combine into a complete package. There is a piece missing in the Chilean pension system.

Strengthening the current system undoubtedly is a good idea but may not be enough. Expanding the Solidarity pillar will alleviate the problems to some – but if too generous it will disincentivize necessary savings in the individual account system. Increasing contributions and improve enforcement *will* solve the problems – but only in the very long run. There will be at least one generation of workers that already are so behind in contributions that they will never be able to catch up.

To address the interests of this very large group a new piece will have to be introduced into the system. The objective of this piece should be explicitly to compensate workers with inadequate savings or pensions.

Such elements are not uncommon in an international perspective and would typically involve collective or pooling elements to mitigate risks between generations.

There are several models in operation globally to fill the gap between the PBS+APS and the individual-accounts in Chile. Examples include Canada, Netherlands, and Sweden. These models expand coverage by adding intergenerational risk-sharing to the pension system, stressing the fundamental role of pensions in modern welfare societies and would allow immediate compensation of workers and retirees.

Reform Proposal

At the time of writing the Chilean government has not put forward its reform proposal to parliament.

From what the working group has been told, the reform will strengthen the Solidarity pillar by increasing pension benefits from the current level about 30% below the poverty line. It will also expand the range of compensatory benefits to incentivize specific groups with inadequate savings to contribute to the individual account system. Finally, contributions will be increased from 10% to 14%.

There will be no change to retirement ages.

Outside the reform, a separate proposal to better enforce collection of contributions from self-employed is presented to parliament – unfortunately, it seems, with a transition period of at least 8 years.

These measures will certainly strengthen the pension system – but will not solve some of the core issues mentioned above. The Chilean pension system will most likely continue to fall short of the pension expectations of a large group of workers.

Final Thoughts

The Chilean pension system is well-governed and well-run, with strong, independent supervision. It will, in theory, deliver adequate retirement income to Chilean workers, but in practice only do so for workers who contribute regularly to the system. In reality, the average replacement rate[3] is around 35%. Simply put, Chile needs to put more money into the pension system.

If we first look at the strengths of the system, the Chilean pension system provides a Solidarity pillar reaching out to those without any – or little – savings. The poverty rate[3] among the elderly is 16.3% only slightly above the poverty rate of 16.1% for the entire population. In other words, Chilean retirees are neither better nor worse off than the rest of the population.

The individual account system obviously bears the strength of any fully capitalized pension and provides security and wealth to account holders. Historically, AFP's have delivered sizeable returns to members at a decent cost level.

Any pension reform strengthening these elements will strengthen the Chilean pension system and will in the long run provide better coverage – in particular, if measures to better enforce contributions are implemented.

The problem is, that strengthening the current elements will not solve the Chilean pension crisis. Realistic measures will do little to middle-aged workers that have not saved enough. Basically, it will take another one to two generations to fully harvest the benefits of changes to the current system. Until then, the system will continue to deliver below expectations.

It is the view of the working group that the Chilean pension crisis cannot be solved within the boundaries of the current system.

The major weakness of the Chilean pension system is the legacy of a poor fit to the labour market. There already is at least a generation of middle-aged workers that have not saved sufficiently and will not be able to compensate before they retire.

Should Chile decide to reach out to this group, it will be necessary to add a new component into the Chilean pension system to bridge current needs with future income. Such a piece could be inspired by pension plans in Canada, Netherlands, or Sweden relying on a collective pension contract. This would allow parameters to be set to favour middle-aged workers to quickly provide higher benefits to this group.

Adding a new element is complicated – and will probably take (more) time. Until then, any expansion of the current system is strongly encouraged.

Reform will require multiple iterations. Commitment and political will to compromise is paramount to success. Consideration should therefore be given to creating a process to facilitate this long-run transformational change journey.

Appendix

LIST OF INTERVIEWEES

AFP Habitat

- Alejandro Bezanilla, Chief Executive Officer
- Leon Fernandez de Castro, Chief Planning and Development Officer
- Cristian Rodriguez Allendes, Chairman of the Board

Libertad y Desarrollo

- Luis Larraín A., Executive Director

The Presidential Office

- Augusto Iglesias P, Coordinator of the current process of reform

Comisión de Usuarios del Sistema de Pensiones

- María Eugenia Montt, President of the Commission
- Esmolek Jose Troncoso Cisterna, Representative of Pensioners
- Roberto Fuentes Silva, Representative of the private institutions of the Pension System
- Ivonne Bueno Velasco, Technical Secretary
- Ana Maria Muñoz Cáceres, Representative of workers

Chilean Central Bank

- Solange Berstein Jauregui, Director of Financial Policy Division

Undersecretary of Social Security

- Ursula Schwarzhaupt, Chief of Research

Cuprum AFP

- Pedro Atria, Chairman of the Board
- Martín Mujica, Chief Executive Officer
- María Alicia Montes, Director of Research
- Daniela Zecchetto, Head of Corporate Relations

Superintendencia de Pensiones

- Sergio Rosenberg Aratangy, Head of Capital Markets, Regulator

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