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A State Pension Fund Manager: Going the Wrong Way

A state Pension Fund Manager (AFP, *Asociación de Fondos de Pensiones*) would not contribute to solve the system's problems and it would probably cause additional ones. Therefore, it is a deceiving solution that could only anticipate the end of the model, since it solves nothing and encourages other reforms. The current system is subject to improvement, but not through proposals that do not hold up to a serious technical analysis and which are only attractive for the political speech.

There is no doubt that the pension matter has taken part of the public policy agenda for quite a while. As usually in these complex issues, which do not have obvious solutions nor are exempt from costs, simplistic views appear that do not get to the bottom of substantive problems, or if they do contribute, costs exceed the potential benefits. This would be the case if a state Pension Fund Manager (AFP) is created, an idea that is somehow present in eight of the nine nominations currently competing in the presidential election.

However, the creation of a state AFP does not resolve the problems of the pension system, and engenders other serious disadvantages, which could eventually lead to the end of the individual capitalization system. Thus, we are talking about a disastrous public policy, considering that, with the country's current demographic structure, an individual saving system is the only viable social security alternative in the medium term.

In general terms, we can identify two problems that should be solved in the current pension system:

Actual pensions are lower than the pensioners' expectations.

The contributors are not quite aware of the commissions charged by the pension managers and the services delivered by them, which speaks of a competition problem.

The first problem mentioned above is the most relevant and to reach a reasonable solution it is necessary to find out why pensions are below expectations.

Today, the system pays close to one million pensions, with an average amount of CLP$182,000. But this average is not representative, and it should be corrected due to the distortion produced by the bonus per child. We should recall that this subsidy is granted to all women older than 65 who have complied with the requirement of making at least one contribution to the system. Consequently, between 2008 and 2010, the number of women contributors increased by nearly 200 thousand, many of them contributing just to fulfill this requirement. 254 thousand women have already received the bonus per child, and their pension is already included in the average of paid pensions, despite the fact that in many cases they register only one contribution.

According to a survey from DICTUC[i], from the current old-age pensioners, women have contributed 6.2 years on average. This figure increases to 15.7 if women who have contributed for less than a year are excluded from the calculation. On the other hand, men pensioners have contributed 19.8 years on average. If we compare these numbers with the average life expectancy at the time of retiring, of 24.7 years for women and 17.3 years for men, it is perfectly clear that the system's main problem is the low contribution density. By contributing 10% of the taxable income for less than 16 years in the case of women, it is impossible to achieve a replacement rate close to 70% of the income of the last worked years, for a 25-year period. This obvious problem of financial mathematics is not resolved through a state AFP. Finally, the great success of Chile of significantly extending the life of citizens in the last 30 years leads, by common sense, to the need to increase savings for old age.

Another cause explaining low pensions is that the contribution's 10% rate is insufficient in view of our country's current demographic situation. In fact, in 1980 life expectancy was 67.4 years for men and 74.2 years for women; therefore the longevity to be financed by the pension was slightly over two years for men and 14 years for women. A state AFP does neither correct the problem of an insufficient contribution rate.

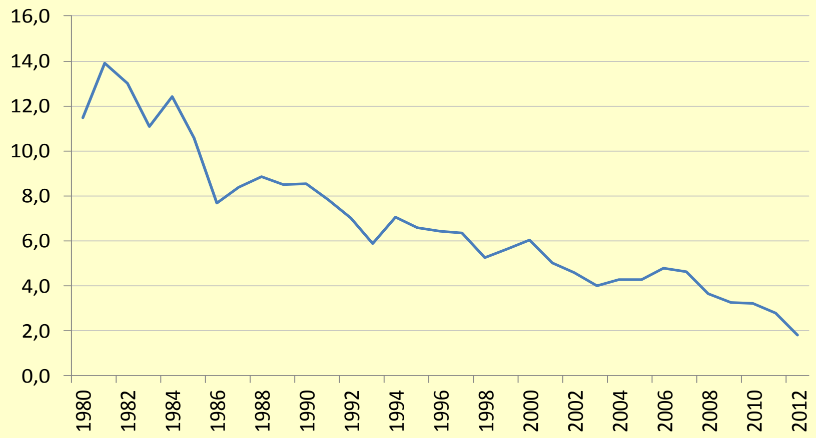
A third cause for low pensions is that many times, especially in the public sector, a percentage of the worker's wage is non-taxable, detaching the future retirement from the income that the worker receives during his active stage. According to a survey of the Undersecretariat of Social Security, for average workers 18% of the wage is non-taxable. The state AFP does not correct this condition.

A fourth reason explaining a replacement rate lower than expected, rather than low pensions, is the increase of real wages throughout life. Since pension savings depend on the average real income, if the latter increases over time, the replacement rate calculated on the basis of the last income drops. Between 1996 and 2013, real wages have grown more than 50%; thus, the success of the economy seems to be conspiring to this low pension perception. Once again, the state AFP is not the solution to the problem.

A last cause explaining reduced pensions is the strong decrease of long-term interest rates at global level, which increases the cost of life annuities. The world's demographic change causes savings to increase, resulting in a rate drop, and the effects of the global financial crisis should be added. Chart 1 shows the evolution of the 10-year T-bill rates.

Chart 1

10- YEAR T-BILL



Source: Banco Central de Chile (BCCh).

In rough terms, each point less in the interest rate causes a pension decrease close to 10%, therefore the rates' drop in the last decade has reduced pensions by approximately 30%. It is possible that this phenomenon tends to partially revert in the following years; however, considering a long-term trend analysis it is highly improbable that rates can recover the levels of the eighties or early nineties. The state AFP does not favor this aspect at all. On the contrary, it can be harmful if it leads to invest wrongly for political reasons (to favor certain sectors for example).

We can therefore conclude that the creation of a state AFP can do nothing whatsoever to improve pensions.

A second issue concerns the system's lack of competition, since contributors are quite unaware of the price charged and the service delivered by the Managers. Table 1 shows the commission structure and we can see that the price dispersion is actually high.

Table 1

FEE FOR DEPOSIT OF CONTRIBUTIONS – AFP AUGUST 2013
% OF TAXABLE WAGE OR INCOME (*)

CAPITAL	1.44
CUPRUM	1.48
HABITAT	1.27
MODELO	0.77
PLANVITAL	2.36
PROVIDA	1.54

Source: Superintendencia de Pensiones (Superintendence of Pensions)

The commission of the AFP *Modelo* is almost 40% less than the AFP that follows, and is equivalent to almost 30% of the most expensive AFP. In fact, the bidding of new members as a result of the 2008 reform managed to reduce the average commission, but until now no Manager has been able to follow the example of *Modelo*, which was also awarded the second bidding. Moreover, it should be noted that this AFP is linked to the firm *Sonda*, which had previous experience in the development of the industry's operating systems. This sheds some light on what is a reality: competing with the established AFPs is a very difficult challenge for everyone (including the State). Would a state AFP increase the competition? Considering the climate of distrust towards the current system, it may be that part of the population perceives that this fact alone can improve pensions, which is false, as we showed above. Actually, the state AFP could attract contributors, but for the wrong reasons, therefore it does not seem the right alternative. Moreover, it is highly probable that a state AFP will not be able to finance itself by charging the commission of *Modelo*, and the measure could result in a significant public expenditure.

The above does not exclude the option of fostering measures that can improve competition, for which several alternatives have been set out, both in terms of new agents and a different commission structure. We can neither ignore the crucial role of the State in the market through the promotion of more and better information, a matter where clear and serious shortages have been detected. It is very hard to implement an individual saving system whose grounds are not understood by those involved. In this perspective, the promotion of a state AFP as part of the solution proposals is negative, because it contributes to this misinformation problem, which in some way deceits workers.

In brief, although it is true that the creation of a state AFP can trigger a significant movement of contributors within the system, it would be for the wrong reasons, which is highly questionable from the point of view of the implementation of a public policy. Thus, a state AFP does not contribute to resolve the system's problems, and it will probably cause additional ones, among which we can mention the following:

1) Subsidized commission: given the difficulties to imitate *Modelo'*s commission, two complex scenarios can be set out. The first assumes that the Public Treasury will have to subsidize the AFP operation, entailing an obviously disloyal competition for the rest of the system, which is not supported by the State. A second scenario would be to create the AFP under the wing of *BancoEstado* in order to reduce administrative costs. However, it violates the banking laws, which should be amended to an extent that does not seem reasonable, since it would open the gate for all banks to create AFPs. The experience of the recent financial crisis shows that it is positive for banks to keep a single line of business, as well as for pension fund managers.

2) Perverse incentives in the use of funds: as in past experiences, there is the risk that funds managed by a state AFP are used in projects that are politically profitable, but privately vey doubtful (education, social housing, public infrastructure or others), which in the end may affect the workers' pensions. And these extreme situations are not only complex in terms of the investments that a state AFP could make, but divided loyalties are also involved in the funds' management. The law does not allow private AFPs, and rightly so, to invest on related companies to prevent them from financing own projects with the contributors' capital. How would this operate for a state AFP, which would be interested in investing on businesses like the underground (Metro) or railways (EFE), or in bonds from the Central Bank or the Ministry of Finance?

3) In relation to the above, it is highly probable that the yield of the funds would be lower than the system's average, or eventually negative. The political pressure in such a situation where public funds are involved can be very difficult to face, which leads to alter the foundations of the individual savings scheme, and thus bring the system to an end.

4) A fourth problem regards the role of the public AFP in choosing, together with their private world peers, the directors that will represent them in the respective private businesses. The fact of giving the Public Treasury the responsibility to influence on these

decisions is a very questionable matter. And there is again the issue of corporate governments in public organisms, since there is no clarity as to how the board of directors in charge of the state AFP would be appointed, which entails the risk of becoming an attractive space for political favors.

5) The supervising role of the Superintendence of Pensions becomes more complex too, since a public organism would be controlling another public organism.

Conclusion

It seems quite evident that the costs of creating a state AFP exceed its few benefits. Although in the short-run it could be perceived as a measure with reasonable cost (but probably modifying the banking law, which seems a sensitive matter), in the medium term the creation of a state AFP would be the beginning of the end of the system, given the problems that could arise over time.

We should neither forget that the previous government summoned a large expert panel who, after a two-year study, did not incorporate the idea of a state AFP as a recommendable policy proposal. Instead, the same study suggested several measures to increase competition, which in the end were not put into practice. The current system is certainly subject to improvement, but not through proposals that do not hold up to a serious technical analysis and which are only attractive for the political speech.

In brief…

- The creation of a state AFP does not resolve the problems of the pension system, and engenders other serious issues which could end with the individual capitalization system.
- With the country's current demographic structure, the only viable social security alternative in the medium term is the individual saving system; therefore, logic tells us that its basis should not be altered.

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