



## PENSION NOTES

No. 14 - MARCH 2017

# 7 Recommendations for the decumulation stage of the Individually-Funded Pension Systems

### Executive Summary

The individually-funded pension systems in the region are approaching maturity, which is why their decumulation stage must be improved before there is a huge increase in pension payments.

7 recommendations are proposed, based on international best practices and the experience of the oldest system in the region:

- **PERIODIC UPDATING OF THE LIFE EXPECTANCY TABLES**, to reflect the substantial increase of this variable in all countries, as a result of the advances in medicine, nutrition, health, etc., in order to enable the correct calculation of pensions and the commitments undertaken by life insurance companies offering life annuities.
- **UPDATING OF THE PARAMETERS OF THE SYSTEM**. The individually-funded systems must also be fitted with the technical means for updating their parameters on a regular basis, so that the pensions they provide meet the objectives or the replacement rates defined when the system was designed.
- **SEPARATION OF PENSIONS FROM FUND REIMBURSEMENT**. In order to make average pensions comparable between the different pension systems, and above all, for the statistics of the individually-funded systems to provide useful and informative data, the reimbursement of contributions paid in by workers with a minimum number of years of contributions - including accrued returns - must be separated from pensions as such.
- **NON-CONTRIBUTORY PENSIONS**. The Latin American experience shows that a significant part of the population does not contribute to the pension systems, or does so very sporadically, due to which they will not be entitled to a pension (in the PAYGO systems), or their accumulated savings will not suffice for financing a suitable pension (in the Individually-funded Systems). The expansion of the coverage of the pension systems and the improvement of contribution densities basically depend on the levels of development of countries and improvements in the labor market, which are processes that require time. In the meantime, the situation of the elderly

who do not have a contributory pension or other sources of income, must be resolved.

- **PENSION OPTIONS.** The pension options employed in the majority of countries are Programmed Withdrawal and Life Annuities. Both alternatives have advantages and disadvantages, and it is positive that future pensioners are able to choose the one that most suits their personal requirements, on a duly informed basis. It is also important to ensure that there is an adequate, transparent and competitive offer that maximizes the benefits received by retirees.
- **ADVICE ON RETIREMENT.** There are different reasons that make it advisable for future pensioners to be able to access technical, customized and simple institutional advisory services, devoid of conflicts of interests, and with regulated fees, that provide services to future pensioners to enable them to select the pension alternative that best suit their reality and personal preferences.
- **PRODUCTIVE COMPETITION BETWEEN PENSION OPTIONS AND PENSION PROVIDERS.** The implementation of an electronic system of consultations and pension amount offers has been proposed, to enable future pensioners to be able to access the pension offer information of the different bidders in a simple, standardized, and comprehensive manner, and allow the latter to effectively participate in offering different pension modes, thereby contributing to reducing commissions, increasing price competition, minimizing the cost of the

information, and increasing transparency, all for the benefit of higher pensions.

## Introduction

It is natural for the individually-funded pension systems to concentrate their efforts mainly on improving the savings accumulation stage in their first years of operation. But as these systems begin to deliver an increasingly significant number of pensions, it is essential for the authorities and the fund managers to take the necessary measures for improving the decumulation, or pension payment stage.

The Chilean AFP system, which began operating in May 1981, has now been operative for 35 years, and is paying 1,190,461 old age, early old-age, disability and survival pensions per month, far exceeding the 673,455 pensions paid by the former PAYGO system, which is being phased out. In the next 5 years we will witness the first old-age pensioners who only contributed to the individually-funded system, heralding the maturity of the AFP system.

The individually-funded pension systems in Peru, Colombia and Mexico, which began operating in 1993, 1994 and 1997, respectively, are advancing towards maturity, so it would be convenient to work on perfecting their decumulation stage before there is a huge increase in pensioners.

This document will discuss the main aspects to be considered in this stage, based on the best international practices, and the accomplishments and mistakes made in Chile.

## 1. REGULAR UPDATING OF THE LIFE EXPECTANCY TABLES

An initial aspect to consider is the need for countries to have up-to-date mortality or life expectancy tables, since it is necessary to know for how many years pensions must be paid to the originator or his family group, in order to be able to calculate the monthly payment in the case of Programmed Withdrawal, as well as the pension amounts and the technical reserves that Insurance Companies must hold, in the case of Life Annuities. Updated tables are also required for calculating the additional capital contributions that insurance companies must pay in the event of the death or disability of members who are covered by the disability and survival insurance, in countries in which such contributions or capital are deposited in the individual accounts.

In order to construct the aforementioned tables, there must be a data base with records of many years of mortality of pensioners and their beneficiaries. In practice, due to the difficulties involved in the construction of a suitable database, the tables of other countries, or former tables that have been adjusted with criteria that probably do not reflect the effective mortality and life expectancy rates, have been used in many cases.

That is precisely what happened in Chile, where the first table used, the KW-70, was of American origin. It was replaced by the RV-85, of mixed origin, in 1985. RV-04, calculated on the basis of an exclusively Chilean population was only implemented in 2004 (further information in [Pensions Note No. 9](#)).

It is important for tables to be updated periodically due to the sharp increase in life expectancy in all countries, as a result of the advances in medicine, nutrition, health, etc. If

tables remain unchanged for a long period of time, people will live longer than indicated in the tables, and will therefore receive pensions for a longer period of time than estimated, which can lead to the insolvency or bankruptcy of the Insurance Companies offering life annuities. In programmed withdrawal, the pension amounts paid will be greater than those paid with updated tables, exhausting the funds at a faster rate, and affecting pensioners or the public budget, if government subsidies are involved. Furthermore, the infrequent updating of tables could generate a political problem, since the implementation of new tables would entail a significant drop in pension amounts.

By way of example, the increase in life expectancy in Chile, from the KW-70 table that was used at the beginning of the system to the current CB-RV-14 table, implemented in 2016, is 5.89 years (43.5% increase in life expectancy) for men and 6.97 years (32.2% increase in life expectancy) for women, both measured at the respective legal retirement ages. Hence, Chilean law currently makes it mandatory for the regulating agencies to recalculate the tables every six years, also making them dynamic, i.e. they are updated yearly based on estimates of the increase in life expectancy.

In Peru, the system started off using the Chilean RV-85 table until 2006, carrying on with the modified RV 2004 of the same origin, until 2011, and currently applying the amended and adjusted RV-2004 table.

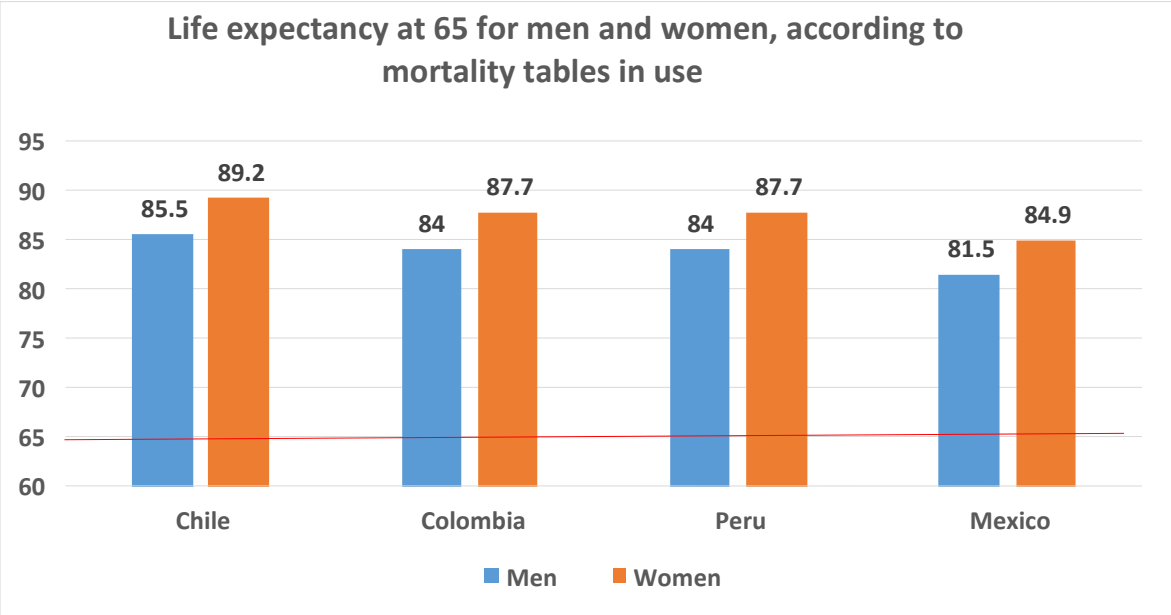
Colombia started off with the RV 89 table until 2010, and carried on with the RV 08, which is still being used today.

The situation is more critical in Mexico, where the EMSAM - 97, which is almost 20 years old, has been used since 1997.

According to the mortality tables of the different countries, 65-year-old men are currently expected to live another 20.5 years in Chile, 19 years in Colombia and Peru, and 16.5 years in Mexico. I.e., 65-year-old men are currently expected to live to 85.5 years of age in Chile, 84 in Colombia and Peru, and only

81.5 in Mexico. The results are very similar for 65-year-old women: their life expectancy is another 24.2 years in Chile, 22.7 years in Peru and Colombia, and 19.9 years in Mexico, i.e., they will live to an average age of 89.2 in Chile, 87.7 in Peru and Colombia, and only 84.9 in Mexico (see Graph 1).

**Graph 1**



Source: FIAP.

**2. UPDATING OF THE PARAMETERS OF THE SYSTEM**

Failure to update parameters has been a deficiency in the operation of all the individually-funded systems in the region, since the retirement age and the contribution rate have not been adjusted in any of the countries, despite the meaningful changes in the variables affecting pension amounts, such as life expectancy, the age at which people start working, market returns, and the interest rate used for calculating pensions.

For example, only due to the combined effect of the increase in life expectancy and the reduction in the interest rate used for calculating pensions, the amounts of the latter in Chile have dropped by around 50% since inception (see [Pensions Note No. 9](#)).

In the PAYGO systems, changes in demographic variables, together with an inadequate structure of incentives and administrative shortcomings (particularly in some Latin American countries), have defunded the systems and made it impossible to maintain defined benefits. The considerable financial imbalances, and the limitations on government financing of the

deficits of these systems, have made the ongoing review of their parameters necessary. So much so that between 1995 and 2016, 76 countries increased the contribution rate in the PAYGO programs, 53 countries increased the retirement age, and 66 adjusted the benefits formula (or directly reduced benefits) to reduce fiscal costs.<sup>1</sup>

In the individually-funded systems, on the other hand, demographic changes do not generate financial imbalances, but they are causing a gradual, automatic reduction in pension amounts, which can be financed. This reduction is mitigated by the good average returns obtained by the pension fund managers, and because these systems, unlike the PAYGO systems, are not adversely affected by the sharp decline in the global birthrate (see Graph 2), since the accumulated funds of each individual remain unaltered and do not depend on whether there are more or fewer births, and the magnitude of the required adjustment is therefore less.

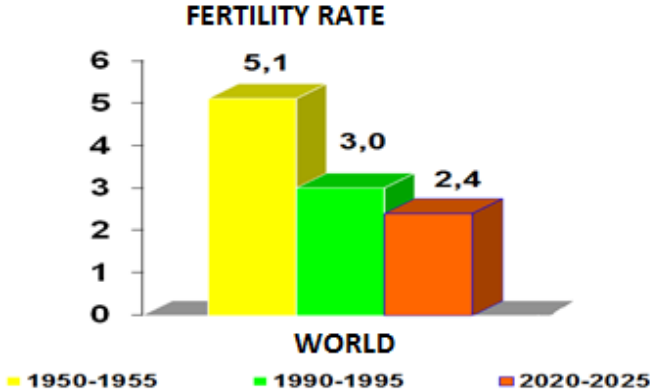
Experience shows the need to fit the individually-funded systems with a technical framework that regularly updates its parameters, so that the pensions they provide meet the objectives or the replacement rates defined when the system was designed.

There are ways of constructing this framework, including automatic adjustments, such as for example, indexing the retirement age to life expectancy, or else, legally establishing a technical Commission with powers and means for reviewing and updating the parameters of the system, so

that pensions reach a certain replacement rate.

No method is superior to any other; they all have advantages and disadvantages, and each country must implement the one it considers most suitable to its own reality.

**Graph 2**



**Fertility Rate:** The total number of children each woman would give birth to if she lived to the end of her fertility span (from 15 to 49).  
Source: Population Division, United Nations.

<sup>1</sup> Source: FIAP, "Parametric Reforms in the Public PAYGO Pension Programs: 1995 - 2016".

### **3. SEPARATE PENSIONS FROM FUND REIMBURSEMENT**

Countries with distribution systems have a minimum number of contribution periods required for accessing a pension. If workers fail to meet this minimum number of years of contributions throughout their working lives, they are simply not entitled to a pension in the contributory system.

There are no minimum numbers of years of contributions for accessing a pension in the individually-funded systems, since the funds are owned by the workers and can only be accessed by them. In an extreme case, an individual who only contributed for one month in his working life is entitled to a pension, of a very small amount, due to the extremely low savings rate. In Chile, for example, there are many women who retire with only one monthly contribution, because in order to access the Bonus-per-Child-Born-Live that the State provides to mothers at age 65, they are obligated to contribute to an AFP only once. This has had a significant negative effect on the average pensions granted in the individually-funded system.

In order to make average pensions comparable between different pension systems, and above all, for the statistics of the individually-funded systems to provide useful and educational information, the reimbursement of contributions paid in by workers with a minimum number of years of contributions - including accrued returns - must be separated from pensions as such.

Furthermore, CLAPES UC ("Dissatisfaction with pensions: 7 conclusions and 12

proposals"<sup>2</sup>), proposes that pensions should be separated into Full Pensions, for those with 30 or more years of contributions, and Partial Pensions, for those with less than 30 years of contributions, and above the threshold defined for fund reimbursement.

Lump sum fund reimbursement is socially convenient, when the amount of the pension that can be financed is very low, and does not really affect the standard of living of the beneficiaries. A one-off lump sum payment is preferable, since that way beneficiaries can invest it in some kind of income-generating business. There are positive experiences in this regard in different countries of the region.

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<sup>2</sup> Available online:  
<http://www.clapesuc.cl/assets/uploads/2016/11/28-11-16-informe-grupo-mejores-pensiones.pdf>

#### 4. NON-CONTRIBUTORY PENSIONS

The Latin American experience shows that a significant part of the population does not contribute to the pension systems for different reasons, or does so very sporadically, due to which they will not be entitled to an old age pension (in the PAYGO systems), or their accumulated savings will not suffice for financing a suitable pension (in the Individually-funded Systems).

The reasons that explain the behavior of this large group are varied and, among others, include unpaid work (housewives), work in small family businesses, labor informality, independent or self-employed individuals (who are not required to pay social security contributions in the majority of countries), unemployment, etc.

The real solution to the lack of contributions lies in the improvement of the labor markets of countries, such as for example, facilitating the participation of those who currently do not have access to paid employment, reducing unemployment, and the incorporation of self-employed individuals into social security protection. However, progress in labor markets usually takes time and occurs together with the economic development of countries. Improvements in pensions resulting from these advances will occur in future generations. Hence, the situation of the elderly who do not have sufficient accumulated savings to finance a minimum contributory pension, must be resolved.

To do so, international agencies recommended the establishment of a zero, or non-contributory pillar, that grants social pensions focusing on lower-income retirees, whose benefits are financed by the nation's general taxation. The amount of the benefit must be carefully determined. It usually only

covers basic needs, due to the fiscal cost involved, and in order not to discourage social security contributions.

It is essential for the pension system to be consistent in its entirety, in order to generate incentives for people to save for their old age.

#### 5. PENSION OPTIONS

Pension systems should offer different modes or types of pensions to workers when they retire. An initial aspect worth highlighting, is that it makes no sense to allow the lump sum withdrawal of the savings accumulated throughout one's working life, unless they are minimal and do not suffice for financing a socially acceptable pension. A reimbursement of funds is recommended in this particular case, or alternatively, allow the pension to be raised to the minimum, even if it means reducing the period in which it will be received. In the remaining cases, if the legislation in force made it mandatory for workers to save or contribute throughout their active lives to finance a pension, it makes sense that those savings should be used for paying them a pension throughout their passive lives.

Two pension options are used in the majority of countries: Programmed Withdrawal and Life Annuity. Both alternatives have advantages and disadvantages, and future pensioners should be able to choose the one that most suits their personal requirements, on a duly informed basis, or even choose some kind of combination between them.

**Programmed Withdrawal:** Basically, consists in the ongoing management of accumulated savings by the AFP, which performs an actuarial calculation, based on the rules and regulations, to estimate the amount of the pension, based on the balance accumulated in the individual account, the life expectancy of the worker and his family group, and the

projected interest rate his savings will earn in the future. The main advantages of this pension mode are its revocability, and the fact that the funds still belong to the worker and are therefore inheritable when there are no longer any pension beneficiaries. The main disadvantage, on the other hand, is that pensioners assume the return and longevity risks. If your life expectancy is greater than the life expectancy listed in the tables, which is an average, and some people therefore live longer than others, your savings will be insufficient and your pension levels will decrease (longevity risk). This problem can be avoided by taking out a longevity insurance.

**Life Annuity:** In this case, the funds accumulated in the AFP are transferred to an Insurance Company, which is responsible for paying the pension to the originator and his beneficiaries. There is no inheritance in this mode, because those who die before fulfilling their life expectancy finance those who exceed their life expectancy. (Alternatively, guaranteed pension payment periods can be agreed in case of the death of the originator). The great advantage of this pension mode is the stable pension amount (as long as it is automatically and periodically reset against inflation), since the pensioner transfers the investment return and longevity risks of the originator and his beneficiaries to the insurance company. The only risk the pensioner assumes is the insolvency or bankruptcy of the insurance company, for which the State can extend guarantees that fully or partially protect the pensioner. These guarantees warrant an active role of the governments in establishing regulations and the oversight of the insurance companies, so as to minimize the cost of the government guarantee.

For further information regarding pension modes, please see [Pensions Note No. 6](#).

## 6. ADVICE ON RETIREMENT

Due of the fact that people mostly retire only once in a lifetime, so they cannot learn from past experience; that the decision to retire is important to the future welfare of individuals; that it involves mandatory savings, and; that this is a complex decision that requires understanding the advantages and disadvantages of each one of the pension options and sub-modes (e.g. life annuity with different guaranteed periods) and knowing which insurance companies offer life annuities, it is highly advisable that in addition to any counseling that may be provided by pension providers, future pensioners should have access to personalized institutional advisory services provided by specialized independent advisers, with no conflicts of interests, and with regulated commissions, which will allow them to select the pension alternative best suited to their reality and personal preferences.

## 7. PRODUCTIVE COMPETITION BETWEEN PENSION OPTIONS AND PENSION PROVIDERS.

Strong competition between the different pension options and pension providers is desirable, but not sufficient, since this competition must be productive, i.e., to the benefit of pensioners through better pensions.

A first step is the one recommended in the previous point, namely that members should have access to personalized institutional advisory services to enable them to make informed decisions.

Pension providers should also not focus their competitive efforts on the numbers of their sales staff, advertising expenses, delivery of



current benefits, etc., but as previously mentioned, on the provision of better pensions.

The Chilean experience in these matters is positive. The retirement process was characterized, among other aspects, by the high commissions of the sales staff (5.91% of the RV premium in the year 2000); excessive influence of the sales staff, with considerable asymmetry in the information provided to future pensioners; and weak price competition (pension amounts), mainly due to the lack of transparency and demand information.

Hence, a legal reform (Law 19.934 of 2004) established the Pension Amount Consultation and Offers System (SCOMP), the public list of future pensioners, and maximum commissions payable to sales staff.

In simple terms, what SCOMP does is to simultaneously send the necessary background information for calculating a pension (accumulated balance, age and gender of the originator and his beneficiaries) anonymously to all pension providers and, subsequently, send information of the offers received for each one of the requested pension options or sub modes to the person who is retiring, ranking from highest to lowest, depending on the amount of the pension offered, and indicating the name of each provider.

With this background information and the counseling referred to in the previous point, the future pensioner can make a truly informed decision.

The results of the legal reform are very positive, since commissions were reduced to around 1% of the saved balance, price competition increased, the cost of information was minimized, transparency increased (delivery of a certificate with clear and easily comparable pension bids) and irregularities were eliminated, all of the above for the purpose of higher pensions.

Sergio Baeza<sup>3</sup>, the Chairman of SCOMP, calculates that each retiree saves \$2,400 only due to the drop in the commissions of sales staff and brokers, a figure that compares very positively with the operating cost of US \$35 per pension request processed by SCOMP, which is financed by the AFPs, the Life Insurance Companies and the sales agents and brokers.

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<sup>3</sup> Source: "Reducing the transaction costs of retirement annuities in Chile," in the [2010 FIAP Book](#).