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Chilean insights

for the Dutch pension debate

The Dutch can learn a few lessons from the Chilean experience. The 2008 Reform, the recent debate in Chile and the Bravo Commission Report that evaluated the Chilean pension system draws relevant lessons for the current Dutch discussions on pension design.[1]

CHILI: SELECT CHOICE

BRAVO EVEN LESS CHOICE: NOT FIVE BUT THREE

From its inception in 1981 and up to 2008 the Chilean pension system consisted, fundamentally, of a large second pillar. A landmark reform in 2008 introduced a solidarity pillar, tackling the needs of the most vulnerable. The discussion after that reform has turned more to the adequacy of the pension benefits of middle income workers. The solidarity pillar is very much valued by the population in general and the Bravo commission acknowledges that, because it provides of protection for the lower income population and it is a risk sharing element which was absent before the reform in 2008.

The adequacy of benefits is low mostly because the participants contribute too little to their individual accounts, even in the case of middle income workers. Therefore, a number of measures were put in place to incentivize the contribution level such as subsidies for younger workers and new voluntary savings facilities. However, the subsidy program which was in place for the younger generation turned out not to be very effective and voluntary savings have increased but still not substantially.

The Bravo Commission proposes to further increase the adequacy level of pensions by extending the retirement age above 60 years for women. Women on average only contribute for 15 years to the pension system, but are paid out for almost 30 years. This is of course an unsustainable situation. The Bravo Commission proposes to increase the contribution rate and to extend the solidarity pillar to the middle incomes to raise the level of adequacy. The increase in contribution would be allocated in part to finance this extension in solidarity, according to the Commission. In this way the contribution will be raised as well and the solidarity pillar will be less dependent on the national budget.

Risk sharing is another important topic that was tackled by the Commission. The solidarity pillar is a risk sharing device especially for the most vulnerable. Through the fiscal budget of the government, the solidarity pillar compensates for fluctuations in the financial markets, but also for negative life events that would have an impact on the contributions of workers. Therefore, by extending the coverage of this pillar to a larger part of the population they would also benefit of this feature. Additionally, in the retirement phase it was also considered relevant to find a way to find a way to increase longevity risk sharing, the Bravo Commission proposed in this respect compulsory annuitization.

Another topic of potential interest for the Dutch debates is the status of the self-employed. The 2008 reform introduced automatic enrollment for a limited period of time --initially three years but recently extended--for self-employed workers in a certain tax category. This temporary automatic enrollment program was supposed to become mandatory in 2015 but it was postponed. During the soft-compulsion period it was expected that a large number of self-employed workers would start contributing. There was a significant increase from 5% to almost 30% of the target population; however, it was considered to complicate to force 100% of these workers in one year the total amount of the contribution. The reasons behind the lower than expected coverage, can be related to some design problems, but basically to an insufficient communication about the benefits of contributing.

Insights for the Netherlands

Freedom of Choice

From the Chilean experience several lessons can be learned. The most valuable one is that freedom of choice comes with restrictions. There is a clear trade-off between the freedom acquired and the restrictions imposed. The positive element of freedom of choice is the sense of ownership that comes with it. People are owner of pension wealth and realize they have to think about retirement up until a point. We can not say that people become more knowledgeable about how to provide an adequate pension benefit. However, they are easily mislead by intermediaries when it comes to making sensible choices. They are easily tempted by a new bicycle, radio or other electronic device, and are subject to considerations that are not necessarily aligned with an adequate pension. This happened in Chile in the 1990s. The lesson is that the costs, service or risk/return profile of pension investments does not seem to be the most important drivers of decisions

by participants in a pension fund. Indeed, most of the switching was incentivized by sale agents (intermediaries) that had an interest in switching behavior by pension participants.

Chile has a lot of experience with choice between multiple funds and different pension providers. And this experience is not in all aspects favorable. On the one hand participants seemed to be more involved in pensions in general, but on the other hand the participants did not seem to be better informed when it comes to decision making in pensions. Short term considerations seem to be more important than costs and return of the pension portfolio. We have seen that behavior also during the financial crisis in 2008 and even after that in terms of investment decisions. A number of people changed from the riskiest fund to the less volatile in worst moment of the crisis, which implied making the loss and afterwards moving back to the riskiest fund. There are movements that try to maximize the short term return, but at a high risk.

Impose regulation

The role of intermediaries should not be underestimated. Therefore, the role of sales agents and advisors should be regulated. In Chile, they have to be registered; we have a lot of documentation required and penalties for misbehavior. For example, in terms of switching between providers, participants use to be able to switch twice a year because of the operational system took 4 months to change the registration by provider. So providers knew that participants once they had switched they would stay at least for four months. The value of this switch was so high that this implied that the providers could pay huge fees to sales agents and other intermediaries for every switching participant. Now, regulation in place makes sure that the operation takes less than 20 working days. Although this regulation made switching easier and faster, the number of switches remained limited.

Furthermore, the introduction of a bidding process for new members for a period of two years has lowered the cost of the pension providers. The 2008 reform introduced an auction mechanism by which all individuals opening an account in the pension system for the first time are not allowed to choose their provider but are tendered for the lowest fee. The winner of the auction is entitled to the flow of all the new individual accounts opened as of some pre-specified date and for two years. After two years, the individuals can move to another AFP should they wish to do so. The growth of market share of pension providers is also mostly due to the acquisition of new members and not due to participants transferring their funds to another pension provider.

Competition and Information

One of the key points to understand from the Chilean system is the notion that control of information provision is important, because competition in itself does not mean that participants will make the right decisions for themselves. The information asymmetry between intermediary and pension participant is large, but can be limited by standardizing the products and by creating a benchmark by an independent authority.

In the accrual phase, Chilean Pension funds (AFPs, by their Spanish acronym) manage a family of five funds that differ with respect to quantitative investment limits defined by asset class. Workers may freely choose up to two funds in which they wish to place their pension savings and they can switch to riskier funds, with the exception of participants close to retirement, who cannot select the most aggressive fund (Fund A). These options are available within the same AFP. Workers that do not make an active decision are assigned to a default fund that follows a lifecycle structure geared at de-risking savings using step-wise deterministic rules towards the retirement age. The Bravo Commission proposes the simplification of the multi-fund system by reducing the number of investment fund types from five to three-to make the scheme simpler for participants, by eliminating the riskiest and the less risky extremes.

In the decumulation phase, the Chilean pension system offers four well-structured products and a limited lump-sum option design. The decumulation products menu comprise phased withdrawals (PW), immediate life annuities (ILA), and hybrids based on these two products that include a combination with a deferred annuity (DA). A phased-out withdrawal is computed as a life time income and recalculated every year so that it remains a life time income conditional on age that you have at every moment in time. So the pension decreases over time because as you age your life expectancy increases. So when I am 65 my life expectancy (of my cohort) would be 83, but once I get 70 my life expectancy of my cohort goes to 86. So when my fund is computed every year my money is stretched out over a longer time period in order to be able to pay an adequate pension benefit.

People are comparing an annuity that is constant over time and the phased out withdrawals that is a decreased line over time that is in the first years higher than the annuity pay-out but than is decreasing rapidly over time. When the interest rate changes in such a way that the phased withdrawal is very high compared to the annuity, people tend to choose the phased withdrawals. So the choice is very dependent on the pension outcome for the first year of payment, which depends on the level of interest rate. Therefore, the Bravo commission decided to propose to have only one option: compulsory annuitization. The reason is that people tend to biased to phased withdrawals payments at once at the beginning of the period when due to the interest rate the first payment is higher. Of course, life time income is conditional on age. The older you are becoming the higher the life expectancy of remaining cohort, but this is not sufficiently taken in to account when participants are deciding between PW and an annuity. And then there is the issue whether you could expect that people are time consistent with themselves. When ex-post the outcome does not match the expected result, people tend to complain anyway, even though you may have given them the right information 20 years ago. However, the drawback of compulsory annuitization is that people with low life expectancy do no longer have the option to give their pension benefits as an inheritance to their family. And people may have the feeling that they have less ownership over the fund. The upside of compulsory annuitization is that there is more risk sharing which increases the pension benefits overall.

Like the Bravo Commission, I am in favor of more annuitization, because this would enhance risk sharing of longevity risk, which will increase the average pension benefit. That a choice for annuitization meant lower inheritance of the next generation, is in my view of less importance, but still might need attention. My own proposal was to have

compulsory partial annuitizationto cover longevity risk at advanced ages, for instance starting at 80-85 years.[2] This would be implemented by a longevity insurance premium that would be paid throughout the active working life and would cover pensions as from a given advanced age (Berstein et al, 2015). This would provide a floor to the ones that choose a phased withdrawal, and benefit largely from risk sharing. Products of this type have been widely studied in the literature. The payment of advanced-age benefits may be by means of a life annuity, provided by an insurance company or by the State; alternatively it could also be a mutual arrangement that spreads the risk across a generation.[3]

Financial planning

Finally, Chile has some experiences with reversed mortgages. As Joseph Ramos showed in his study, there are significant benefits of this type of products, but there are also costs that tend to be very high.[4] Culturally, Chileans value bequests of the family home within the family. Very few Chileans see the advantages of living out of the value of their home. So, reversed mortgages are not popular in Chile. Actually, many Chilean families have arrangements within the family where children finance parents and help with maintaining the value of the home.

Another innovation is a hybrid form of DC which is advocated by Robert Merton and is called targeted retirement products which are life time products. This multi-funds product with a default option and life cycle that targets a replacement rate for the average worker. So these products are focused on the long term horizon. Participants have some freedom of choice. The default option is there to prevent a choice for a high risky fund with high returns. Although I see advantages to the use of targeted replacement rates that are individual based, a lot of regulation should be in place with regard to the communication of the product. For consumers it should be clear that it is a projection not a guarantee. Furthermore, because the results are only visible in the long term, the regulator should deal with the possibility of complaints by participants for which the outcome did not match their expectation. Having said al this, defined contribution pension schemes should indeed be long term oriented.

To conclude

Chileans have long experiences with competition in pensions. And the experiences are not in all aspects favorable. People may make choices but not for the right reasons. Intermediaries may use their advanced knowledge not in the best interest of their customers. Customers are easily subtracted by short term considerations. For all these reasons it is important to regulate a competitive pension market properly, by introducing standard products, and providing independent information on pension products. Furthermore, participants should be protected for their own wrong choices by limiting risky investment options and defining a proper default option.

Finally, the Bravo Commission that evaluated the Chilean pension system has come to the conclusion that adequacy of Chilean pension benefits is a major concern and that adequacy should be raised, not only by increasing contribution and retirement age, but also with solidarity and risk sharing of longevity risk. In that sense, Chile seems also to have learned something from the Netherlands.

1. The report can be accessed (in Spanish) here: http://www.comision-pensiones.cl/
2. Berstein, Solange, and Marco Morales, and Alejandro Puente. (2015). 'Rol de un Seguro de Longevidad en América Latina: Casos de Chile, Colombia, México y Perú.' International Federation of Pension Funds (The Role of Longevity Insurance in Latin America: The case of Chile, Colombia, Mexico and Peru).
3. Milevsky, Moshe. (2004). 'Real Longevity Insurance with a deductible: introduction to Advanced-Life Delayed Annuities.' Managing Retirement Assets Symposium. Milevsky, Moshe. (2014). 'Market Development of Deferred Annuities.' Longevity 10 Conference, Universidad Diego Portales, Santiago de Chile. Milevsky, Moshe. (2015). 'King William's Tontine Why the Retirement Annuity of the Future Should Resemble its Past.' Cambridge University Press.
4. Ramos, Joseph. (2015). 'Reverse Mortgage as a Fourth complementary pillar of the pension system.' International Federation of Pension Funds.