

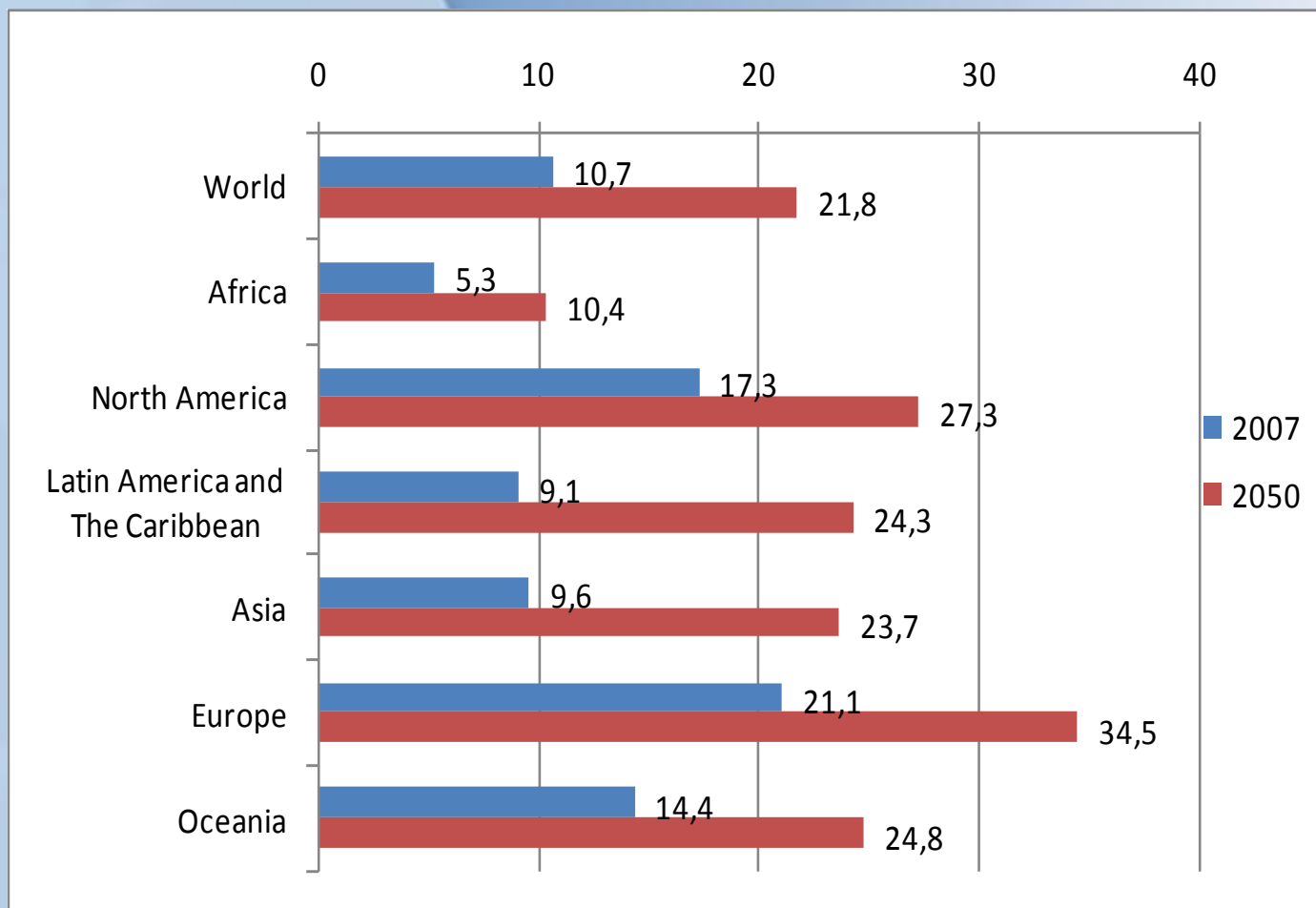
AGEING AND FULLY-FUNDED PENSIONS

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- There is plenty of documentation on the trend towards population ageing.....

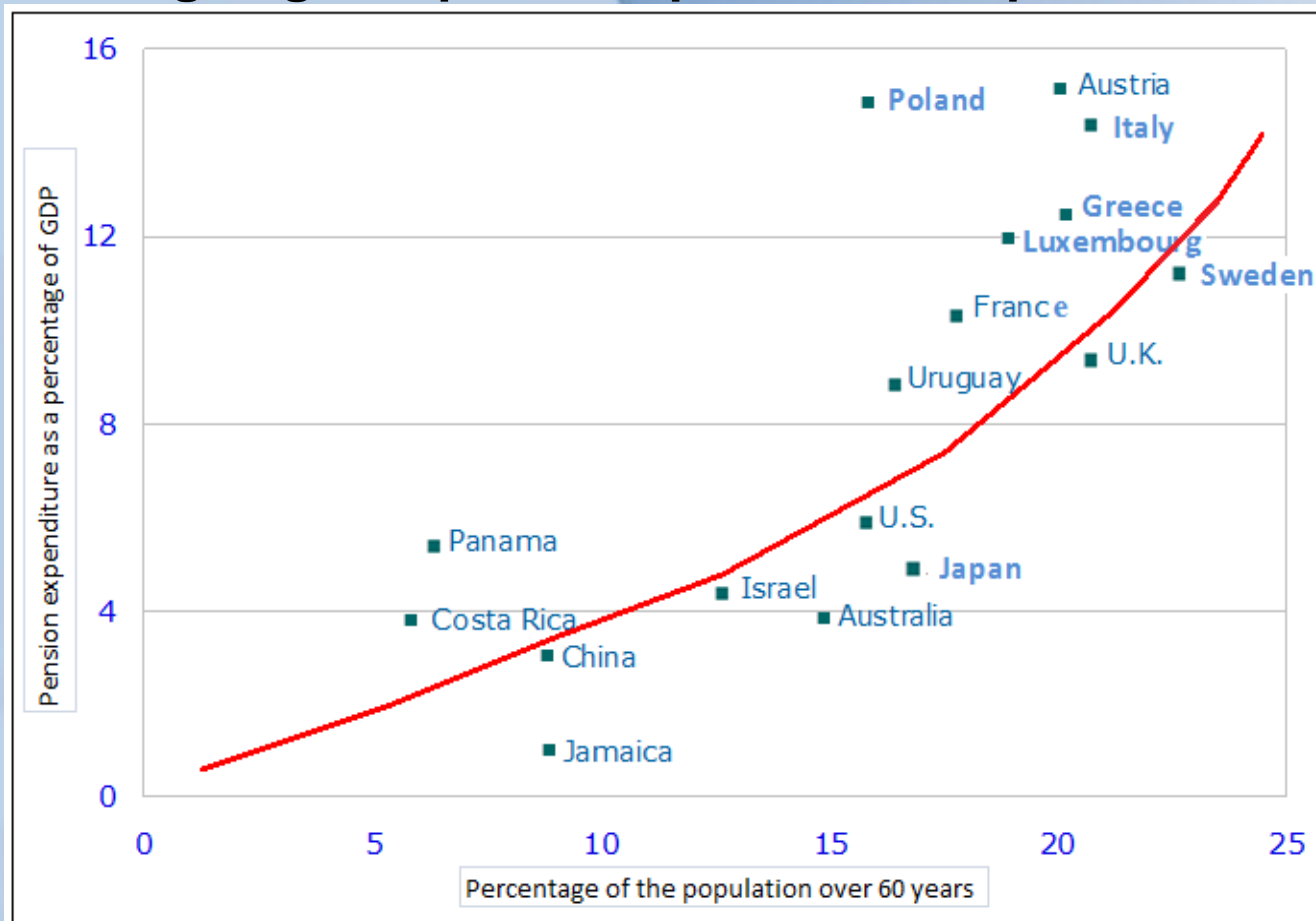
% of the population that is 60 years of age or over



Source: Population 2007: World Population Ageing 2007, United Nations. Population 2050: World Population Prospects: The 2006 Revision, United Nations.

- One important effect is the increased expenditure on public pensions.

Ageing and public expenditure on pensions



- In order to cope with the effects of ageing on the financial position of pension systems, countries have turned to:

1. Parametric reforms of traditional systems:

- **Δ^+ contribution rate**
- **Δ^+ retiring age**
- **Adaptation of other parameters in the formula of benefits; replacement rate; minimum number of years contributed; percentage of pension accrual; n° of years taken into account for calculating the reference wage for pension purposes; mechanism for index-linking pensions.**

2. Replacement (total or partial) of the public pay-as-you-go system with a private, fully-funded, individual program.

- But parametric reforms offer only limited options.....

- ✓ **To increase the contribution rate:**
 - **Has negative effects on the labour market**
 - **Encourages evasion**
 - **Is unpopular**

- ✓ **Despite parametric changes, unfunded liabilities have continued to increase.....**
 - **The effect of parametric changes on the financial balance of the system is only temporary.**

- ✓ **The cost of the system falls on the younger generations.**



- In a private, fully-funded individual program:

- ✓ Each member pays a percentage of his/her gross wage into an individual account which is his/her personal property.
- ✓ The pension fund administrators (AFP), manage the resources that have been deposited, investing them in financial instruments, which produces a return.
- ✓ The AFPs' investment instruments are regulated by law and are duly diversified.
- ✓ There is independence between the pension fund and the company managing it.
- ✓ The AFPs charge a commission for managing the resources.
- ✓ When the member retires, he/she has access to the resources that have been accumulated, plus the interest gained by the yield of the investments, in the form of a pension.
- ✓ The member chooses the pension mode: Programmed Withdrawal or Life Annuity.

25 countries have set up mandatory, fully-funded, individual programs

Country	Year when the Mandatory Fully-funded Individual System Began
Chile	1981
Peru	1993
Colombia	1994
Uruguay	1996
Bolivia	1997
Mexico	1997
El Salvador	1998
Hungary	1998
Kazakhstan	1998
Poland	1999
Costa Rica	2000
Latvia	2001
Bulgaria	2002
Estonia	2002
Kosovo	2002
Panama (*)	2002
Russian Federation	2003
Dominican Republic	2003
Croatia	2004
Lithuania	2004
India (*)	2004
Slovakia	2005
Macedonia	2005
Nigeria	2005
Rumanía	2008
Ukraine (**)	
Armenia (***)	
(*) Reform for employees in the Public Sector.	
(**) Reform passed but not implemented.	
(***) Reform proposed but not yet passed or implemented.	

Mandatory Systems in FIAP December 2008		
Latin America	Members	Funds (MMUS\$)
Bolivia	1,226,775	3,885
Colombia	8,568,274	26,020
Costa Rica	1,747,195	1,609
Chile	8,372,475	74,313
El Salvador	1,817,197	4,535
Mexico	39,063,973	70,927
Panama	342,513	565
Peru	4,296,480	15,901
Dominican Rep.	1,838,217	1,405
Uruguay	841,843	2,872
Europe and Asia	Members	Funds (MMUS\$)
Bulgaria	3,035,174	1,310
Russian Federation	3,593,017	15,677
Kazakhstan	9,613,112	11,781
Poland	13,823,806	46,682
Rumania	4,531,859	294
	Members	Funds (MMUS\$)
Total Mandatory Systems	102,711,910	277,776
Voluntary Systems in FIAP December 2008		
Latin America	Members	Funds (MMUS\$)
Brazil	2,214,714	179,388
Honduras	24,408	46
Europe	Members	Funds (MMUS\$)
Spain	10,598,591	110,661
Ukraine	487,600	102
	Members	Funds (MMUS\$)
Total Voluntary Systems	13,325,313	290,197
Source: FIAP.		

- The fully-funded solution is more effective than parametric adjustments to traditional systems.....

- 1. In fully-funded programs there is a direct link between effort and benefit, which acts as a brake on evasion.**
- 2. Fully-funded programs are not affected so much by a fall in the birthrate:**
 - Funds accumulated by each individual remain unaltered and do not depend on whether there are more or fewer births.**
- 3. Fully-funded programs have a built-in financial adjustment mechanism:**
 - Assets must be equal to liabilities at all times.**
 - Minimum pensions are the government's responsibility (Pillar I)**

The Multi-Pillar System

PILLAR I	PILLAR II	PILLAR III
<p>Non-contributive pensions, focussing on the poor.</p>	<p>Mandatory payments into an individual capitalization account.</p>	<p>Voluntary payments for people with higher incomes.</p>

There must be a Pillar 1, focussing on the poorest members of society, because contributive systems, whether fully-funded or pay-as-you-go, only provide for those who pay contributions, i.e. formal workers.

4. The fully-funded program is an incentive to greater coverage, because the worker has ownership rights over his/her funds.

5. The contribution rate needed to fund a given level of pension (e.g. 70% of the average wage) is lower in the fully-funded program than in the pay-as-you-go program.

Country	Real rate of return since the outset (%)	Real growth in wages (%)	Difference between return and wage growth
Bolivia	16.2	8.8	7.4
Colombia	11.8	1.4	10.4
Chile	10.5	1.8	8.7
El Salvador	11.3	-0.2	11.5
Mexico	10.6	0	10.6
Peru	5.7	1.8	3.9
Uruguay	9.5	3.6	5.9

✓The fully-funded program produces higher returns than the pay-as-you-go system.

✓There is a considerable positive difference between the returns of the funds' investments and the growth in wages.

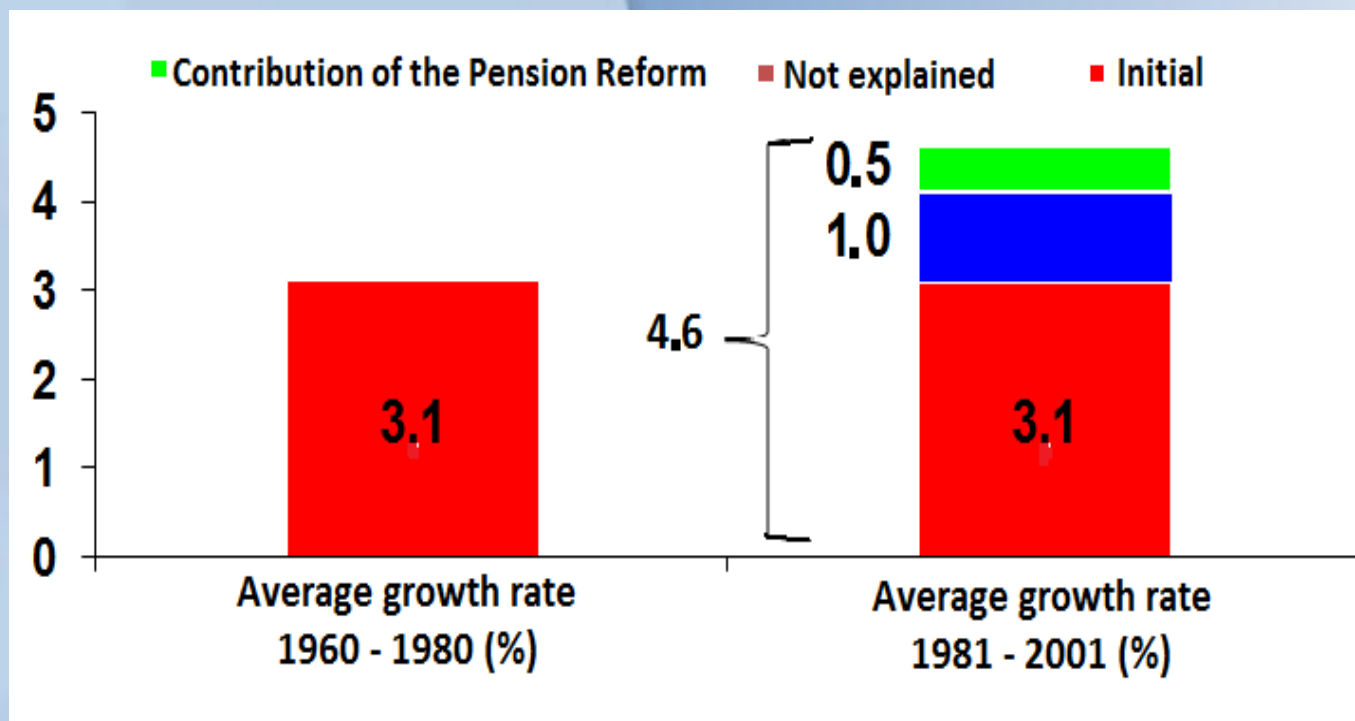
6. The fully-funded program is more “friendly” to the economy than the pay-as-you-go program:

Positive effects on

Labour Market	Capital Market
Reduction of the pure tax on work increases total employment	It improves the quality of regulation in the financial system
It favours mobility and encourages formal employment	It produces a deepening of the financial market

- The increased economic growth derived from capitalization improves the capacity to pay worthwhile pensions:

Pension Reform and Growth of GDP in Chile



The reform towards a fully-funded system in Chile has contributed 0.5 percentage points to the real average growth of the GDP, 4.6%, that took place between 1981 and 2001.

It must be recognised that, although fully-funded programs are more efficient than pay-as-you-go systems in terms of facing ageing, they are still affected by this trend, through the increase in life-expectancies.