The emerging pension fund management market in Latin America

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Abstract This article examines the emergence of a pension fund management market in Latin America following extensive pension reform in the region. The key feature of pension reform in Latin America has been the partial or total replacement of unfunded social insurance pension schemes with individual capitalisation pension plans. The establishment and development of a pension fund management sector is key to the success of the reforms.

Keywords: *pensions; fund management; pension reform; regulation; performance; Latin America*

Introduction

There has been a rapid transformation of the pension environment in Latin America in the 1990s. A number of countries in the region have reformed their pension systems. The reforms implemented borrow key features from Chile's 1981 pioneering pension reform, which replaced long-standing unfunded social insurance pension schemes with individual capitalisation pension plans. In the new pension environment, employees are required to contribute a fraction of their earnings to a retirement account, managed by private pension fund managers.

Pension reform along similar lines has been implemented in Peru in 1993, Argentina and Colombia in 1994, Uruguay in 1996, Mexico, Costa Rica, and Bolivia in 1997, and El Salvador in 1998. Enabling legislation has been approved in Venezuela and the

Dominican Republic. While there are important differences in pension system design across these countries, they all have introduced individual pension plans competitively offered by new pension fund managers.^{1,2}

In Latin America, this is a novel way of organising pension provision, and the creation of a pension fund management market is the most important innovation introduced by the reforms. The new pension fund managers are responsible for managing and investing employees' pension contributions. As a result, the success or failure of the new pension plans will come to depend on whether the pension fund managers are effective as pension providers. This, in turn, will depend on whether the market environment in which they operate encourages competition, generates the right set of incentives for both pension fund managers and affiliates, and is

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Table 1: The pension fund management market in Latin America

Country	Date start	Pension fund managers	Number	Affiliates (m) ¹	Pension funds as % of GDP
Chile	May 1981	AFPs (<i>Administradoras de Fondos de Pensiones</i>)	9	5.9	40.0
Peru	June 1993	AFPs (<i>Administradoras Privadas de Fondos de Pensiones</i>)	5	1.7	2.0
Colombia	April 1994	AFPs (<i>Administradoras de Fondos Privador de Pensiones</i>)	8	2.0	1.3
Argentina	July 1994	AFJPs (<i>Administradoras de Fondos de Jubilaciones y Pensiones</i>)	15	7.0	3.1
Uruguay	April 1996	AFAPs (<i>Administradoras de Fondos de Ahorro Previsional</i>)	6	0.4	1
Costa Rica	April 1997	OPCs (<i>Operadoras de Planes de Pensiones Complementarias</i>)	8	0.08	
Bolivia	May 1997	AFPs (<i>Administradoras de Fondos de Pensiones</i>)	2	0.3	
Mexico	August 1997	AFOREs (<i>Administradoras de Fondos de Retiro</i>)	14	13.3	8.6
El Salvador	April 1998	AFPs (<i>Administradoras de Fondos de Pensiones</i>)	5	0.57	

Figures for 1998 or from latest available data.

¹Chile, Argentina and Mexico also provide data on active contributors, which were 2.6, 3.4 and 10.6m respectively.

adequately regulated. These issues are the focus of this paper.

The new pension fund management market in Latin America

The new pension fund managers have many important functions. They include collecting and investing employees' contributions; arranging disability and survivor insurance for active contributors; and providing phased withdrawal pensions as well as a range of supporting services.

To enter the market, pension fund managers must satisfy the regulator with regard to minimum capital and expertise. Typically, the pension fund managers are incorporated businesses whose sole purpose is to offer standard pension products. They operate a segregated fund which is valued daily. With the exception of Mexico and Costa Rica, pension fund managers can only operate a single pension fund for all their affiliates, and must charge uniform

commissions and fees.

The designers of the new pension plans in Latin America aimed for the pension fund managers to operate in a competitive environment, albeit one subject to detailed supervision and regulation. Competition extends to quality of service, the level of commissions and charges, and rates of return. The voluntary transfer of affiliates from one pension fund manager to another enforces competition. Regulation extends to pension products, the incidence of commissions and fees, investment portfolios, minimum rates of return and information flows to affiliates and the regulator.

Table 1 provides some indicators of the emerging pension fund management market in Latin America. Having reformed earlier than the rest, Chile's pension fund management sector is the most developed, with a combined pension fund valued at 40 per cent of GDP and over 5m affiliates, although fewer than half of them contribute

regularly.

The pension fund management market in the other countries is comparatively smaller due in part to their more recent inception, but also to differences in pension system design and labour market conditions. Some countries have chosen to reform and retain an unfunded public pension scheme in competition with the new individual capitalisation pension plans, thus limiting the potential market for the latter (this is the case for Peru, Colombia, Argentina, Costa Rica and Uruguay). In most countries, affiliation to a pension plan is compulsory for dependent workers, but voluntary for others (the exception is Argentina, where a second-tier pension scheme is also compulsory for independent workers). Informal sector employment has been traditionally high in Latin America, and has risen as a share of total employment in the 1980s and 1990s. Roughly one in two workers in Latin America is employed in the informal sector. Notwithstanding these restrictions, there is a large potential market for pension fund managers in Latin America, especially in Mexico and Argentina.

Market entry

With the exception of Bolivia, there are no limitations on market entry outside minimum capital requirements. In Bolivia, pension designers restricted the number of pension fund managers to two, appointed through international tender for five years. In the other countries, the relative ease of market entry is reflected in the fluctuations in the number of fund managers. At the start of the reform there were 12 fund managers in Chile. During the 1980s their number fluctuated between 12 and 14, then rose to 22 in 1994, and declined to 8 by December 1998. The rise in the number of fund managers in the early 1990s followed

regulatory changes relaxing entry restrictions, while the subsequent reduction is due to the intensification of competitive pressures and market consolidation. In Argentina, mergers have reduced the number of fund managers from 25 at the start of the reform to 15 by December 1998. This seems to indicate that, while entry into the pension fund management markets is not difficult, retaining market share is harder.

Participation by foreign partners in pension fund management in Latin America has been an important feature, and has made an important contribution in both capital and expertise.

Investment portfolios and rates of return

The investment portfolios of pension fund managers are subject to detailed regulation. This is motivated in part by government financing needs (especially as the transitional costs of pension reform are large), but also by prudential concerns relating to the underdevelopment of domestic capital markets. Broadly, the regulations impose maximum investment limits for specified assets, issues, or issuers, which help promote the diversification of pension fund investment. There are also risk classification requirements for permitted assets.³ The two most important issues here relate to investment in equities and foreign assets. In some countries, equity investment has not been permitted initially both to reassure potential affiliates and to provide a window for capital market modernisation.

Similarly investment in foreign assets is in most countries restricted to government issues, and as a share of fund portfolios.

In all countries, investment portfolios are strongly focused on government debt. This is shown in Table 2. In Chile and

Table 2; Performance indicators of pension fund managers in Latin America

Country	Commissions		Investment		Market concentration			Managers performance			
	Commission (% of earnings)	Insurance premium (% of earnings)	Government debt as % of portfolio	Equity as % of portfolio	Annualised real returns from start	Share of largest 3 by affiliates	HHI ¹ by affiliates	HHI ¹ by fund	Operational costs/ operational income	Sales costs/ operational costs	Annual transfers (m)
Chile	2.90	0.63	39.5	22.6	10.9	0.65	0.17	0.13	0.84	0.39	1.57
Peru	3.72	1.38	0.4	34.8	5.3	0.75	0.28	0.24	0.96	0.54	
Colombia	3.49	1.87	20.1	2.3	9.3	0.60	0.17	0.17			
Argentina	3.41	0.95	51.9	13.2	12.3	0.58	0.13	0.12	0.90	0.46	0.97
Uruguay	2.85	0.60	80.3			0.69	0.22	0.37			
Costa Rica			92.0		6.2	0.90	0.43	0.45			
Mexico	4.44	2.50	99.0	94.6	4.2	0.44	0.11	0.11			
Bolivia	3.0	2.00									
El Salvador	3.25	1.20	74.2			0.81	0.25	0.45			

¹HHI is the Herfindahl-Hirschman Index, a measure of market concentration computed as the sum of the squared market shares of fund managers. The number obtained by dividing 1 by the computed HHI is usually interpreted as the number of equally-sized firms which the market can accommodate.

Table 3: Real annual rates of return of pension funds for selected countries (December of each year)

	1982	1986	1993	1994	1995	1996	1997	1998
Chile								
Mean	28.8	12.3	16.2	18.2	-2.5	3.5	8.1	-1.14
Highest	16.5	15.5	17.0	21.1	-1.8	4.1	8.8	-0.09
Lowest	5.3	10.6	14.6	15.7	-4.6	2.9	7.4	-2.75
Peru								
Mean			^a 11.7	8.5	5.5	5.8	11.1	^b 2.24
Highest			^a 14.0	10.6	6.0	7.4	11.8	^b 3.17
Lowest			^a 9.8	7.4	5.3	4.6	10.5	^b 0.49
Argentina								
Mean				^c 13.1	19.7	19.8	14.7	-1.4
Highest					23.7	21.4	16.5	0.2
Lowest					14.2	14.9	9.9	-2.8
Mexico								
Mean								8.4
Highest								10.3
Lowest								6.5

Mean is weighted average of all pension fund managers' returns

^aYear to August 1994

^bYear to February 1999

^cYear to July 1994

Argentina, government debt accounts for 39 and 47 per cent of pension funds investment, and in Uruguay, Mexico, El Salvador and Costa Rica, it accounts for over 70 per cent. Equities absorb around one fifth to one third of the pension funds in Chile, Argentina and Peru, but their share is marginal in other countries, except for Bolivia.⁴ There is a strong 'home bias' to pension fund investment which is explained in part by regulation, but mainly by the large transaction costs attached to foreign investment, and the higher domestic rates of return. In Chile, pension funds are permitted to invest up to 12 per cent of their portfolios in foreign assets, but by 1998 their share was only 1.6 per cent.

The rates of return of pension funds are closely regulated in all countries, except for Mexico. The regulation 'template' is to set a band centred on the average rate of return of all pension funds, with its lowest point defined as the minimum rate of return, and to require pension fund managers to supplement the pension fund if their returns fall below this minimum. In

Chile, for example, the band is set at one half of the average, or 2 percentage points, above and below the average, whichever gives the widest band.

Returns above the top of the band go into a stabilisation fund used, together with the fund managers' reserves, to supplement the fund when required.⁵

Underdeveloped capital markets, together with investment portfolio and minimum rates of return regulations, leave little discretion to fund managers. As a result, the investment portfolios of pension fund managers within a country are very similar, and so are the rates of return they achieve. This has also militated against the development of a money management sector, which is performed 'in house' by the pension fund managers. The rates of return secured by the pension funds are shown in Table 3. For most countries, this is a very short period of time for proper evaluation, but Chile's experience shows both that high rates of return can be secured, and that these tend to decline over time. The rapid growth of the pension funds increases demand for a

restricted number of financial instruments, which is likely to have some price effects.

Pension fund managers' performance

The performance of pension fund managers in Latin America has been mixed. The shared experience is that initial infrastructure investment impacts negatively on the balance sheets of the pension fund managers, but that subsequent growth in affiliates improves their financial position. Table 2 shows some indicators of pension fund managers' performance.

Commissions

Commissions provide the main source of income of the pension fund managers. Most countries have regulated the incidence of commission, but left their level to be set competitively by the fund managers. Fund managers are permitted to charge fixed commission as well as variable commissions, with the latter based on contributory earnings and/or fund balances. Charges on transfers, and other services, are also permitted. In Mexico it is possible for fund managers to charge commission as a proportion of excess real positive returns. In Colombia, the fund managers are free to choose the commission base, subject to a ceiling of 3.5 per cent of contributory earnings.

In the initial stage, earnings-related commissions generate most of the commission income, with fixed commissions in second place. It is likely that in the future, as the pension funds grow, variable commissions based on fund balances will become more important. It is also likely that transfer fees will be used more effectively by fund managers, and by the regulator, as a means of encouraging competition.

Another feature of the new pension plans in Latin America is that fund managers raise charges related to disability and survivor insurance. Pension plans include a disability and survivor pension benefit calculated on a defined benefit formula. Pension fund managers are liable for these benefits, but normally reinsure with insurance companies. A disability and survivor insurance premium is, in some cases, identified as a separate component.

Commission levels, including the disability and survivor premium, are high at roughly one third of contributions or 3.5 per cent of covered earnings. Table 2 shows they range from just under 3 per cent of earnings in Chile and Uruguay, to 4.4 per cent in Mexico.⁶ Moreover, for those countries which have had a longer run, Chile, Peru and Argentina, a measure of pension costs net of disability and survivor insurance premiums shows a rising trend. Disability and survivor insurance premiums should decline over time as the gap between affiliates' pension funds and a hypothetical fund needed to finance their disability and survivor pension benefits declines, and risk probabilities can be predicted with more accuracy. To the extent that overall commission levels are not reduced in line with the falling cost of this insurance, net commission levels rise.⁷

Operational costs

In the initial period after the start of pension reform, the structure of costs of pension fund managers is dominated by large set-up costs. These are associated with the initial investment in buildings, equipment, marketing and personnel. It is not surprising, therefore, that pension fund managers' balance sheets show significant operational deficits in the first few years of operation. By 1997, some pension fund managers in Argentina,

Peru, and Colombia, were still experiencing losses.² Rapid growth helps distribute these costs more widely. The switch of affiliates from pre-existing pension schemes, and the publicity associated with pension reform, greatly facilitates affiliations and all pension fund managers can grow at the same time.

After this phase is completed, competition among fund managers for market share becomes more acute and as a result marketing and sales costs rise. Except for new entrants to the labour market, fund managers' growth in affiliates becomes a zero-sum game. These trends can be observed in Chile, Peru and Argentina, where marketing costs are high and account for an increasing share of operational costs (see Table 2). The size and rising trend of the marketing costs of pension fund managers highlights one of the key weaknesses of the new pension plans.

Market concentration and segmentation

In the new pension environment, pension fund managers compete for affiliates who are able to transfer from one fund manager to another with relative ease. At the same time, the pension fund managers are supervised and regulated to safeguard the interests of affiliates. The interaction of competition and regulation encourages two markedly different market strategies among fund managers, which have resulted in both market concentration and market segmentation.

Competition, expected to work through affiliates' exit behaviour, has not operated as envisaged. In Chile, for example, transfers in 1997 reached 1.5m (this is staggering given there were only 2.6m active contributors). Studies for Chile and Argentina have shown that transfers are explained

mainly by sales personnel and marketing expenditures, with the relative performance of pension fund managers having only a marginal impact.⁸ In a sense this is to be expected, as assessing the long-term performance of pension fund managers is a complex and costly activity for experts, let alone affiliates. Moreover, the regulations on pension products, investment portfolios, and rates of return, conspire to generate 'herd' behaviour among fund managers and reduce performance differentials.

The evidence shows there are significant economies of scale in pension fund management, which can be exploited by larger fund managers. These apply to many of the services provided by the pension fund managers, such as fund investment, record keeping, marketing and information. They explain the consolidation of the market in terms of a reduction in the number of fund managers in the majority of countries. As shown in Table 2, market concentration in pension fund management is high whether measured by the size of the funds or the number of affiliates. The implication is that large pension fund managers have cost advantages.

Smaller pension fund managers can survive and prosper providing they can segment the market by attracting affiliates with high earnings and/or strong loyalty. As earnings-related commissions are the main source of income for fund managers, smaller fund managers able to attract high earners can compensate for their higher relative costs. If, in addition, affiliates owe some allegiance to their fund manager, fostered by membership of a trade union or professional body for example, this ensures a fairly stable situation. The outcome is a segmentation of the

market with large fund managers exploiting economies of scale at one end, and smaller fund managers aimed at selected groups at the other end. This segmentation adds to the rise in sales and marketing costs.

These issues are central to recent evaluations of pension reform in Latin America, and to the lessons they yield for other countries. One strand of views recommends scaling down existing regulations applying to pension fund managers, especially investment portfolio and rate of return regulations.^{9,10} The opposite strand favours fine-tuning and developing the regulatory framework of pension fund managers, for example through restricting transfers by affiliates, thus reducing sales costs, or through regulating information flows and sales personnel registration and training to inject greater transparency and probity into the market.¹¹ The upshot of this controversy is that the regulatory framework of the pension fund management market in Latin America is not settled as yet.

Conclusion

There has been a rapid spread of pension reform in Latin America in the 1990s, which has established a new pension fund management market. Chile's pension fund managers, with over 5m affiliates and fund value at 40 per cent of GDP, show the significant growth potential for this sector in Latin America. The success of pension reform in the region will depend on the rapid establishment and development of pension fund managers.

There has been a rapid growth in affiliations to the new pension plans, and the pension funds have benefited from relatively high rates of return. The financial position of the pension fund managers reflects the impact of high

initial set-up costs, and large marketing and sales costs. A process of market consolidation can be observed in the countries with a longer experience of pension reform.

The new pensions environment in the region relies on both competition and regulation. Affiliates exit behaviour is expected to ensure competition among fund managers, while regulation introduces prudential rules safeguarding pension savings. The mix of competition and regulation has resulted in both market concentration and market segmentation. The regulatory framework of the emerging pension fund management market in Latin America is not yet settled.

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- 2 Queisser, M. (1998) 'The Second-Generation Pension Reforms in Latin America', Working Paper AWP 5.4, OECD; Paris.
- 3 There are also regulations applying to the custody of titles.
- 4 In Bolivia the funds were constituted at the start of the reform by shares in privatised corporations.
- 5 There are variations on this template. In Argentina the formula is based on nominal rates of return. In Colombia, the average is also adjusted by a reference portfolio and in Costa Rica by a risk measure. A key factor is the time window for the calculation, which is one year in all cases except Colombia where it is three years. It has been argued this encourages a short-term investment outlook among fund managers.
- 6 Due to the diverse base on which commissions are charged, these are rough estimates. Taking account of charges for transfers and other services would probably add a further one half of a per cent to the commission level quoted. From the perspective of affiliates, it is important whether the charges are deducted from earnings or from the pension fund.
- 7 In Argentina, commissions are deducted from the pension scheme contributions, and the remainder is capitalized. Rofman (Rofman, R. (1997) 'Evolución, Componentes y Efectos de las Comisiones del Régimen de Capitalización', in *Estudios sobre el Régimen de Capitalización Argentino 1996*, Superintendencia de Administradoras de Fondos de Jubilaciones y Pensiones, (Editor), SAFJP: Buenos Aires) simulates the impact on capitalisation of the reductions in the disability and dependent survivor insurance premiums in the period July 1994 to

December 1995. He estimates that the fall in insurance premiums, if passed on to affiliates, would have reduced commissions from 3.5 per cent of earnings to 2.2 per cent and increased the residual left for capitalisation from 7.5 per cent of earnings to 8.8 per cent.

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