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An Examination of the Latin American Pension Systems — The Challenges Ahead

- Latin American countries are experiencing important demographic shifts which will result in aging populations with insufficient comprehensive social security savings
- Individual savings, Chile's AFPs, Mexico's AFORES and Brazil's PAYGO system have made important strides in pension reform but further changes are needed to cover the needs of aging populations and financing gaps
- Latin American pension systems will have to loosen the current investment restrictions in order to meet both current and future draw-downs on benefits

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In recent months the media enthusiastically proclaimed the ascendancy of Brazil and the overall rise of Latin America, having emerged from decades of economic stagnation, inflation, corruption, and political instability. The commodity boom (2003-2008) and ensuing foreign direct investment have created brisk regional GDP growth averaging 5.5% per annum. In a notable reversal the largest Latin American economies have improved their respective net international reserve position and fiscal balances. In contrast, the financial media has criticized both European and American governments for their lack of fiscal and monetary discipline as well as poor regulatory oversight. Risk capital has thus flowed to these vibrant Latin American economies.

Although these Latin American economies are recently ascendant, population demographics and the general lack of long-term public and private savings indicate all is not perfect. Latin America's fastest growing population segments are the age groups above 45 years old. The UN has concluded that Latin America's population aged 65 or older will triple by 2050, particularly in Brazil, Chile, and Mexico. Over the past decade, population growth has barely met replacement rates. The most recent Mexican census of 2010 projects a 1.7% growth over the past ten years.¹ Savings rates are generally low. Large segments of the working population are not participating in government sponsored savings plans for varied reasons, ranging from financial illiteracy to working within the informal economy.

The developed economies are experiencing similar demographic and savings rate challenges. France, Greece and Italy passed pension reform bills in 2010, raising the minimum retirement age. Spain, facing a severe demographic challenge, is debating its own reforms, including asset sales and a tobacco tax to avert a Greek-style debt crisis, and the bipartisan Simpson-Bowles Commission recently recommended that the minimum Social Security retirement age in the U.S. be increased to 69 with reductions in Medicare benefits to reduce the budget deficit from 10.64% to 2.2% of GDP by 2015.

How Latin America prepares for these near-term demographic and savings challenges will dictate the region's future fiscal and national health. An examination of the various pension systems will provide insight into the needs and recommended adjustments. Already the unfunded pension liabilities are creeping upwards, and the region's credit outlook can be affected if reform is not enacted in the near term. Specifically these reforms will have to include modifications or supplements to the underfunded existing PAYGO that certain countries use, adding Defined Benefit (DC) system(s), encouraging higher savings rates through fiscal incentives, and broadening the base of financial literacy. Although PIMCO's co-Founder Bill Gross has postulated that as the population ages in developing nations, consumption will decline providing the savings necessary to match potential care needs-- we would suggest that the evidence is not entirely supportive of this view.

¹ *Censo Mexico 2010 Preliminary Report*

One size fits many...

Latin America has a mix of fully funded systems (Chile and Mexico), personal savings accounts, PAYGO (Brazil), and hybrid systems (Colombia and Peru). Chile was faced with a bankrupt social security system in 1980 and the government embraced the premise that a fully funded system was preferable to a PAYG. Chile's answer was to revise its social security system, constructed on three pillars:

1. Mandatory privately managed defined contribution plans
2. Means-tested public plans
3. Complementary optional private plans

The Chilean system also emphasizes transparency, openness to domestic and international competition, and is governed by explicit national law.²

Chilean pension savings comprise 65.1% of 2009 nominal GDP with over 95% of civilian salaried workers covered.³ There are minimum pension benefits for those who transitioned from the old system into the new system (private-public partnership). Chile's low debt profile and its pension reserve sovereign wealth fund enhance its ability to meet future pension obligations. The benefits of fully funded plans have included the deepening of local capital markets and the ability of the government to extend its debt profile through tapping the independent pension administrators (Administradoras de Fondos de Pensiones), or AFPs. The Chilean model has been adopted in Argentina, Bolivia, Colombia, Costa Rica, the Dominican Republic, El Salvador, Mexico, Panama, and Uruguay, and certain Eastern European countries.

In 2008, structural weaknesses in the Chilean system were addressed by the Bachelet government's Marcel Commission. The Government enacted legislation to improve the individual account system, encouraging competition amongst the AFPs to lower costs and expand coverage. The participant was also free to switch between rival AFPs. Other changes to the pension scheme included: replacing the means-tested pension guarantee with a non-contributory pension guarantee (creating a more generous payout coupled with an incentive to contribute), increasing foreign asset allocation, streamlining the commissioning structure, and establishing an educational fund. These reforms will continue to be implemented into 2012.

Chile continues to have some shortcomings, despite its early pension reform leadership. The IMF has cited the system for being underfunded, potentially causing structural economic imbalances.⁴ The Chilean Finance Ministry's Office of Budget Oversight (Dirrecion de Presupuestos - DIPRES) calculated at the end of 2009 that the Net Present Value ("NPV") of unfunded pension liabilities amounted to 8.6% of GDP. These contingent liabilities included the recognition bonds (7.9%) (introduced in the 1980s after the privatization of the pension system) and the minimum pension guarantee introduced in 2008 (0.7%).

² Professor Sebastian Edwards; "Three Pillars of the Chilean Pension System"

³ OECD Pension Markets in Focus July 2010

⁴ "Chile and the IMF" - Selected Issues September 2010

Following the Chilean example, Mexico established private sector retirement fund administrators (Administradora de Fondos para el Retiro), known collectively as AFORES. As of July 1, 1997 the law required that every private sector Mexican worker be enrolled in an AFORE plan (for the self-employed, participation is voluntary). Certain older workers in rural areas are exempted and allowed to have a non-contributory pension. Individuals are free to choose their AFORES. The National Commission for the Retirement Savings System (CONSAR) regulates and supervises the AFORES. Within the AFORES, an individual establishes a retirement account Sociedades de Inversión de Fondos para el Retiro, (SIEFORES).

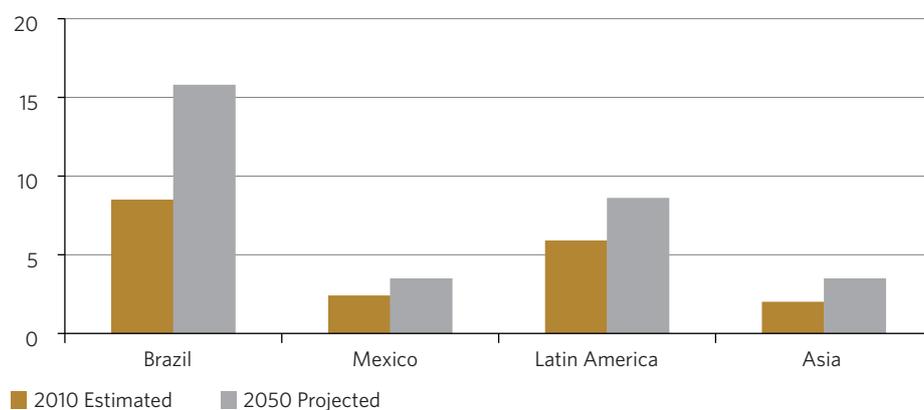
Mexican pension funds' investment rules have liberalized somewhat since 1997, but are still highly regulated by international standards. The system allows an optimum investment strategy to be established according to each worker's risk tolerance. Individual retirement funds come in five different types, ranging from the conservative Siefore Basica (SB1), to (SB5) - similar to U.S. lifecycle funds. The investment strategy requires that approved investments be diversified among long-term domestic instruments tailored to each worker's profile.

The Mexican defined contribution system provided through the AFORE does not cover the entire working population. The program was extended to cover both public sector (2007) and utilities workers (2008) through the ISSSTE.⁵ PEMEX (Petroleos Mexicanos, the state-owned oil company) employees, certain state and local employees, and the military are currently exempt from these DC plans. These individuals represent a significant segment of government workers.⁶ The PEMEX PAYGO system, for example, carries an annual cost of about 2% of GDP.⁷

Order and Progress?

Latin America's economic giant, Brazil, has favored its PAYGO model. Its pension system is divided into a two tiers: one for the civil service and the other for the private sector. The National Institute for Social Security (INSS) manages and regulates both pension types.

Pension Related Spending (% of GDP)



Source: Standard & Poor's

Brazil has a growing private pension system (second only to Chile) that is represented by open (any worker can participate) and closed (employment based) funds. The system does have weaknesses. In a recent analysis, S&P raised alarms over the projected cost of unfunded pension liabilities for Latin America, and specifically Brazil.⁸ Brazil pays out more than it collects, in spite of an active pension contribution rate that is over 40%. Social security costs have been consuming over 8.5% of nominal GDP⁹. Over the past

⁵ Instituto de Seguridad y Servicios Sociales de los Trabajadores

⁶ INEGI - Instituto Nacional de Estadísticas y Geografía

⁷ Banco de Mexico 2009 Annual Report published April 2010

⁸ Global Aging 2010: Irreversible Truth Standard and Poor's October 7, 2010

⁹ Ministerio da Previdencia Social September 2010 Bulletin, Banco Central do Brasil November 2010

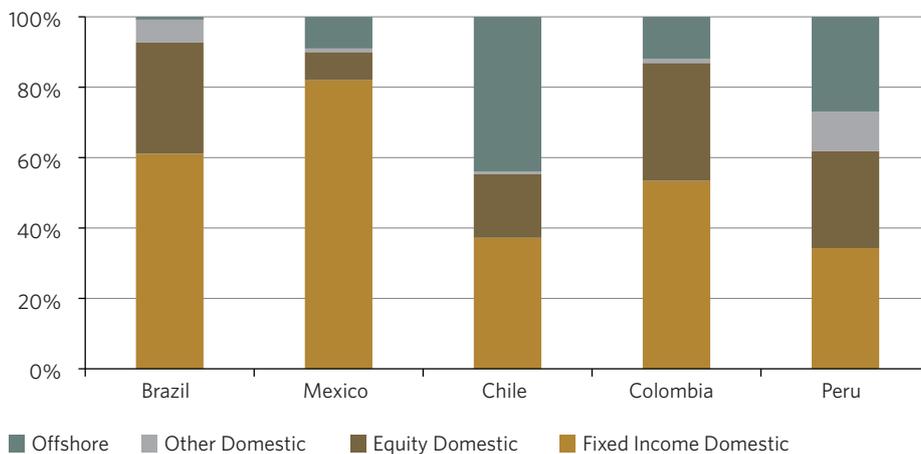
two years, the INSS has been running a deficit of 1.5% of nominal GDP.¹⁰ Further complicating matters is the fact that the Brazilian 45-plus age segment is growing significantly faster than any other population segment.¹¹ Clearly, Brazil will have to consider adjustments to its social security plans to staunch the bleeding.

Since 1998, Brazil has reformed its pension system twice. One change amended the pension payout formula to utilize actuarial analysis rather than the last three years of wages. Penalties were also established for early retirement. The second principal change occurred in 2003 when President Lula raised the civil service retirement age from 53 to 60 with a benefit formula akin to the private sector system. These reforms were diluted however, by the hiring of an additional 256,000 workers and the raising of the minimum wage, to which pensions are pegged. Overall, the government's share of revenue allocated to payroll, administrative, and pension costs has been rising steadily since the recent financial crisis - and this is expected to continue unless further reforms are adopted.

Expanding Investments and Approaches

Government restrictions on the diversification of investments coupled with low rates of return have widened the gap between liabilities and available funding. Chile and Peru have responded by lifting restrictions on portfolio's investments in international assets (80% and 30% of assets, respectively). Mexico is expected to expand pension asset diversification in 2011 to include emerging debt, REITs, private equity, and foreign mutual funds.

Latin Pension Funds Current Asset Allocation (%)



Source: ABRAPP, Amafore, Superintendencia de Pensiones, Superintendencia Financiera de Colombia, Superintendencia de Banca, Seguros, y Afp

Brazil's regulators, for example, have targeted a real rate of six (6) percent return. In order to achieve this goal, Brazil will have to liberalize its restrictions on investment types (which it tried in 2009 and 2010 with CMN Resolutions 3,792 and 3,846). Brazil may have to consider international fixed income and equities as well as alternative investments to facilitate higher returns. Regulators will also need to resist populist political impulses to plug fiscal holes or siphon the funds for so-called "national interests" - as witnessed with the nationalizations of Argentina's \$30bn system in 2008 and Bolivia's \$3bn system in 2010.

¹⁰ *ibid*

¹¹ Instituto Brasileiro de Geografia e Estatística Censo 2010

Conclusion: A Good Start but More Work to Do

Positive pension trends in the major Latin American countries do exist.

First, pension assets in the large regional economies have doubled in recent years (in sharp contrast to many in the developed world), with Brazil having the world's 7th largest system and the only Latin American pension fund (Previ) in the world's top 25.

Second, the governments and the private sector have recognized that coverage and funding issues still exist. A recent BBVA study showed that 60% of informal workers in Paraguay, Bolivia, Peru, Nicaragua, Ecuador, Guatemala, and Mexico had no social security/pension coverage. As populations age, governments have to address unfunded liabilities with varying degrees of urgency. The Chilean overhaul of 1981, the Bolivian and Mexican privatizations of 1997, and Brazil's 1998 and 2003 reforms were reactions to these issues.

Third, the highly regulated, Chilean multi-fund pension model has been copied both regionally and globally. It proved resilient during the 2008 financial crisis. Colombia is currently transitioning to this model.

Fourth, the strength of international reserves and flexible exchange rates allow certain Latin American economies to facilitate longer term investments in international assets in order to meet the growing needs of an aging population. Several Brazilian financial experts we spoke with recently cited that over 60% of pensions continue to invest in fixed income only, reinforcing the need for asset and strategy diversification to meet the expanding needs of a population that is both aging and not fully armed with the knowledge, tools, and products to save for retirement.

Fifth, while pension regulators and national agencies have provided greater financial transparency over time, there is more work to be done. This improving scenario is an invitation for the private sector to join with the public sector to facilitate further financial product development, education and literacy – addressing weaknesses that continue to exist even within Chile's progressive regime (according to Solange Bernstein¹²). Foreign providers' expertise should also be welcomed. Private asset managers and asset servicers can add value in offering investment advice as well as operational and technical expertise. Furthermore, these service providers can continually improve the performance of the AFPs, AFORES, and Fondos de Previdencia Fechados through competition, operational efficiencies, best practices and market intelligence.

If Latin American governments and pensions realistically assess the challenges they face and build upon sound structures and reforms, they can meet their objectives and avoid the crises that have plagued others – the keys will be to expand solutions and learn lessons from others.

¹² Superintendent of Chilean Pensions in a speech given at the International Federation of Pension Fund Administrators (FIAP)

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