



The impact of auctions of new members in the Peruvian Pension System Some Lessons

World Bank, april 2014



Pension Reforms in Latin America

- ❖ In recent years, Latin American pension systems have been reformed, due to the need of:
 - ❖ Increase coverage,
 - ❖ Improve efficiency,
 - ❖ Reduce administrative costs,
 - ❖ Promote competition, and
 - ❖ Improve financial education

- ❖ Some measures have been accompanied by more flexible investment management.



PERUVIAN PRIVATE PENSIONS SYSTEM REFORM: MAIN ISSUES

To foster efficiency

- To promote and to take advantage on large scale economies.
- To concentrate and outsource operative process (adjudication, collect, late payment collection, etc.)
- Savings due to improved processes moving to price.

To promote competition

- Auction of new members.
- Major transparency and competition.
- Opening to new pension management and insurance firms.
- Transition towards fee on asset under management (AUM).

To increase coverage

- To expand contributions collected by the employer but not delivered to the AFP.
- To extend coverage: self-employed and small and micro enterprises

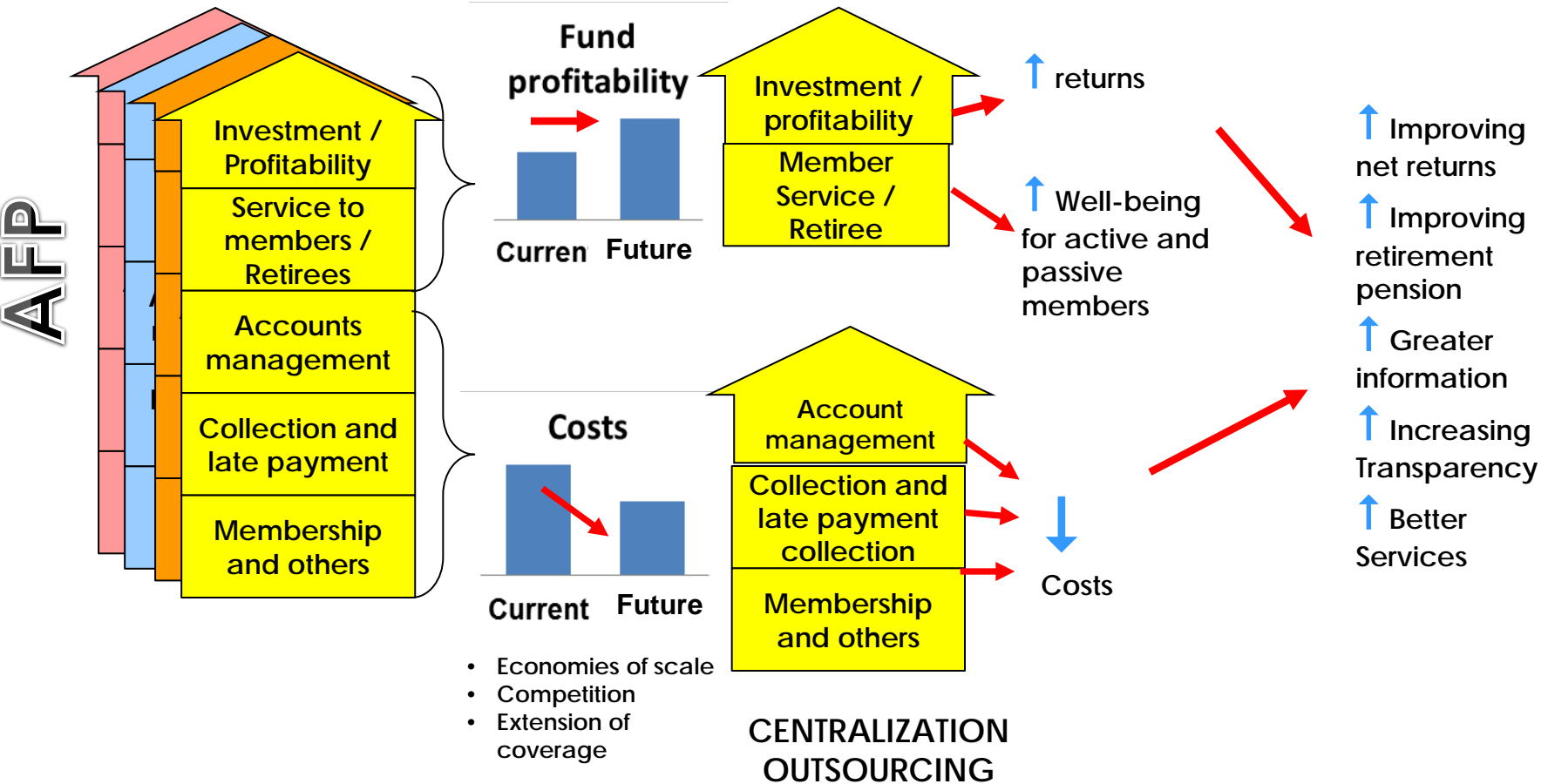
To improve investment and risk management

- To extend investment alternatives and proficient use of financial instruments.
- To speed up investment processes
- To improve risk management and Risk based Supervision
- Fiduciary responsibility

- The reform aim is to provide **highest net return for the members, through cost reduction, improving processes and investment alternatives.**
- This process must be enforced with a **better education and active participation of members.**



Specialized Institutions focused in investment performance and quality of services





Foster efficiency and promote competition in the Peruvian Pension System

The strategy for reducing cost management implied, among other measures, the introduction of an auction system of new affiliates like in Chile.

The reason for that was:

- ❖ Competition in the pension fund market was very difficult to achieve and focus in the ability of the sales force
- ❖ There were barriers to entry because the administrative and sales cost. That is because the new entrants have to compete with the old participants, not only in affiliate new members but also in gaining market share, to reach economies to scale
- ❖ There was no evidence of economics to scale. Fund size was increasing, whereas management fees were not reducing at the same pace.

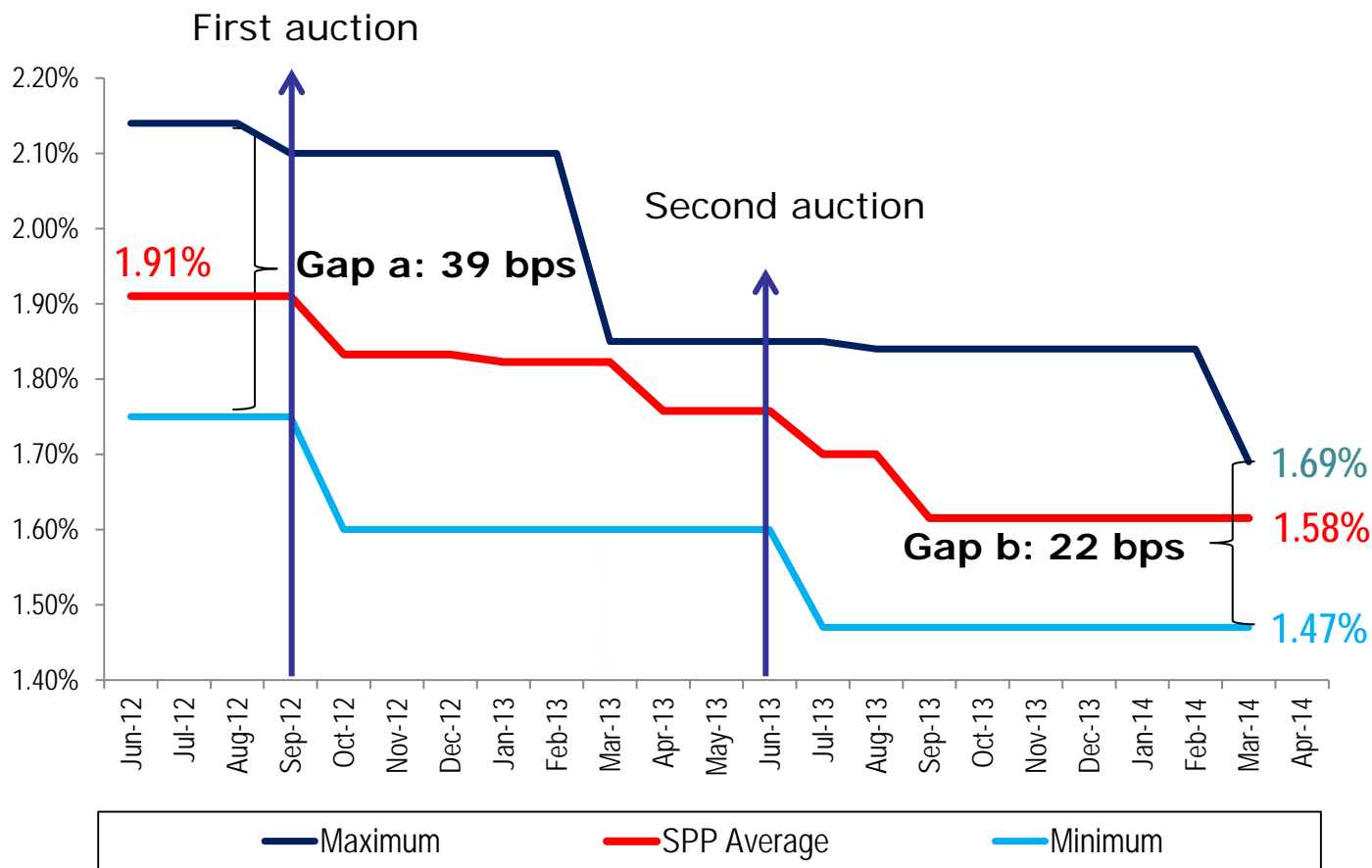


The Effects of the Auctions in Peru: A reduction in the management fee

AFP	Fee as a percentage of the salary before the Reform	Fee as a percentage of the salary after the first auction	Fee as a percentage of the salary after the second auction	Mixed Fee	
				Fee as a percentage of the salary	Annual Fee of new contributions to the Assets Under Management
Profuturo	2.14%	2.10%	1.84%	1.49%	1.20%
Horizonte	1.95%	1.89%	1.85%	1.65%	1.40%
Integra	1.80%	1.74%	1.74%	1.55%	1.20%
Prima	1.75%	1.60%	1.60%	1.51%	1.90%
Average without Habitat	1.91%	1.83%	1.76%	1.55%	1.43%
Habitat				0.47%	1.25%
Average with Habitat	1.91%	1.83%	1.76%	1.37%	1.40%

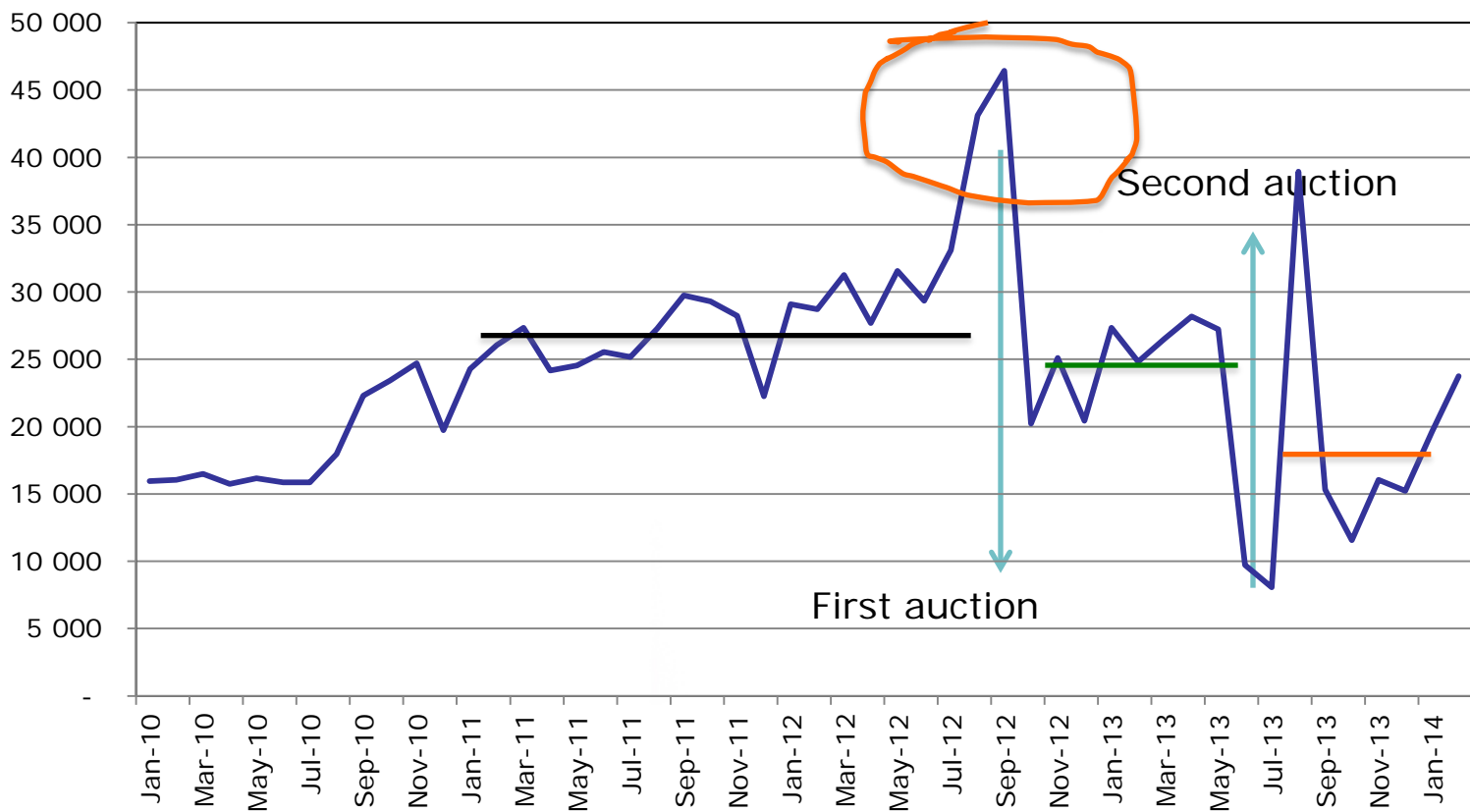


The price dispersion is also being reduced





Evolution of funds' new members in the private pension system





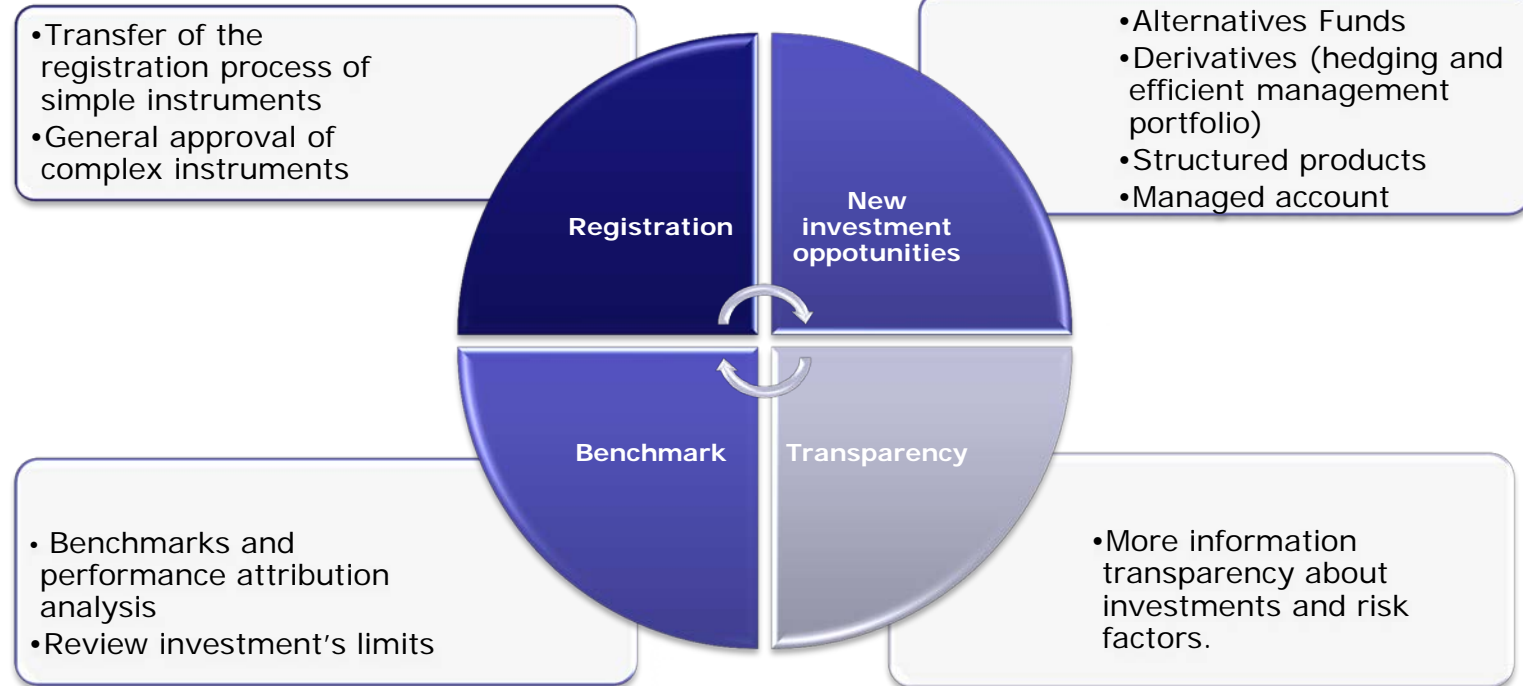
How to reinforce the effect of price reduction made by auctions in the net returns of investments

- Due to the reduction of cost price gap dispersion, investment returns become the important driver of price decision.
- Therefore improving investment rules, to allow for more diversification and to expand investment opportunities will boost the achievement of higher returns net of costs, will be translated in higher pensions in the future.
- For that reason the Peruvian reform has introduced also a new investment regulation



PERU: PENSION FUNDS' INVESTMENTS

New Rules



Strengthening Corporate Governance, Investment and Risk Management and Internal Audit.

Minimum Requirements: Infrastructure, Professional Qualifications and Relevant Experience.

Guidelines for the Investment Process.

Stricter risk based supervision of SBS: More flexibility comes with more responsibility and better risk management.



In summary

- Auction of new participants helps to reduce prices.
- The impact on prices will depend on the presence of public pension system, as a competitor of the DC system.
- Pay as you go systems should be closed before any auction.
- Auctions reduces barriers to entry
- Pension providers need to change operative processes in order to get the advantage of the auctions. It could involve some costs. No sales cost strategy is not optimal when there is a PAYG system in place.
- However, Auctions bear some critics about freedom of choice and a temporary creation of monopoly. To mitigate this, must properly design exit mechanisms (look at net return among peers).
- More flexible investment rules, coupled with the reduction in price dispersion made by the auctions, achieve the objective of higher return net of fees for the participant.



The impact of auctions of new members in the Peruvian Pension System Some Lessons

World Bank, april 2014