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Has Pension Reform Failed Latin America?

(based on the *Latin American Economic Outlook 2008*)

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- ◆ Pension reform in Latin America has helped deepen capital markets, but with mixed results in terms of increasing national savings.
- ◆ Private pension funds have a still untapped potential to help to improve corporate governance, both internally — the administration of the funds themselves — and externally — by influencing the governance standards of the companies in which they invest.

Latin America leads the developing world in pension reform. Since Chile launched the process in 1981, nine other countries in the region have moved from publicly managed “pay-as-you-go” pension systems to privately managed fully funded defined-contribution systems of individual accounts for the beneficiaries. As the *Latin American Economic Outlook 2008* shows, there are many recipes for reform: some countries completely replace the old system, while others introduce privately managed pension funds on a voluntary basis only.

Whatever the recipe, most pension reform efforts share a set of broad goals. Most important, reforms aim to provide a reliable source of retirement income for workers by reducing the unsustainable fiscal drain that is a feature of existing publicly managed systems. At the same time, because most Latin American countries have long suffered from low domestic savings and financial fragility, governments have also sought to use pension reform to boost local savings, provide a stable domestic source of finance for growth and poverty reduction efforts, and promote the development of local capital markets. Finally, better governed pension funds can influence corporate governance — that is, they can limit costly and sometimes corrupt self-dealing by corporate insiders — in the firms whose shares they buy on behalf of workers.

The results vary, in part because some countries launched their pension reforms much more recently than others. In Chile and Peru, for instance, pension reform has been accompanied by fiscal consolidation and increased national saving. In the case of Chile, pension reform has furthermore enhanced the role of the stock market and

the size of the local mortgage bond market, while improving local corporate governance. The picture is less encouraging in other countries, like Colombia and Mexico, where savings failed to increase or even fell. Governments in Argentina and Bolivia succumbed to fiscal pressures that weakened their pension-fund systems. The difficulty of discerning the reforms’ impact on national saving in Latin America is compounded by the many other policy changes with large savings effects that coincided with pension reform.

In contrast to the disappointing overall impact on national saving, pension reform has brought about a significant deepening of capital markets in many Latin American countries. By the end of 2006, pension-fund assets under private management in the region amounted to \$390 billion, granting them a dominant position relative to other asset holders in their domestic financial systems. Brazil and Chile have by far the largest pension-fund industries, totaling around 65 per cent of all Latin American pension assets. The case of Chile is particularly significant: with assets worth more than 60 per cent of GDP as of December 2006, the relative size of the Chilean pension system comes close to that of OECD countries with well-developed private-pension industries.

Given the size and weight of the private pension fund industry in these economies, better regulation and improved governance have become priorities for policy makers throughout the region. More clearly-written mission statements, detailed codes of conduct, and stronger accountability mechanisms would better align the incentives among active and retired workers, employers

and pension-fund administrators. Equally important is the potential of pension-fund administrators to induce widespread improvement in the quality of governance in the enterprises whose equities they acquire as assets. Large pension funds in Brazil, working closely with other domestic institutional investors, have played an important role in promoting higher levels of corporate governance in publicly listed companies. In general, however, pension funds have not yet become the drivers of improved corporate governance that they could be one day.

The OECD experience with pension reform suggests five important lessons, careful consideration of which could improve results in Latin America. First, local financial market infrastructure and regulatory frameworks must be strengthened. Second, investment limits — particularly those on equities and foreign assets — should be re-examined with a view to facilitating diversification while

maintaining high prudential standards. Third, giving individual members a broader range of investment options will make them more keen to seek information on performance differences, increase the services provided to members, raise member participation and improve resource allocation. Fourth, high fees must come down as a result of two possible options: the liberalisation of the market to allow other players to enter — so costs can be reduced through competition — or the centralisation of contribution collection, record keeping and reporting in one national site — so administrative costs can be lowered. Fifth, rules governing private pension funds should strengthen the responsibility of institutional investors as trustees of workers' retirement assets; this calls for transparency in management and effective communication between fund managers and members.



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