



GOBIERNO DE CHILE
SUPERINTENDENCIA DE AFP

Plans to Encourage Competition in the Chilean Pension System

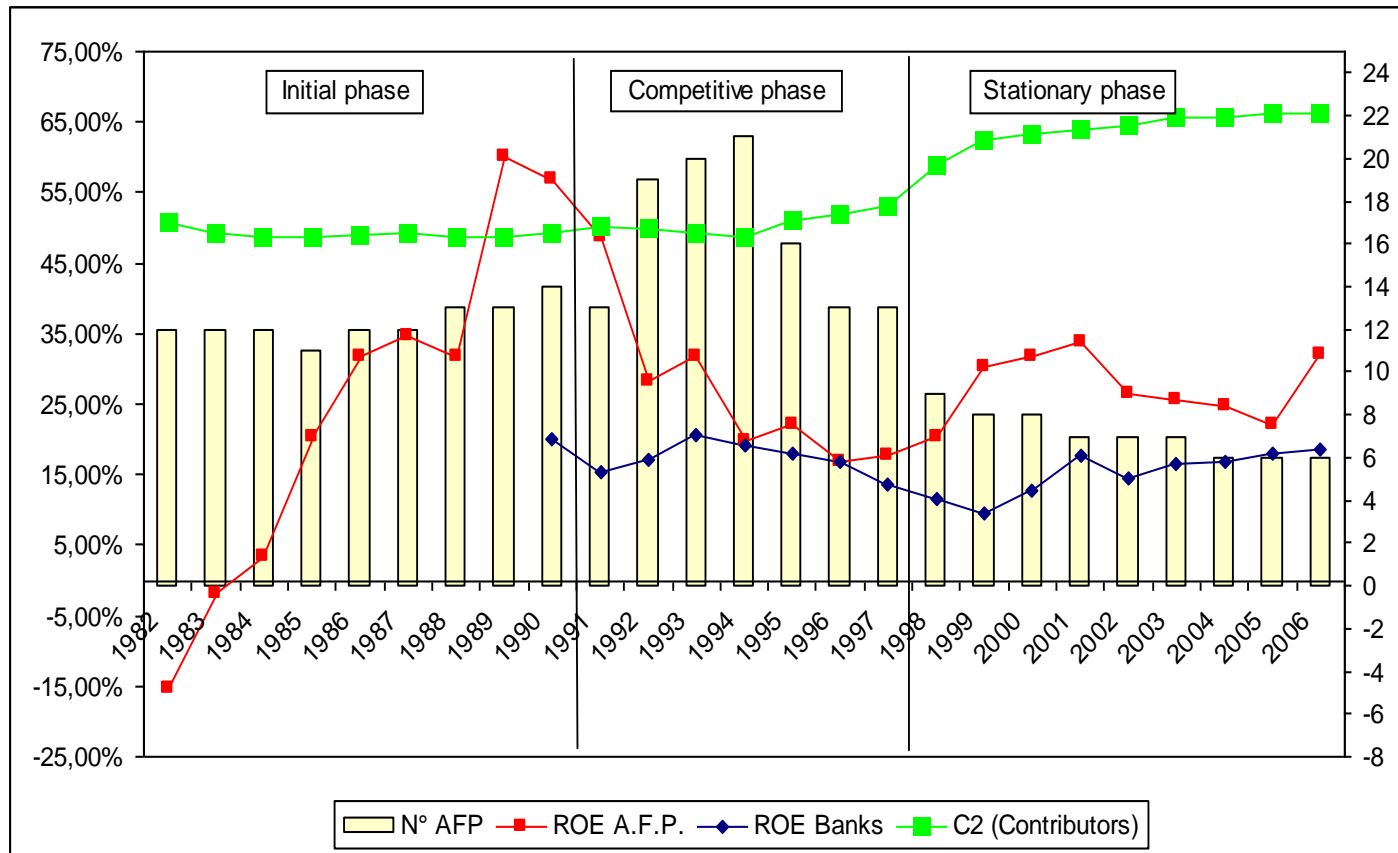
Solange Berstein
Superintendent of AFP

Assesement of Current Situation

❖ Three stages in the history of industry:

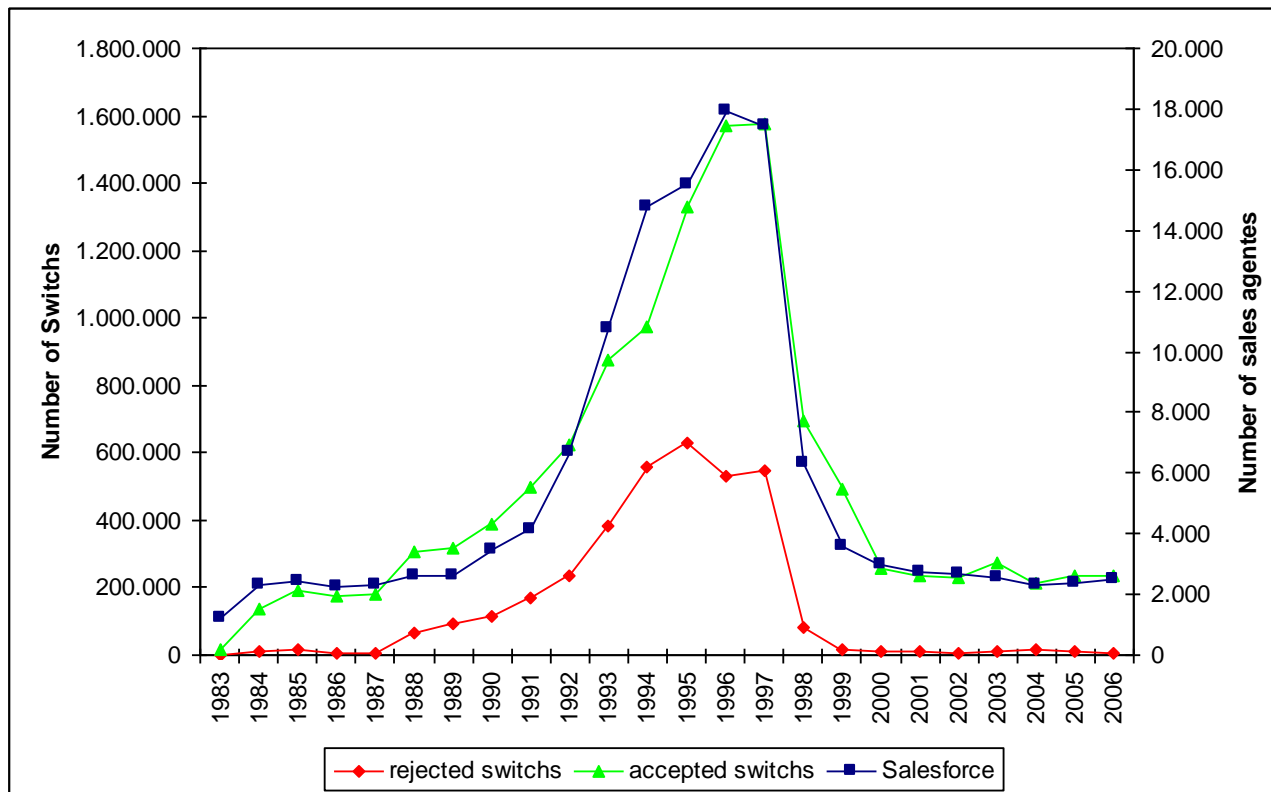
- Initial phase (1981-1990):
 - High costs and fees
 - Returns increasing at the end of this phase
 - Low turnover of firms in the market
- Competitive phase (1991 - 1997):
 - High entrance and acquisitions of firms
 - High operative costs, low returns
 - High turnover of members between AFPs
- Stationary phase (1998 - today):
 - Low movement of firms in the market
 - High returns.
 - Increased Concentration.

Evolution of the industry



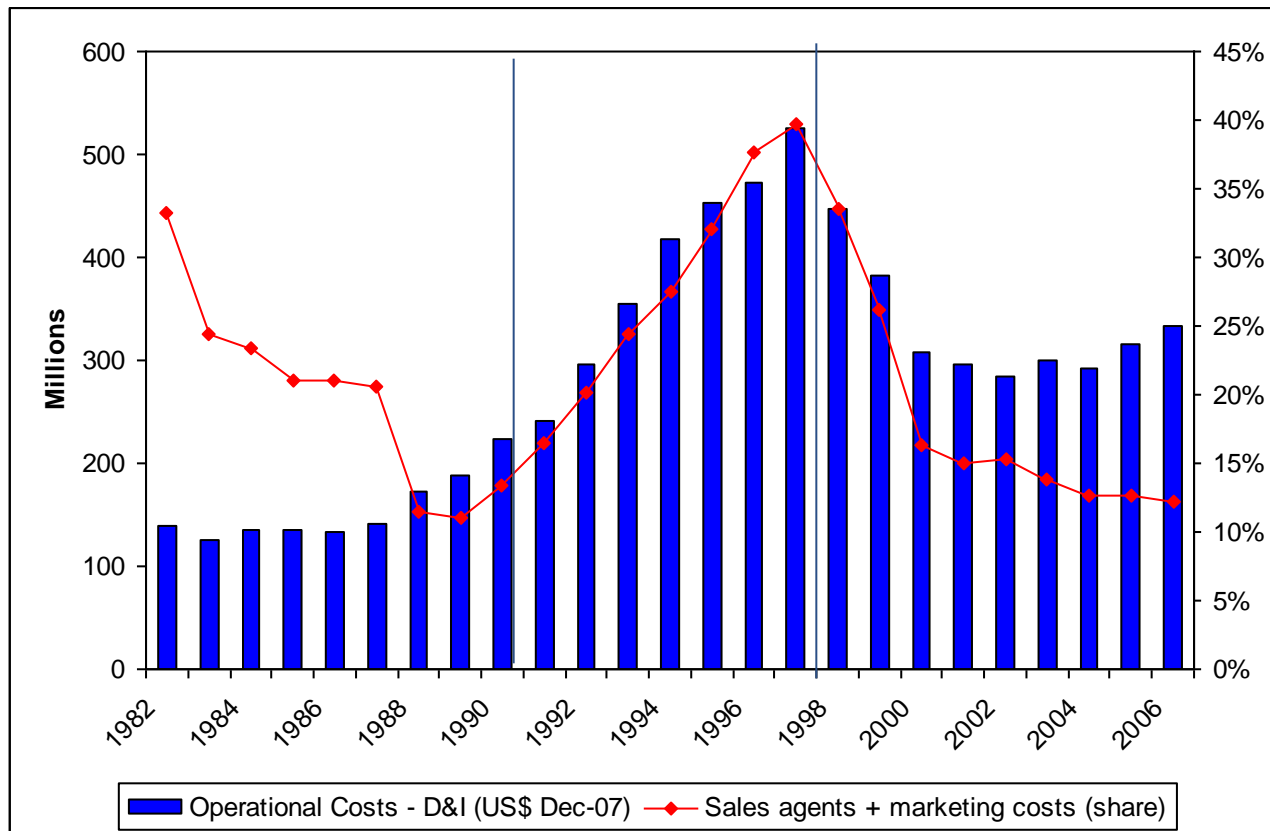
Competitive phase

❖ Switching behavior highly driven by salesforce.



Competitive phase

❖ Increasing importance of Operational Costs, sales agents & marketing costs in particular.



Market Characteristics that define competition

❖ Economies of Scale:

- Weak evidence beyond a relatively small amount of members once controlling for members characteristics
- Different efficient level for different functions (e.g. record-keeping vs. fund management)

❖ Sensitivity of Demand

- Very low with respect to price (fees)

As a result: A Market with low level of Contestability

- Incentive to attract high income workers and “refuse” self-employed

❖ Provision of D&S Insurance

- Incentive to attract low risk individuals reinforces incentive to attract high income workers.

❖ Marketing based on sales force:

- Barrier of entry due to visibility and threat of “commercial war”

Plans to Encourage Competition

❖ Recently published reform law includes measures to improve competition.

- Bidding process for new entrants
- Outsourcing
- Separate provision of D&S insurance
- Changes in fee structure

Bidding process

- ❖ Procurement market for new entrants
- ❖ AFPs compete for the market of future new entrants.
- ❖ New members in a period of two years are assigned to AFP with lowest bid.
- ❖ Resulting fee must be lower than the minimum existing at that point.
- ❖ Same fee is applied to all members (Existing AFPs must lower fees to win the auction)
- ❖ Members must remain in winning AFP for up to 2 years unless other AFP sets lower fees (+ other non-compliance clauses)

Consequences of bidding process

- ❖ Mechanism to increase price-sensitivity of demand
- ❖ Allows achievement of efficient scale without incurring on marketing costs or commercial war.
- ❖ New members assigned to most convenient provider for them: least costly

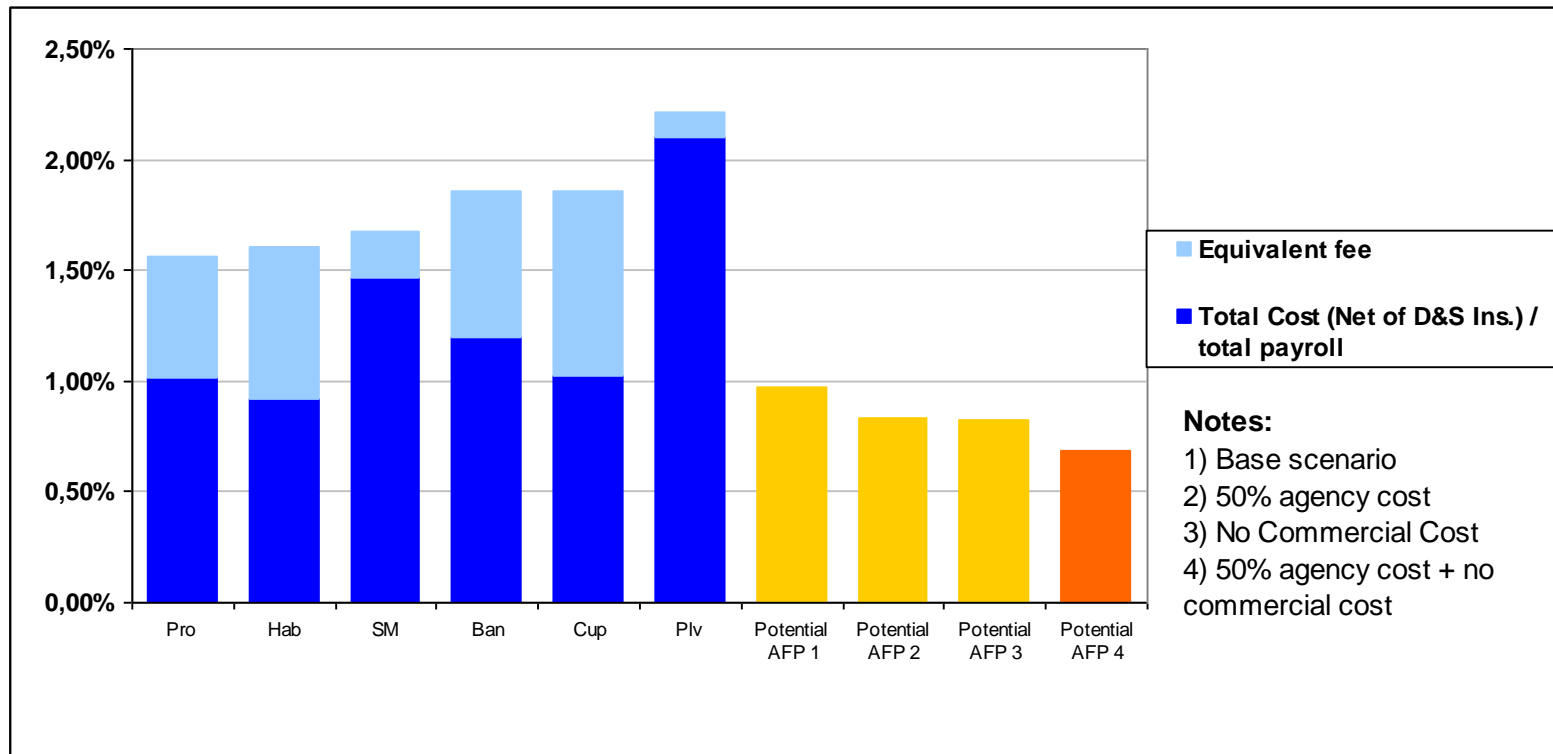
“Variation in 24-months net return w.r.t. real choice.”

	Cheapest		Highest return	
	Number of people	Average variation	Number of people	Average variation
Improve	77,3%	11,5%	31,8%	8,9%
Same	12,2%	0	5,4%	0
Worse	10,5%	-3,8%	62,8%	-18,4%

If rate of return=5% and fee=1.3% of income. The variation in return to compensate for a reduction of the fee to 1% would be -288 basis points.

Potential entrant to the market

- ❖ According to a simulation exercise based on data about costs per process, a new entrant could charge lower fees than the ones currently prevailing in the market.



Outsourcing

❖ Current limits to outsourcing:

- Regulation due to limited supervision of outsourced activities
- Value Added Tax: Fees are exempt of VAT, while certain outsourced activities are not.

❖ Measures in the law:

- Attributions for Superintendence to supervise outsourced activities, even at external company.
- Tax credit for VAT paid on outsourced activities against Income Tax
- Explicit authorization to outsource customer service and account management activities.

Disability and Survivorship Insurance Provision

❖ Current Situation:

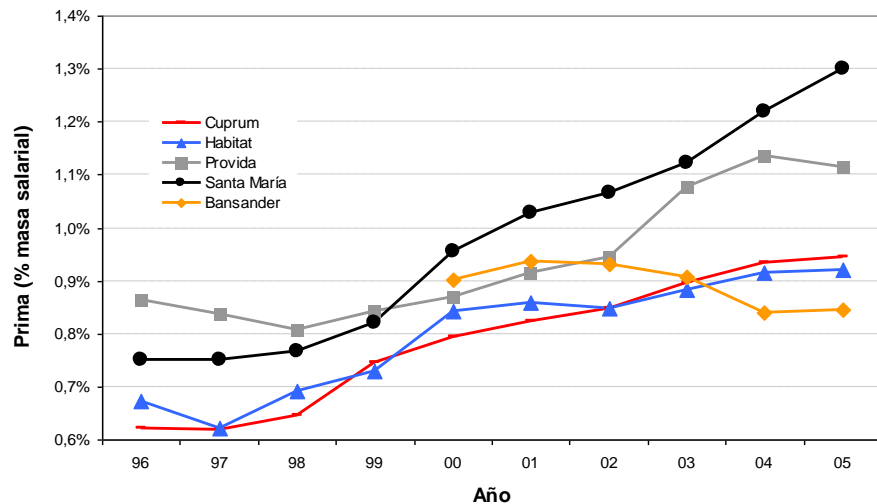
- Each AFP hires a D&S Insurance for its own affiliates
- Cost of premium is included in AFP commission
- Structure of Contracts is such that in practice risk is covered by AFP and not by Insurance Company

❖ Consequences:

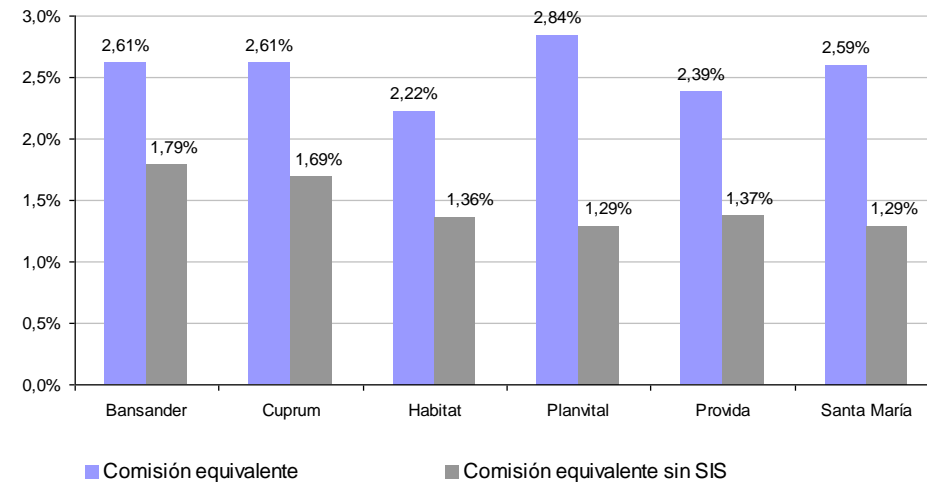
- Inefficient risk pooling
- Incentive to cream the market
- Low transparency of insurance cost and true AFP fees
- Barrier of entry to new AFP: Insurance costs currently represent 50% of AFP costs & uncertainty of its affiliates risk profile.
- Cross-subsidies across gender and other groups.

Distortions of current provision of D&S Insurance in the market

D&S Insurance Cost per AFP



Average fee with and without insurance cost by AFP.



Persistent differences in cost of insurance. Risk profile of members differs across AFPs

The apparently most expensive AFP would be the cheapest one without including D&S insurance cost in fees.

New law: Separate provision of D&S Insurance

- ❖ D&S Insurance is hired jointly by all AFPs
- ❖ Contract is awarded through a bidding process to one or more insurance companies
- ❖ Unique premium for all affiliates to the system. AFPs charge fees net of insurance cost.
- ❖ True insurance provision, no adjustments for realized mortality and morbidity.
- ❖ Insurance companies in charge to pay benefits and monitor disability qualification process.

Fee Structure

❖ Current Situation

- Both a fixed fee (in \$) and a variable fee (As a % of monthly salary) may be charged. This makes price comparison across AFPs more difficult.
- AFPs offer administration of a short-term savings product (“Account 2”) free of charge. Members with mandatory savings subsidize those who maintain this product.
- Other fees may be charged from the account balance, which makes them less visible and reduce pension savings

Fee Structure

❖ New Law:

- Fixed fee is eliminated
- AFPs are allowed to charge administration fee for “Account 2” (in the same way they charge for Voluntary Pension Savings)
- Fees charged against account balance are eliminated

❖ These measures allow management fees to align more closely to true management costs for mandatory accounts, eliminating certain cross-subsidies (albeit maintaining one across income).

❖ All these measures can jointly affect three dimensions:

- Allow more efficiency, reducing operational costs
- Increase competition, reducing margins.
- Facilitate transparency and information provision to affiliates.



GOBIERNO DE CHILE
SUPERINTENDENCIA DE AFP

Plans to Encourage Competition in the Chilean Pension System

Solange Berstein
Superintendent of AFP