

The Chilean pension tender model

February 2017

The Association of Superannuation Funds of Australia (ASFA)

The Association of Superannuation Funds of Australia Limited (ASFA)

Level 11, 77 Castlereagh Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
T +61 2 9264 9300
T 1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au

ABN 29 002 786 290 ACN 002 786 290

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system so people can live in retirement with increasing prosperity. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90 per cent of the 14.8 million Australians with superannuation.

February 2017 v1.0

Contents

| | |
|--|----|
| Executive summary | 4 |
| Section 1: Introduction | 5 |
| Section 2: A brief description of the Chilean pension system | 6 |
| Section 3: The context for the 2008 Chilean pension system reforms | 7 |
| Section 4: The 2008 reforms – administration fees and the tender process | 8 |
| Section 5: The effect of the Chilean tender process on administration fees | 9 |
| Section 6: Risks of the Chilean tender process | 12 |
| 6.1: The tender process is based on fees, which poses risks to member outcomes | 12 |
| 6.2: Successive tender rounds have increased risks for AFPs that win tenders | 16 |
| 6.3: Successive tender rounds have not led to an increase in competition | 19 |
| Section 7: Looking ahead | 20 |
| Section 8: Lessons for Australia | 22 |
| References | 23 |



Executive summary

Chile's pension system incorporates a biennial tender process, where all workers who enter the labour force for the first time become members of the pension fund administrator (AFP) that wins the tender for those workers. The AFP that offers the lowest administration fee wins the tender.

The tender process, however, is not delivering on its main objectives. Indeed, over the longer term the tender process risks a 'race to the bottom' among AFPs to reduce fees at the expense of investment returns and member services.

ASFA has identified the following issues with the Chilean tender process:

- successive tender rounds have reduced the level of administration fees for AFPs that have won tenders, but have not led to a broad-based reduction in fees.
- the tender process is based on fees, so AFPs that win the tender have an incentive to reduce the resources they devote to internal investment management, reduce the quality of their administrative functions, and reduce the quality and range of member services
- successive tender rounds have not led to an increase in market competition. Since the first tender round in 2010, only one new AFP has entered the market. Further, only one AFP participated in the most recent tender round
- successive tender rounds have increased risks for AFPs that win tenders. Successive tender rounds have pushed down fees (for the tender holder). The lower the level of fees, the more vulnerable an AFP is to adverse shocks to member contributions – such as from an economic downturn.

In this context, a Chilean-style tender process would not be appropriate for the Australian superannuation system.

Aside from the issues mentioned above, Chilean funds do not offer the range and complexity of services provided by Australian funds. Adoption of a tender model in Australia would likely lead to a significant reduction in the services and benefits offered to members.

The Chilean Government introduced the tender process, in part, to reduce fees. However, fees for Australian MySuper products compare favourably with fees in the Chilean system. Further, the Australian system offers higher quality member services compared with the Chilean system.

Introduction

The Chilean pension system has attracted significant international interest and has been championed, by some, as an example of sound pension-system design. However, the reality for many current and prospective Chilean retirees is the system is failing to deliver the retirement incomes people anticipated.^{1,2} Successive Chilean Governments have introduced reforms to improve member outcomes, but some of the solutions have introduced new problems.

This paper focuses on a particular aspect of the Chilean pension system – the tender process for allocating new workers to funds. Every two years, the Chilean pension system regulator (the Superintendencia de Pensiones, or SP) holds a tender for the management of new workers' accumulation accounts (for a two-year period). Any of Chile's privately-owned pension fund administrators (the Administradoras de Fondos de Pensiones, or AFPs) can bid. The AFP that offers the lowest administration fee wins the tender.

The Chilean Government implemented the tender process to increase competition among the very small number of AFPs (including by encouraging new market entrants), to reduce fees and to improve outcomes for members.³

The tender process has not spurred an increase in competition. Indeed, only one new AFP has entered the market since 2010 and only one AFP participated in the most recent tender.

The tender process has led to lower fees among those AFPs that have won the tender. However, the focus on fees by AFPs that win the tender risks compromising their net returns and the quality of their member services. Over the longer term, the tender process risks a 'race to the bottom' among funds to reduce fees at the expense of returns and member services.

A Chilean-style tender process would not be appropriate for the Australian system. Aside from the issues mentioned above, Chilean funds do not offer the range and complexity of services provided by Australian funds. Adoption of a tender model in Australia would likely lead to a significant reduction in the range and quality of products and services offered to members.

Further, the Chilean Government introduced the tender process, in part, to reduce fees. However, fees for Australian MySuper products compare favourably with fees in the Chilean system (see Box 1).

A brief description of the Chilean pension system

Chile's pension system has three main pillars; a poverty prevention pillar, a mandatory contribution pillar, and a voluntary savings pillar. This basic structure has been in place since 1981, although each of the pillars has been subject to some degree of reform throughout the subsequent 35 years.

The mandatory pillar comprises a fully-funded defined contribution scheme, in which the AFPs manage individual members' accounts. It is compulsory for all employees to contribute 10 per cent of their monthly wage/salary to the AFP to which they are affiliated (employers deduct contributions and forward them to AFPs).^{4 5} With the exception of new workforce entrants, employees can choose their AFP and switch at any time. Mandatory contributions are exempt from income tax. The government also provides significant tax incentives to encourage people to make voluntary savings.

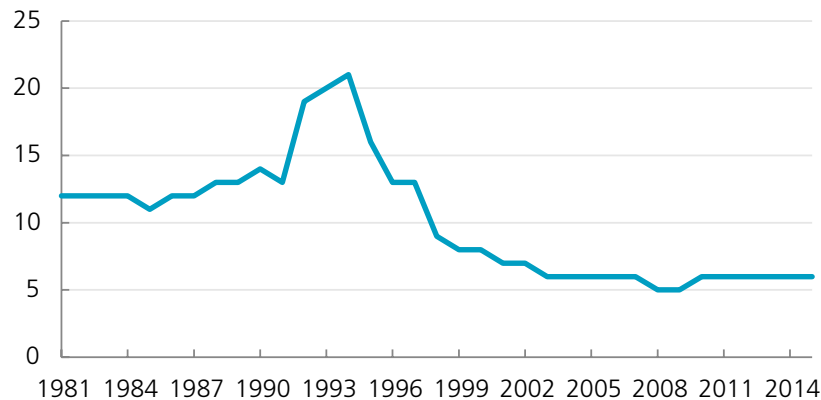
Upon retirement, individuals who have made contributions receive an income stream based on their accumulated balance.^{6 7} If a person's pension income is below the statutory minimum, and provided the person contributed for at least 20 years, the government provides the person with the difference. The government also provides a state-funded pension for retirees who do not fully participate in the system – such as workers in the informal workforce.

The Chilean pension system is heavily regulated. For example, AFPs must comply with a host of investment limits regarding fund asset allocations – including the types of instruments and issuers, and minimum and maximum proportions for government securities, equities and foreign assets.

The context for the 2008 Chilean pension system reforms

In 2008, the Chilean Government introduced a comprehensive set of pension reforms that encompassed all three pillars. With respect to AFPs, the main goals of the reforms were to reduce the degree of market concentration among AFPs and to lower AFPs' management costs and the fees charged to their members.⁸

Chart 1: Number of AFPs



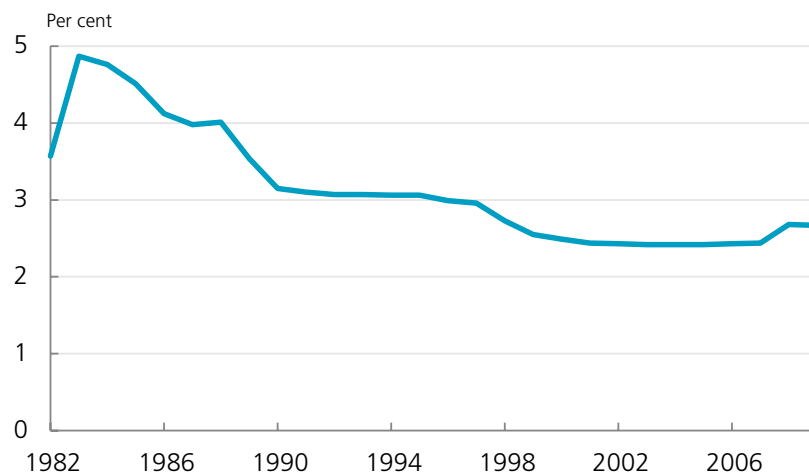
Source: Superintendencia of Pensions.⁹

Market concentration among AFPs had increased markedly from the mid-1990s (Chart 1) as a result of mergers and takeovers, following a period where AFP numbers had increased sharply (which reflected, in part, a more positive political environment). From 1994 to 2003, the number of AFPs declined from a peak of 21 to only six. This spurred public debate as to whether there could be sufficient competition in such a highly-concentrated market.¹⁰

Leading up to the reform period, there was also intense public debate about whether AFPs' fees were too high (where AFPs' fees incorporated insurance premia). Total fees were indeed very high during the period immediately following the 1981 reforms, which reflected, in large part, the high cost of insurance (Chart 2). Over subsequent years total fees declined. This reflected falls in insurance premia and also AFPs' administrative fees, particularly from 1996 to 2002 for the latter.¹¹ However, leading up to the 2008 reform period, the broad consensus was that fees were still too high – as evidenced by AFPs' high profit rates.¹²

Chart 2: Fees charged by AFPs (% of average monthly income)¹³

Includes insurance premia



Source: Superintendencia of Pensions.¹⁴

The 2008 reforms – administration fees and the tender process

Two key reforms were the simplification of AFPs' fee structures and the introduction of a tender process to allocate new workforce entrants to an AFP.

The 2008 reforms mandated that AFPs can only charge their members a single administration fee. AFPs levy the administration fee only on members that make contributions, as a fixed percentage of their wage/salary (in addition to contributions). For AFPs, the administration fee covers costs of administrative functions, distribution and internal investment management. AFPs also directly charge members premia for disability and survivors' insurance. AFPs pay for the cost of external investment management from funds' earnings.

The Chilean Government also introduced a biennial tender for the management of the accumulation accounts of workers who join the pension system for the first time. Existing and prospective AFPs can participate in each biennial tender. The regulator awards the tender to the AFP that offers the lowest administration fee (which does not incorporate premia for disability and survivors' insurance). The AFP that wins the tender must charge the same administration fee to all its members – existing and new.

Workers allocated to the tender winner must remain members of that AFP for the duration of the tender – except in certain circumstances. For example, the regulator allows a member to switch to another AFP if that AFP charges a lower fee than the tender winner for two consecutive months (see Section 6.1 for other circumstances).

The tender rules ensure the fees of tender winners cannot increase over successive biennial tenders. In particular, for an AFP to win the tender from the incumbent AFP, its bid must be lower than any AFP's fee on offer in the market at the time that the tender is conducted.¹⁵

The effect of the Chilean tender process on administration fees

Successive tender rounds have reduced the level of administration fees for the AFPs that have won the tenders, but have not led to a broad-based reduction in fees. The fee outcomes for successive tender rounds are noted in Table 1.

For the first tender period, which started in August 2010, a new AFP—AFP Modelo—was the successful bidder. As a new AFP, Modelo's total assets at the start of its tender period (August 2010) were negligible. Modelo was again the successful bidder for the next tender period, which started in August 2012. AFP Planvital, also a small fund, was the successful bidder for the next two tender periods, starting in August 2014 and August 2016 respectively. Planvital was the only participant in the most recent tender round.

Table 1: Administration fee charged by AFPs that have won the tender

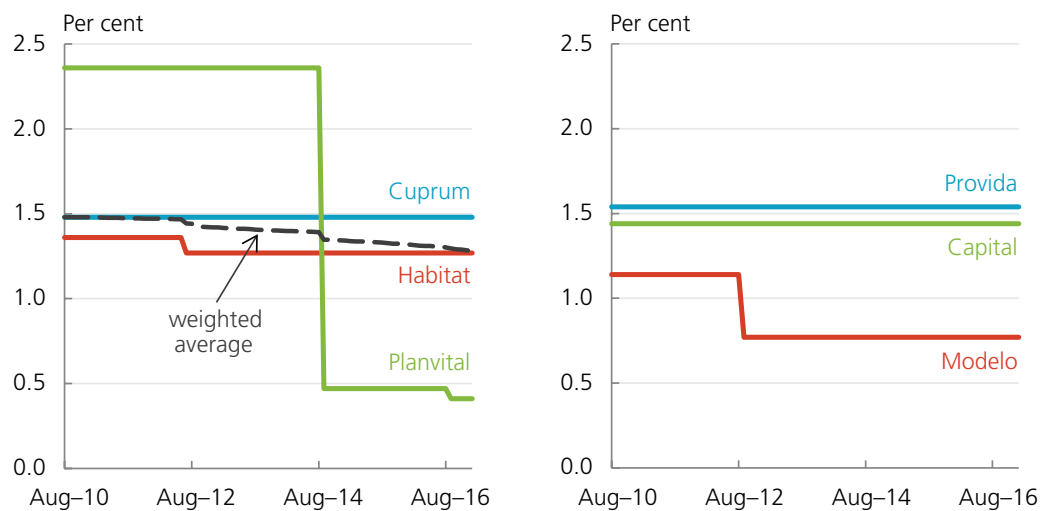
| | | Aug-10 | Aug-12 | Aug-14 | Aug-16 |
|----------------------|---|--------|--------|--------|--------|
| AFP Modelo | Fee (% of monthly income) | 1.14% | 0.77% | | |
| | share of AFP assets at start of tender period | 0.0% | 0.4% | | |
| AFP Planvital | Fee (% of monthly income) | | | 0.47% | 0.41% |
| | share of AFP assets at start of tender period | | | 2.7% | 3.1% |

Source: Superintendencia de Pensiones and ASFA calculations.¹⁶

Note: the share of total AFP assets is at the time that the relevant AFP began its tender period.

The lower administration fees charged by the AFPs that have won tenders have reduced the calculated (weighted) average administration fee – but only by a small degree (Charts 3 and 4).

Charts 3 and 4: Administration fee charged by each AFP (% of monthly income)
Excludes insurance premia



Source: Superintendencia de Pensiones and ASFA calculations.¹⁷

Note: the average fee is weighted by members' average monthly income.

On only one occasion has an AFP reduced its administration fees independent of the tender process – AFP Habitat reduced its administration fee by nine basis points in June 2012. This suggests the introduction of the tender process has failed to deliver on one of its key policy objectives – to reduce fees among the broad set of AFPs. More importantly, there are significant risks associated with fee-based competition, which are discussed in Section 6.

It should be noted the AFPs’ administration fees depicted in Charts 3 and 4 are as a percentage of monthly income. As a percentage of assets (which is typically the manner by which fees are reported in Australia), administration fees in the Chilean system average approximately 0.6 per cent, using methodology from the Organisation for Economic Co-operation and Development (OECD).^{18 19} Table 2 shows the current level of administration fees charged by AFPs on both bases. A broader comparison of fees in the Chilean and Australian systems is shown in Box 1.

Table 2: Administration fee charged by each AFP²⁰

As at December 2016

| AFP | % monthly income | % assets |
|-----------|------------------|----------|
| Planvital | 0.41 | 0.17 |
| Modelo | 0.77 | 0.33 |
| Habitat | 1.27 | 0.56 |
| Capital | 1.44 | 0.64 |
| Cuprum | 1.48 | 0.66 |
| Provida | 1.54 | 0.69 |

Source: Superintendencia of Pensions and ASFA calculations.

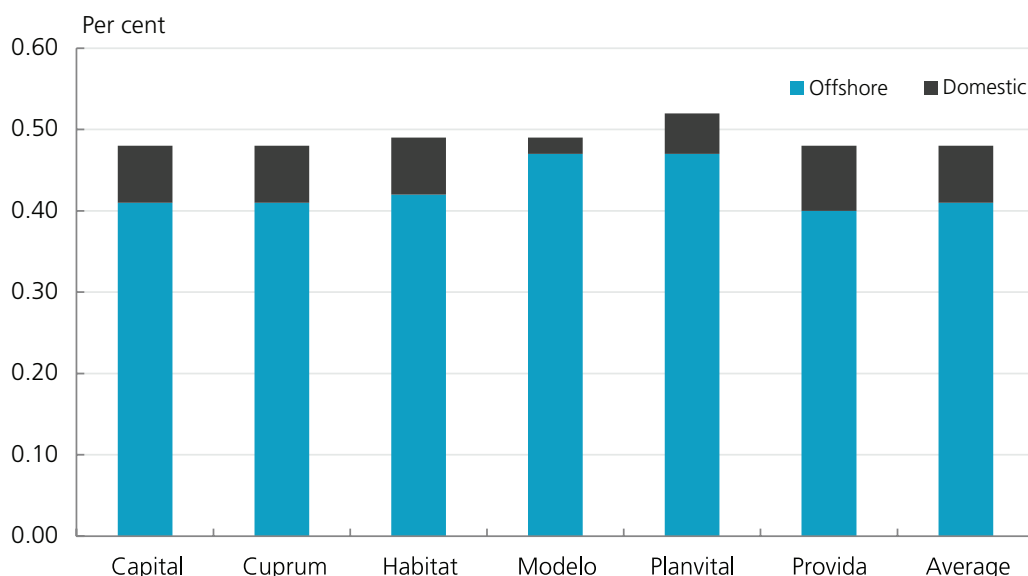
Fees for external investment management

Administration fees do not include the investment management fees that AFPs pay to external investment managers. On average, AFPs outsource around 40 per cent of their assets to external managers and around 90 per cent of externally-managed assets are managed by foreign fund managers.²¹ On average, investment fees for offshore managers are 0.58 per cent of assets under management, while fees for domestic managers average 0.76 per cent.²²

Investment fees differ according to portfolio construction. Box 2 shows that AFPs must offer four of five fund types, with each type differentiated by prescribed asset allocation limits. For the fund type with the highest allocation to growth assets (Fund type A), investment fees for offshore managers average 0.58 per cent of assets under management, while fees for domestic managers average 0.84 per cent.²³ In terms of total Fund assets A, Fund A external investment fees average 0.48 per cent (Chart 5). A comparison with fees in the Australian system is shown in Box 1.

Since the fees AFPs pay to external investment managers are not incorporated in AFPs’ administration fees, the tender process would not be expected to have any effect on AFPs’ choice of external investment manager, nor on the fees external managers charge AFPs.

Chart 5: External investment management fees for each AFP (% of total assets)
Fund type A, average for September quarter 2016



Source: Superintendencia of Pensions.²⁴

Box 1: Comparison of fees of Chilean AFPs and Australian MySuper products

There are inherent difficulties in comparing fees of different pension systems. In particular, systems differ regarding the products and services offered to members (such as investment strategies), which are reflected in fees. Further, systems differ regarding specific fee structures. That said, fees for MySuper products compare favourably with fees in the Chilean system – as concluded by Chant West in their 2016 research paper *Chilean Pension System: Updated comparison with Australia* (note that ASFA has updated the fee figures for Chile for new data, so these differ from Chant West's figures).

A comparison of fees needs to consider total fees. Fee categories are defined differently in the two systems. In particular, AFPs' administration fees incorporate the cost of internal investment management.

Administration fees for AFPs are higher on average than for Australian MySuper products. For AFPs, administration fees are equivalent to an average of 0.61 per cent of assets.²⁵ Research undertaken by Chant West shows MySuper products administration fees average 0.28 per cent of assets.²⁶ The current tender holder, AFP Planvital, charges administrative fees equivalent to 0.17 per cent of assets.²⁷ However, as discussed later in this paper, fees of this level risks adverse outcomes for both Planvital – in terms of its viability as a corporate entity, and its members – in terms of net returns and service quality.

Comparison of investment fees needs to account for differences in portfolio composition. In particular, Australian funds have a higher allocation to growth and alternative asset classes.²⁸ As such, investment fees for MySuper products should be compared with the investment fees for AFP funds with comparable asset allocations. MySuper products have a similar asset allocation (on average) to AFP Fund type A – the exposure to growth assets is 72 per cent and 76 per cent respectively.²⁹ Investment fees for MySuper products average 0.59 per cent of assets, whereas external investment fees for AFP Fund type A average 0.48 per cent.³⁰

Overall, total MySuper fees average 0.87 per cent of assets, which is lower than the average fees for AFP Fund A (1.09 per cent).³¹ Also, MySuper fees compare favourably to Planvital's fees. Although Planvital's fees are somewhat lower (0.69 per cent versus 0.87 per cent), Planvital has produced relatively poor investment outcomes, which more than offset the lower fees it charges (see Section 6.1 for more details).³²

Risks of the Chilean tender process

6.1: The tender process is based on fees, which poses risks to member outcomes

The tender process is based on the administration fees that AFPs charge their members. For those AFPs that win the tender, the tender process puts downward pressure on AFPs' costs and margins. However, the focus on fees by those AFPs risks compromising their net returns and the quality of their member services.

Risk: Lower returns from in-house investment management

AFPs' administration fees cover the cost of any in-house investment management, so there is an incentive for AFPs that win the tender to reduce the resources devoted to in-house investment management (see the next part of this section for more on outsourcing of investment management). On average, AFPs manage around 60 per cent of their assets in house.³³

AFP Planvital's recent investment performance highlights the risks of the tender process to funds' returns. Planvital's investment outcomes have been relatively poor compared with those of the other AFPs over the past three years. Since February 2014, Planvital's gross returns for each of its fund types have been the lowest (on average) within the respective fund cohorts (Chart 6). In contrast, prior to winning the tender, Planvital's returns were on par with other AFPs (note that AFPs must offer four or five separate funds, which are differentiated by prescribed limits on allocations to variable income investments – see Box 2).

Ultimately, what matters for members are net investment returns. The outcomes in Chart 6 are for gross returns. Planvital's total fees are around 0.40 per cent lower than the industry average (0.69 per cent compared with a weighted average for the industry of 1.09 per cent - see Box 1).³⁴ Accounting for this, the returns for Planvital's A, B and C funds would be at the bottom of the relevant distribution.

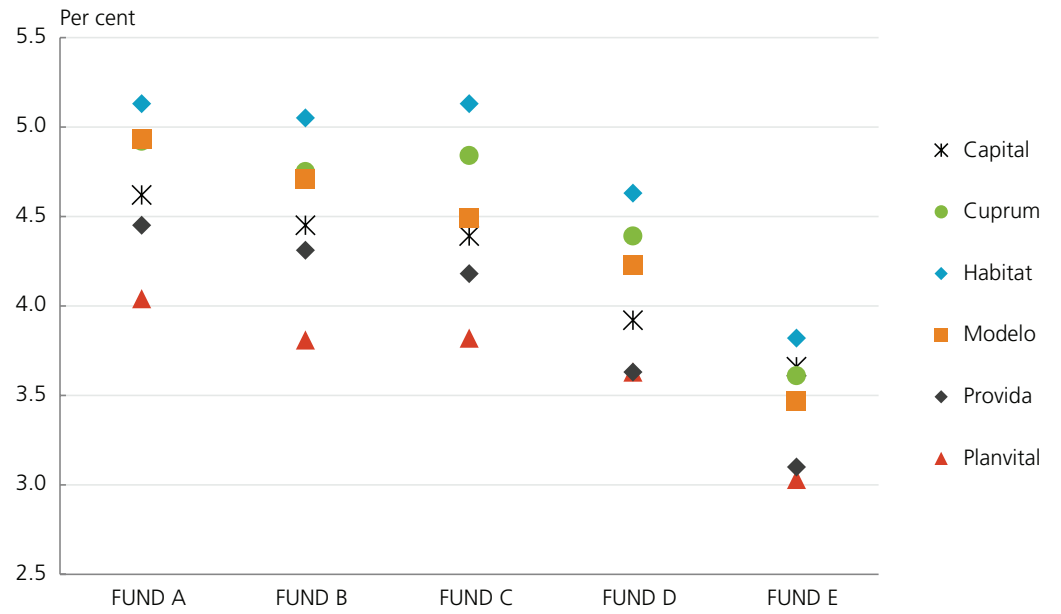
Although a number of factors may explain the relative deterioration of Planvital's investment performance, cutting costs to accommodate lower fees is likely to have contributed. Chant West notes Planvital has less resources devoted to investment management than the other providers, as part of its low cost structure.³⁵

The tender system incorporates mechanisms that permit new members to switch from the tender winner to another AFP if returns are relatively poor. However, these are not likely to be an effective check on AFPs' behaviour.

Firstly, new members can switch if their funds' gross returns are below minimum benchmarks (see Box 2). However, these minimum benchmarks are arguably too low to be effective. For example, the returns of AFP Planvital's funds since it won its first tender are well above the minimum return benchmarks. Secondly, there is scope in the regulations to permit new members to switch if their funds' net returns are relatively low. However, the criteria that need to be satisfied are not well specified – which limits their effectiveness.³⁶

A broader problem with these switching mechanisms is the benefits to individuals and the broader system depend on new members—who have been automatically allocated to an AFP—being sufficiently engaged to monitor their funds' performance and to make the decision to switch. Indeed, historically, fees have not been a particularly strong driver of members' choice of AFP.³⁷

Chart 6: Real gross average annual returns of funds, by AFP and fund type
 From February 2014 to January 2017



Source: Superintendencia of Pensions.³⁸
 Note: Returns data for the exact period of PlanVital's tender are not available.

Box 2: Minimum return benchmarks for funds

AFPs must offer four or five separate funds, differentiated by prescribed limits on allocations to variable income investments – which include equities and interests in mutual funds. Fund type A is optional, although all AFPs currently offer Fund type A.³⁹ The prescribed limits on variable income investments are in Table 3.

Table 3: Portfolio limits on variable income investments

| Fund type | Maximum limit | Minimum limit |
|-----------|---------------|---------------|
| Fund A | 80% | 40% |
| Fund B | 60% | 25% |
| Fund C | 40% | 15% |
| Fund D | 20% | 5% |
| Fund E | 5% | 0% |

For each fund type, regulations prescribe minimum return benchmarks.⁴⁰ If a fund does not meet its benchmark, the AFP must top-up members' accounts from its reserve fund, which is funded by the AFP.

For Funds A and B, the minimum return is the lesser of:

- the average of the three-year real returns of all funds of that type, less four per cent
- the average of the three-year real returns of all funds of that type, less half the absolute value of that average.

For Funds C, D and E, the minimum return is the lesser of:

- the average of the three-year real returns of all funds of that type, less two per cent
- the average of the three-year real returns of all funds of that type, less half the absolute value of that average.

Not only do the minimum benchmarks provide significant leeway for fund performance, the three year benchmark timeframe may incentivise AFPs to take a relatively short-term investment focus.

Risk: Limits on external investment management may adversely affect returns

AFPs have an incentive to outsource investment management to external managers. This is because the cost of external investment management is not incorporated in AFPs' administration fees and thus is not incorporated in the tender process. It should be noted that outsourcing investment management is a legitimate strategy for AFPs – after all, it is a common feature of pension systems throughout the world.⁴¹

There are some restrictions, however, on external investment management that may adversely affect member outcomes. In particular, there are prescribed caps on the fees AFPs can pay external investment managers (Table 4). To the extent that the caps restrict investment managers from investing in particular assets—in order to deliver higher returns and/or diversification benefits—the caps would lead to sub-optimal investment outcomes for members.⁴²

Table 4: Limits on fees for external investment management

| Asset class | Asset sub-class | Type | Maximum fee (% of assets, annual terms) |
|--------------------|----------------------|------------|--|
| Shares | Domestic, Global, EM | Index | 0.60 |
| | Domestic, Global | Active | 1.29 |
| | EM | Active | 1.59 |
| Bonds | Domestic | Index | 0.26 |
| | | Active | 0.75 |
| | | High-yield | 1.01 |
| | Global | | 1.02 |
| | EM | | 1.07 |
| Diversified | | | 1.11 |
| Cash | | | 0.61 |
| Other | | | 1.97 |

Source: Joint Resolution between Superintendent of Pensions, Superintendent of Securities and Insurance and Superintendent of Banks and Financial Institutions.⁴³

Risk: Lower quality administrative functions and member services

AFPs that win the tender have an incentive to reduce the quality of their administrative functions and/or reduce the quality and range of their member services. AFPs' fee revenues cover the cost of a range of functions. These include back office administrative functions, such as processing contributions and paying pensions, and member services, such as operating call centres and providing member information via websites. Funds are, however, limited regarding the degree to which they can reduce service quality – tenders do require winning AFPs to maintain a number of minimum service standards.⁴⁴

Chile's pension regulator (the Superintendencia de Pensiones, or SP) assesses the quality of three broad AFP functions – managing pension accounts and processing pensions, managing accumulation accounts and collecting contributions, and providing information to members. For its Service Quality Index, SP uses 75 indicators, against which each AFP's performance is scored.

Unfortunately, the lack of recent public data means it is difficult to draw firm conclusions about the effects of the tender process on service quality – the last published data is for April 2014. AFP Modelo won the tender in 2010 and again in 2012. The available data shows that the quality of AFP Modelo’s administrative functions and member services was around 20 per cent lower than the average of the other five AFPs for the period for which data is available.⁴⁵ Given data limitations, the most that can be concluded is the tender process has accommodated relatively poor quality administrative functions and member services.

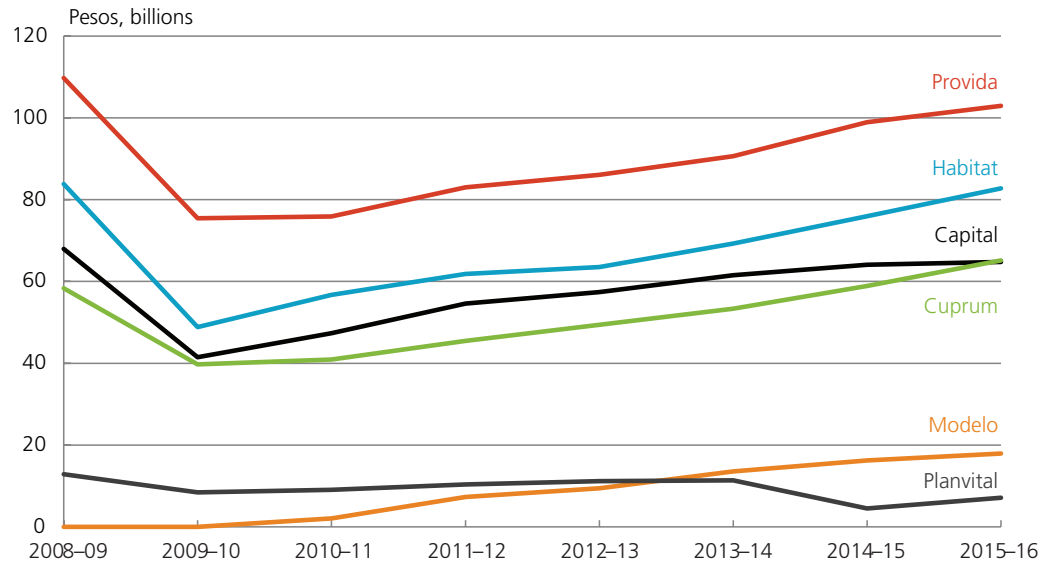
6.2: Successive tender rounds have increased risks for AFPs that win tenders

When an AFP submits a bid lower than its current fee, it is making a judgement that its loss of fee revenue on a per member basis will be more than offset by the effect of a higher number of members (given the winning AFP will be allocated all new workers for the next two years). The two key considerations for an AFP are the expected number of new members and the expected incomes of all of its members – new and existing.⁴⁶ However, both of these factors—and thus AFP fee revenue—are uncertain and vulnerable to adverse shocks. Ultimately, the lower the level of fees, the greater the risks to an AFP’s financial viability.

Risk: Effects of adverse macroeconomic conditions

A major risk to AFP fee revenue is domestic economic and labour market conditions. Growth in employment and wages directly affect member contributions and thus directly affect fee revenue. An economic downturn would adversely affect contributions from existing members to all AFPs, and curtail the flow of new members to the AFP holding the tender. The effects of an economic downturn are evident in Chart 7. Chile was in recession in 2009 and the unemployment rate increased from 8 per cent to 11 per cent.⁴⁷ AFP revenues fell markedly in fiscal year 2009–10.

Chart 7: AFP revenue, financial year



Source: Superintendencia of Pensions.⁴⁸

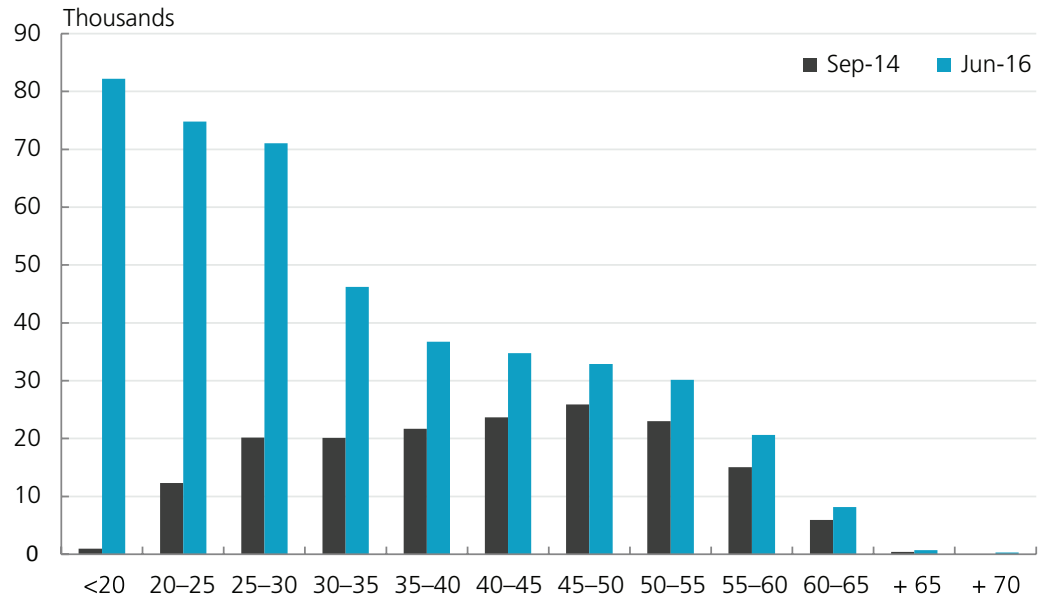
The tender process exacerbates such risks. Successive tender rounds have pushed down fees for the tender holder. The lower the level of fees, the more vulnerable an AFP is to adverse shocks to member contributions.

Risk: Weak contributions from new members

For tender holders, there are also risks to fee revenue associated with the flow of new members. A large proportion of new members will be workers entering the labour force for the first time.⁴⁹ On average, new labour force entrants have lower incomes than the existing workforce, and thus contribute less in fees than existing workers (on average). All else being equal, the effect of new members on an AFPs' fee revenue would be larger for AFPs with relatively small memberships, where new members would account for a relatively large proportion of the AFP's membership.

The experience of AFP Planvital bears this out. Planvital won the 2014 and 2016 tenders. In 2014, Planvital won the tender with a bid of 0.47 per cent, which was far lower than its prevailing administration fee of 2.36 per cent. As expected, Planvital's revenue fell in fiscal year 2014-15 (Chart 7). Although Planvital's revenue increased thereafter, as it received new members, revenue has yet to recover to its 2013-14 level. Planvital received 270,000 new active members during its first tender, but those were younger and had lower incomes (on average) than Planvital's existing active members (Chart 8), and so did not contribute as much on a per person basis.

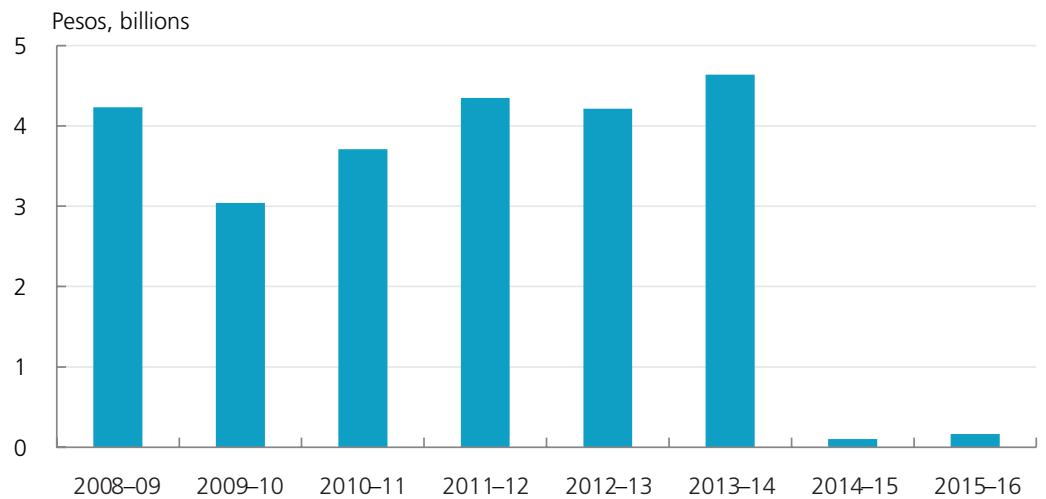
Chart 8: AFP Planvital's active members, by age cohort



Source: Superintendencia of Pensions.⁵⁰

As a result, Planvital's operating profit declined sharply in 2014–15 (Chart 9). Note that AFP profit is the profit of the administrator itself, not of its funds. If an AFP fails, the assets of the members would not be affected, but would be transferred to another AFP and subject to the new fund's fee regime.⁵¹

Chart 9: AFP Planvital's profit, financial year



Source: Superintendencia of Pensions and ASFA calculations.⁵²

The broader point is that the tender process poses risks to the sustainability of individual AFPs, and this is likely to affect AFPs' willingness to participate in future tenders.

For an existing AFP, winning the tender would lead to a large fall in fee revenue from its stock of existing members (an AFP has to charge the same administrative fee to all of its members). This would lead to a large fall in the AFP's profits.

For a potential new AFP, winning the tender would allow the AFP to enter the system. However, it would do so in a vulnerable financial position – particularly with respect to fee revenue. Firstly, the new AFP would have the lowest administrative fee in the market.

Secondly, its fee revenue per (active) member would be lower than for a large established fund with same administrative fee. This is because the membership of a new AFP would be much younger and have much lower incomes (on average) compared with a large established fund. These issues are explored in more detail in Section 7.

6.3: Successive tender rounds have not led to an increase in competition

A key aim of the tender process was to entice new AFPs into the market and increase the degree of competition among AFPs. This has not occurred.

Since the start of the tender process in 2010, only one new AFP has entered the market – AFP Modelo in 2010. This increased the number of AFPs from five to six. In 2012, a prospective AFP (Regional) bid for the tender. It did not win the tender and did not begin operating.

Lack of market entry, coupled with the aforementioned risks, suggests that successive tender rounds may have bid fees down to levels where potential new AFPs do not consider it viable to enter the market and bid in the tender for new members.

Participation in the tender process from existing AFPs has also declined – from four participants in the first tender in 2010, down to a single participant in the latest tender round (Table 5). For the other AFPs, the current tender-winning fee may be too low to warrant participation in future tenders – the current tender-winning fee is less than half of the current calculated average fee. For the other AFPs, winning the tender would lead to a dramatic fall in their fee revenues and profitability.

Table 5: Tender bids (% of monthly income)

Grey denotes tender winner

| | Cuprum | Habitat | Modelo | PlanVital | Regional* |
|-------------|--------|---------|--------|-----------|-----------|
| 2010 | 1.32 | 1.21 | 1.14 | 1.19 | |
| 2012 | | | 0.77 | 0.85 | 1.04 |
| 2014 | | | 0.72 | 0.47 | |
| 2016 | | | | 0.41 | |

Source: Superintendencia of Pensions.
*Regional was a prospective AFP.

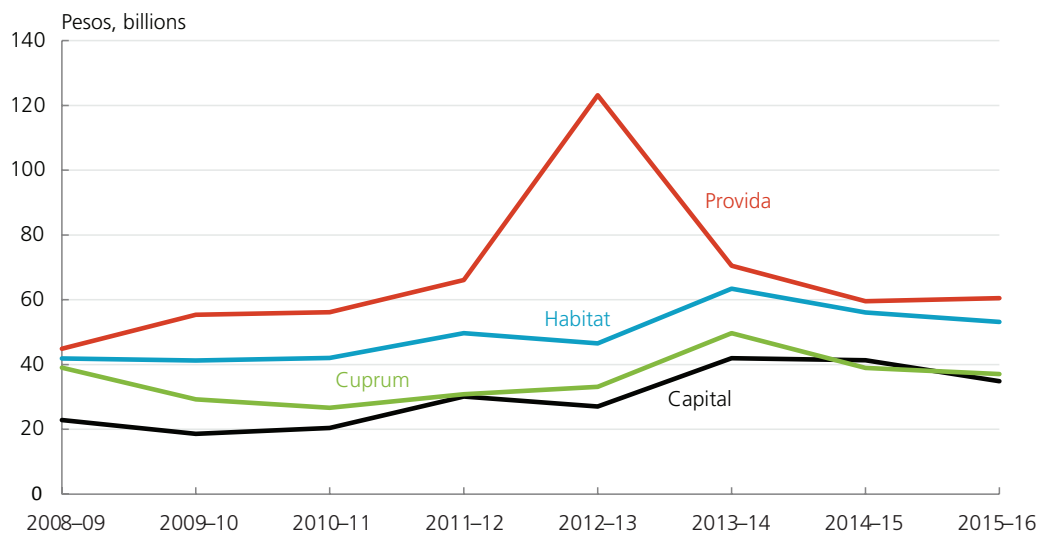
Looking ahead

A key question to ask is how the Chilean system might evolve from here, given that:

- the administration fee for the tender winner has been bid down to a very low and potentially unsustainable level
- participation by AFPs in tender rounds has diminished
- the low level of fees in the tender process means it is less viable for a new, prospective AFP to enter the system and participate in the tender process.

The large AFPs have little incentive to participate in the tender process, nor unilaterally reduce their fees – at least not at present. Charts 7 and 10 show their revenues are still growing at a reasonable pace—driven by wage growth for workers in their existing membership and fees from retirement-phase incomes⁵³—and profits are at the levels of the past few years.

Chart 10: Profit (before tax) for the large AFPs, financial year



Source: Superintendencia de Pensiones.⁵⁴

Note: for AFP Provida, the sharp increase in profit in 2012–13 was driven by the sale of equity interests in foreign pension fund entities.

Over time, revenues and profits of this group of AFPs are likely to come under pressure from declining memberships. Those AFPs that do not participate in the tender process are likely to experience a slow decline in the number of members – not all retirees will stay with their AFP (retirees can purchase annuities and so exit the system), and AFPs that do not win a tender will not be allocated new members.

Another potential source of membership decline for this group of AFPs is member switching. Existing members of these AFPs may switch to the AFPs that win the tender rounds and charge lower fees. At present, however, there is little evidence of switching pressure. Table 6 shows the number of members that have transferred to each AFP for each of the four tender periods. Funds that have won the tenders (highlighted) have not received materially higher transfers from the other AFPs.

Table 6: Number of inward transfers of AFP members

| | Number of inward transfers – monthly average | | | |
|------------------|--|-----------------------|-----------------------|----------------------|
| | Modelo tenders | | Planvital tenders | |
| | Aug 2010 to July 2012 | Aug 2012 to July 2014 | Aug 2014 to July 2016 | Aug 2016 to Nov 2016 |
| Capital | 6,646 | 9,039 | 8,490 | 11,615 |
| Cuprum | 4,455 | 5,322 | 5,559 | 5,747 |
| Habitat | 4,505 | 5,052 | 7,493 | 11,464 |
| Modelo | 343 | 2,592 | 4,662 | 11,051 |
| Planvital | 2,813 | 3,307 | 3,677 | 8,085 |
| Provida | 6,432 | 11,837 | 12,717 | 12,335 |

Source: Superintendencia of Pensions.⁵⁵

If pressure does build on the larger AFPs to reduce fees, then it is likely these AFPs would not participate in the tender process, but instead reduce fees unilaterally in order to retain members – as noted earlier, for this group of AFPs, winning the tender would lead to very large falls in revenue. In doing so, AFPs would judge whether the loss in revenue on a per member basis would be more than offset by the effect of a higher number of members (than otherwise would be the case).

The available evidence, however, suggests the current circumstances could persist for some time – where there is little movement in fees at either end of the spectrum. Pressure on larger AFPs is likely to build slowly. Meanwhile, fees in the tender process are at a very low and potentially unsustainable level, so it is unlikely that fees will be bid down to any great degree.

If large AFP's were to unilaterally reduce fees, the key risk of this dynamic is it would lead to a 'race to the bottom' at a system-wide level. The analysis throughout this paper highlights the risks of fee-based competition – in particular, that AFPs reduce their fees at the expense of investment returns and services to members. Further, the lower the level of fees, the more vulnerable an AFP is to adverse shocks to member contributions. In a system focused on reducing fees (either via tender or unilaterally), these risks may become systemic.

Lessons for Australia

Some commentators claim that adoption of a Chilean-style tender system for default funds for new job starters would substantially reduce the costs of the Australian superannuation system.

However, such a claim is not plausible when the facts of how the system operates in Chile are considered. The Chilean tender system has not led to a broad-based reduction in fees and successive tender rounds have not increased competition. The Chilean Government introduced the tender process to solve a particular set of issues:

- there were a very small number of pension fund providers in the market
- there was a lack of competition
- individuals did not have access to low-cost fund options

These issues, however, are not features of the Australian super system. Australia has a very large number of super providers, ranging from corporate, industry, public sector, retail and self-managed funds. Unlike the market structure in Chile, the Australian super industry demonstrates the characteristics of a competitive market. For example, there are low levels of market concentration at the fund level with many funds operating. Policy settings and market practices such as choice of fund and member investment choice have also served to enhance competition.

A substantial proportion of members actively choose the fund they are in, or consciously endorse the use of the default fund of their employer.

In addition, the Australian system already has low-cost product options, which are automatically provided for default members and which are available for all superannuation contributors. More specifically, MySuper products are designed for 'default' members who do not make an active decision, and a large number of super funds offer a MySuper product. Default superannuation contributions can only be made by an employer to a MySuper product.

As shown in this paper, MySuper fees compare favourably with fees in the Chilean system when assessed on a truly comparable basis.

Adoption of a Chilean-style tender process where only the lowest cost fund (or funds) is selected would likely have a deleterious effect on member outcomes. In particular, a tender process would likely see funds develop products for the tender process that focus on just lower fees at the expense of long-term returns. In Australia, there are much higher allocations to equities and unlisted investments compared with Chile. While these may involve higher fees, they also offer the prospect of higher net returns. A focus on just lower fees would lead to inferior investment outcomes for fund members, and a lower standard of living in retirement.

Further, a focus on just lower fees would likely lead to a significant reduction in the range and quality of products and services offered to members.

Adoption of a Chilean-style tender process would increase financial risks for providers of superannuation services. A feature of the Chilean system is that successive tender rounds have increased risks for the providers that win tenders. In particular, the lower the level of fees, the more vulnerable a provider is to adverse shocks to member contributions – such as from an economic downturn. As indicated in this paper, fewer and fewer Chilean providers have participated in successive tender rounds.

While some commentators suggest that the tender system in Chile is working well, a careful consideration of outcomes in that country indicates that this is not the case. Differences between the systems in Chile and Australia also mean that a Chilean-style tender process would not deliver benefits for fund members if it were to be introduced in Australia.

Adoption of a Chilean-style tender process in Australia would be, in essence, a solution that is not working well in Chile looking for problems that do not exist in Australia.

References

1. When the current system was implemented in 1981, the then Government anticipated that the pensions provided by private pension administrators (the AFPs) to retirees would amount to about 70% of workers' final pre retirement salary. However, for the majority of current (and prospective) retirees in the system, retirement incomes are (will likely be) far less (The Economist 2016, 'The perils of not saving', 27 August and Barr, N. and Diamond, P. 2016, 'Reforming pensions in Chile', *Polityka Społeczna*, No. 1, pages 4-9).
2. According to the latest OECD research, Chile's net replacement rate for average income earners is 38%. This is much lower than the OECD average of 63% (OECD 2015, *Pensions at a Glance 2015*). The net replacement rate as calculated by the OECD is equal to the ratio of retirement income to life-time earnings (after tax). The OECD's replacement rates are forward looking – the OECD projects replacement rates for workers that are just now entering the workforce. Although such projections should be treated with caution — they assume that current legislative settings do not change and they are sensitive to assumptions — they are instructive.
3. Superintendence of Pensions 2010, *The Chilean Pension System*, page 165.
4. It is not compulsory for the self-employed to make contributions. The 2008 reforms included a phased-in mandatory contribution regime that was meant to start in 2012. However, the government has yet to enforce this.
5. There is a statutory maximum monthly mandatory contribution. The regulator adjusts the maximum contribution at the beginning of each calendar year in line with an increase in the official Real Wage Index during the previous year (specifically, the increase in the index for the year to November). The maximum contribution is not adjusted for a fall in the index. For 2017, the maximum monthly contribution is CLP1,994,864 or US\$2,997 – set for the year from 11 January 2017. (Superintendence of Pensions 2010, *The Chilean Pension System*, pages 32-33 and Superintendence of Pensions 2017, *Resolución Exenta No. 9*, 5 January, <http://www.spensiones.cl/portal/regulacion/582/w3-article-11155.html>).
6. A retiree can either receive a 'programmed' income stream from his/her AFP, use the balance to purchase an annuity (from a life insurance company), or choose some combination of the two.
7. If an individual's calculated pension is greater than 150% of the minimum State-guaranteed pension, and greater than 70% of the individual's average monthly taxable wage over the last ten years, the individual may withdraw the surplus as a lump sum (Superintendence of Pensions 2010, *The Chilean Pension System*, pages 42-43).
8. OECD 2009, *Pension Reform in Chile Revisited: What Has Been Learned?*, OECD Social, Employment and Migration Working Papers No. 86, page 45.
9. Data from Superintendence of Pensions: Afiliados activos por AFP, anuales (http://www.spensiones.cl/safpstats/stats/.sc.php?_cid=43).
10. OECD 2009, *Pension Reform in Chile Revisited: What Has Been Learned?*, OECD Social, Employment and Migration Working Papers No. 86, pages 32-33.
11. BBVA 2010, *Pension Reforms in Latin America: Balance and Challenges Ahead*, page 62.
12. OECD 2009, *Pension Reform in Chile Revisited: What Has Been Learned?*, OECD Social, Employment and Migration Working Papers No. 86, page 34.
13. This chart incorporates the various fees that AFPs have charged at various times: administration fees as a percentage of monthly income; administration fees as a percentage of assets (eliminated in 1988); flat monthly administration fees (eliminated in 2010); and premia for disability and survivors' insurance (which is broadly equivalent to disability and life insurance in the Australian superannuation system).
14. Data from Superintendence of Pensions 2010, *The Chilean Pension System*, page 190.
15. Superintendence of Pensions 2010, *The Chilean Pension System*, page 166.
16. Data from Superintendence of Pensions: Estructura de comisiones, mensuales (http://www.spensiones.cl/safpstats/stats/.sc.php?_cid=42) and Activos de los Fondos de Pensiones, mensuales (http://www.spensiones.cl/safpstats/stats/.sc.php?_cid=46).
17. Data from Superintendence of Pensions: Estructura de comisiones, mensuales (http://www.spensiones.cl/safpstats/stats/.sc.php?_cid=42).
18. Administration fees in the Chilean system are levied on monthly income, so are not directly comparable to the fees levied by Australian funds. Balances at retirement are equalised for the two fee regimes with the following assumptions – 40 years of contributions, real rate of return on investment of 5% and real wage inflation of 1.8%. This is consistent with OECD methodology – see OECD (2012) *OECD Pensions Outlook 2012*.
19. The percentage of assets figure is weighted by assets.
20. The methodology for calculating fees as percentage of assets is outlined in footnote 18.
21. Derived from Superintendence of Pensions 2016, *Fees paid by pension funds, June-September 2016* (https://www.spensiones.cl/portal/informes/581/articles-11036_recurso_1.pdf).
22. Superintendence of Pensions 2016, *Fees paid by pension funds, June-September 2016* (https://www.spensiones.cl/portal/informes/581/articles-11036_recurso_1.pdf).
23. Superintendence of Pensions 2016, *Fees paid by pension funds, June-September 2016* (https://www.spensiones.cl/portal/informes/581/articles-11036_recurso_1.pdf).
24. Superintendence of Pensions 2016, *Fees paid by pension funds, June-September 2016* (https://www.spensiones.cl/portal/informes/581/articles-11036_recurso_1.pdf).
25. ASFA calculations. Administration fees in the Chilean system are levied on monthly income, so are not directly comparable to the fees levied by Australian funds. The methodology for calculating fees for AFPs as a percentage of assets is outlined in footnote 18. The percentage of assets figure is weighted by assets.
26. Chant West 2016, *Chilean Pension System: Updated comparison with Australia, December*.
27. ASFA calculations (see footnote 18).
28. Chant West 2016, *Chilean Pension System: Updated comparison with Australia, December*.
29. Chant West 2016, *Chilean Pension System: Updated comparison with Australia, December*.
30. ASFA calculations and Chant West 2016, *Chilean Pension System: Updated comparison with Australia, December*.
31. ASFA calculations and Chant West 2016, *Chilean Pension System: Updated comparison with Australia, December*.
32. Chant West 2016, *Chilean Pension System: Updated comparison with Australia, December*.
33. Derived from Superintendence of Pensions 2016, *Fees paid by pension funds, July-September 2016* (https://www.spensiones.cl/portal/informes/581/articles-11036_recurso_1.pdf).
34. Weighted by assets.

35. Chant West 2016, *Chilean Pension System: Updated comparison with Australia*, December.
36. The law permits new members of the tender winner to switch to another AFP if the lower fee charged by the tender winner does not compensate for the greater yield that could be obtained by members in any other AFP (from the date of affiliation). However, is difficult to compare net returns between AFPs. This is because administrative fees are quoted on a percentage of contributions basis, rather than a percentage of assets basis. In this regard, the OECD notes that one of the great difficulties produced by the Administrators' charging structure is that it makes it impossible to measure their efficiency in managing the resources directly, because the commissions that members are charged cannot be compared directly with the yield obtained by the Pension Fund. (OECD 2011, *Chile: Review of the Private Pensions System*, October and Superintendence of Pensions 2010, *The Chilean Pension System*, page 167 and Superintendence of Pensions 2009, Circular No. 1640, page 8, <http://www.spensiones.cl/files/normativa/circulares/CAFP1640.pdf>).
37. An important factor that affects competition in the industry is the low price elasticity of demand with respect to fees (BBVA 2010, *Pension Reforms in Latin America: Balance and Challenges Ahead*, page 101).
38. Data from Superintendence of Pensions: Rentabilidad Real de los Fondos (<http://www.safp.cl/safpstats/stats/rentabilidad/getRentab.php?tiprent=FP>).
39. Data from Superintendence of Pensions: Rentabilidad Real de los Fondos (<http://www.safp.cl/safpstats/stats/rentabilidad/getRentab.php?tiprent=FP>).
40. Broadly speaking, AFPs' investment funds are differentiated by the proportion of assets invested in variable income investments (such as equities) and fixed income investments (such as bonds). Regulations set the minimum and maximum proportions for variable income investments – for example, equities and interests in mutual funds (Superintendence of Pensions 2009, Régimen de los Fondos de Pensiones: Decreto Ley No. 3500, Title IV, Article 45, page 51, http://www.spensiones.cl/portal/informes/581/articles-3520_libro3500completo.pdf).
41. Superintendence of Pensions 2009, Régimen de los Fondos de Pensiones: Decreto Ley No. 3500, Title IV, Article 37, pages 46-47, (http://www.spensiones.cl/portal/informes/581/articles-3520_libro3500completo.pdf).
42. External managers may have specialist knowledge of particular asset classes or countries that lead to superior net returns for members. More broadly, where investment regulations are a binding constraint on funds' investment choices, these result in an inefficient combination of risk and return.
43. Superintendence of Pensions 2014, Joint Resolution between Superintendent of Pensions (No.41), Superintendent of Securities and Insurance (No.175) and Superintendent of Banks and Financial Institutions (No.183), 27 June 2014 (https://www.spensiones.cl/portal/regulacion/582/articles-10568_recurso_1.pdf).
44. The regulator sets a range of minimum service standards for AFPs. Minimum standards for websites include that they are have adequate security features and provide members with prescribed information. Other minimum service standards include waiting times at service centres (90 minutes). AFPs have discretion regarding some member services – such as provision of retirement calculators. Superintendence of Pensions, Administrative and Operational Aspects of Pension Fund Administrators and the Institute of Social Security (see <https://www.spensiones.cl/compendio/584/w3-propertyvalue-2573.html>).
45. Superintendent of Pensions, Service Quality Index (<https://www.spensiones.cl/portal/institucional/578/w3-propertyvalue-6324.html>). The last data point is for the March quarter 2014. The lack of subsequent data means that the quality of AFP Planvital's administrative functions and member services cannot be assessed. AFP Planvital won the 2014 tender (for the two-year period starting August 2014).
46. In 2009, the OECD noted that about 200,000 new members had flowed into the AFP program every year. As such, around 400,000 would be expected to be allocated to the tender winner during the two-year tender period (OECD 2009, *Pension Reform in Chile Revisited: What Has Been Learned?*, OECD Social, Employment and Migration Working Papers No. 86, page 55).
47. IMF 2016, *World Economic Outlook Database*.
48. Data from Superintendence of Pensions: Boletín Estadístico Electrónico, Estados Financieros (<https://www.spensiones.cl/apps/boletinEstadistico/>).
49. New members also could include individuals that transfer from another AFP.
50. Data from Superintendence of Pensions: Número de cotizantes hombres por edad y AFP and Número de cotizantes mujeres por edad y AFP (http://www.spensiones.cl/safpstats/stats/.sc.php?_cid=13).
51. An AFP is separate from the funds that it administers, which are, in effect, owned by the members (OECD 2011, *Chile: Review of the Private Pensions System*, page 17).
52. Data from Superintendence of Pensions: Boletín Estadístico Electrónico, Estados Financieros (<https://www.spensiones.cl/apps/boletinEstadistico/>).
53. Superintendence of Pensions 2010, *The Chilean Pension System*.
54. Data from Superintendence of Pensions: Boletín Estadístico Electrónico, Estados Financieros (<https://www.spensiones.cl/apps/boletinEstadistico/>).
55. Data from Superintendence of Pensions: Traspasos enviados desde cada tipo de Fondo hacia otras Administradoras, por Fondo (http://www.spensiones.cl/safpstats/stats/.sc.php?_cid=2).