Weak financial links in Chile: too dependent on pension funds

There are two soft spots in our financial system that need to be addressed: one is the dependency of the banking industry on domestic pension funds for long term financing resources; the other, the undercapitalized life insurance industry that pays two thirds of domestic pensions under an annuity structure. Both of these situations could be in the process of being fixed, at last.

To put some figures into perspective it is useful to remind that Chilean GDP for the last four quarters ending June 2008 was approximately US$ 149 billion, growing near 4% annually. At that date, pension funds assets accumulated US$ 107 billion, the life insurance industry managed assets close to US$ 31.6 billion and had US$ 3.5 billion in equity, banking assets and loans were around US$ 182 billion and US$ 121 billion, respectively, whereas the banking industry equity amounted to near US$ 12 billion. Pension funds investments in the banking industry in deposits, bank bonds and shares represented 30% of its total assets, or US$ 32 billion, or 2.6 times the amount invested by banking equity holders themselves.

Pensions and annuities: healthy capital increases in place

In terms of annual cash flows beyond net returns on investments, pension funds collect US$ 4 billion, approximately. People get pensions directly from pension funds (one third of pensions) running down savings under variable payments according to life expectations and returns on the funds that are periodically updated, or by having an annuity contract with a life insurance company (two thirds of pensions) that promises to pay a fixed amount until death. Total pensions paid out of the whole system amount to approximately US$ 2.5 billion annually, while the difference with the US$ 4 billion cash inflow basically increases the assets under pension funds administration. At present time, life insurance companies annually collect from pension funds, for new annuities contracts, a little over what they disburse in annuities already paid for in past decades (US$ 1.7 billion). In other words, beyond net returns on investments, from a collective point of view there is more liquidity coming into the pension system than getting out of it; individually, pension funds continue growing while the life insurance industry is flattening out in its annuity business. The latter fact means that capital requirements in this annuity industry have to be much more observed, for their eventual weakness debilitates the whole pension system. Given the annuity business structure based on demographics and its starting period almost three decades ago, the excess liquidity that it had in the past when the system was growing will cease to exist in the near future under these new more mature industry conditions, so that it will not be able to count on it to smooth out fresh capital needs.

In that sense, the required actualization some years ago of life expectation actuarial tables ordered by regulatory authorities, due to dynamic and larger living periods - ranging from 3 to 5 years dependent on age - for the last two decades and that were not entirely internalized, will in the end demand capital increases of approximately US$ 1.4 billion in the life insurance industry – equivalent to 40% of its equity and inferred from notes to financial statements (SVS) -, if it wants to remain operating under historic leverage levels. The above mentioned figure does not consider yet a lower interest rate to value liabilities, a rate that has remained fixed at a minimum of 3% since the 1980’s, even after having had lower risk free domestic rates in the recent past. A new 2.5% discount rate could be a minimum adjustment, consistent with real long term US Treasury bond rates. Either way, lower business growth makes capital requirements to be closer in time. Ultimately, what authorities are doing is to make sure pension liabilities in annuities are covered by assets under low reinvestment rates.

Banks and that too friendly 30% pension funds investment allocation

Politely explained, an obligatory but successful pension system with individually owned accounts has ended up with five asset managing firms (AFP’s) - whose controllers usually have various domestic financial arms -, supporting beyond prudence domestic banking. Given the impact of this industry profits on pension funds returns, there has been a further and important reason for regulatory entities to protect it and its market. The final result has been the coexistence of a big mutual dependency and uncompetitive conditions in the markets where

they operate, for too long and in spite of efforts to prevail upon them, as the failure of free trade in services can attest. These conditions reflect, for example, upon credit prices that far exceed banks capital costs - which incidentally are very similar to those in the US financial system - and in onerous life insurance prices, tripling in many cases possible competitive price or interest rate alternatives. Or in the astonishing figure of 84% of commercial credit from banks being supplied to 1.6% of debtors. Or worse, 67% of that commercial credit being directed to 1.943 debtors, 0.3% of them (SBIF).

It so happens that when faced with loosening uncompetitive structures, authorities that oversee these financial industries and pensions payments tend to back off. It is clear that what these same authorities have not internalized is the social cost of having capital markets not working efficiently. There is no free lunch: having pension funds so intertwined in the domestic financial industry has weakened its competitive structure.

One sure way to avoid this systemic risk and uncompetitive consequence is by not allowing an investment in the banking industry going beyond 10% of total pension funds or the equity of it, the smaller one. A short period of time to deleverage from pension funds would create healthy conditions for competition in funds in the banking industry and elsewhere, while at the same time would generate competition in the allocation of credit. No friends in the source of funds, no friends in the allocation of them. Further correction of informational and some operational practices that befit competition and that are under the authorities eyes is necessary; releasing this captured source of funds is essential.

Systemic risks and final comments

The capital increase in life insurance companies corresponds to a systemic need in the pension system; so does the requirement to decrease the importance of pension funds in the banking system. Healthy competition and diversified risks always pay off. Concentrating the financial system into the biggest domestic source of funds has not only generated a less competitive one, but also one too entrenched in a small financial club that costs dearly to Chilean long term development growth prospects.

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