



Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance

Background Paper
Peru Country Study

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Abbreviations

| | |
|------|---|
| AFP | Pension fund management companies |
| CV | <i>Cédula Viva</i> |
| FSAL | Financial Sector Adjustment Loan |
| GDP | Gross domestic product |
| IEG | Independent Evaluation Group (formerly OED) |
| IPSS | Peruvian Institute of Social Security |
| OED | Operations Evaluation Department (changed its name to IEG in December 2005) |
| ONP | Pension Normalization Office |
| PRAL | Pension Reform Adjustment Loan |
| SAFP | Pension Supervisory Authority |
| SAL | Structural Adjustment Loan |
| SBS | Superintendent of Banks and Insurance |
| SNP | National Pension System |
| SPP | Private Pension System |

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Preface

This paper belongs to series of 19 country and regional case studies commissioned as background research for the World Bank's Independent Evaluation Group (IEG) report "Pension Reform and the Development of Pension Systems." The findings are based on consultant missions to the country or region, interviews with government, Bank, donor, and private sector representatives involved in the pension reform, and analysis of relevant Bank and external documents.

This case study was authored by Rafael Rofman in 2002.

Summary

1. In the early 1990s, Peru had one of the smaller pension systems in Latin America, with expenditures below 1.5 percent of GDP, old age coverage below 35 percent, and enrollment in the pension system at less than 20 percent of the labor force.
2. Emerging from a serious public policy crisis in the late 1980s, Peru's political climate under the new Alberto Fujimori administration was strongly pro-privatization. With support from the multilateral financing agencies, the new government implemented pension reform, creating a single-pillar funded scheme that closely resembled the Chilean model.
3. While country assistance strategies did not specifically refer to the social security system, several loans granted during the decade included pension reform goals in their policy matrix. Specific goals included implementation of the newly funded scheme, administrative improvements in the public system, and, later, modifications to the private scheme to increase efficiency and competition.
4. The weakest aspect of the strategy was that policy goals concentrated on the design, implementation, and operation of the private pension system and the administration of the public schemes and ignored the more general and critical problem of coverage. By 1996, less than eight percent of the labor force contributed to any pension system; most of the contributors participated in the Private Pension System (SPP). Because this scheme had only one pillar and (at the time) no minimum benefit, the situation could have resulted in a rapid reduction of the already low coverage levels of the elderly.
5. The system's excessive focus on administration, while overlooking the more important problem of coverage, led us to rate the relevancy of the strategy as modest. Achievement of the policy goals explicitly defined in the different loans, however, brought the overall outcome rating to moderately unsatisfactory.
6. We believe that (i) sustainability of the reforms is unlikely—mainly because the existing problems of coverage make new major reforms likely in the near future, (ii) the institutional development impact was substantial because the World Bank helped organize the two most important agencies: the Office of Pension Normalization (ONP) and the Pension Supervisory Authority (SAFP), (iii) the Bank's performance was unsatisfactory, owing to the poor quality-at-entry, and (iv) the Borrower's performance was satisfactory, owing to the quality of implementation and compliance with the agreed programs.
7. The main lesson learned from the Bank's experience with Peru's pension system during the 1990s is that pension reform should be carefully considered, not as a side issue of fiscal or financial reform, but as major policy in and of itself, where the main goal is not to reduce fiscal expenditures or to promote capital markets, but to provide income security to the aged.

1. Background

The Prior System

1.1 The earliest attempts to create a pension system in Peru can be traced back to the mid-1800s, when a retirement scheme for civil servants was created. This scheme was financed through the budget of each government office and had no central administration. The scheme established conditions for access to benefits but actual access was granted directly by the individual offices and agencies. This model originated some 150 years ago but still exists in Peru today as part of the current (and complex) pension system.

1.2 Beginning in the 1930s, several laws created pension schemes for blue-collar workers, bank and commerce employees, and workers in several other job sectors. The multiplicity of schemes and regulations generated significant inequities and financial problems. In the early 1970s, the government decided to promote a consolidation and reorganization of the pension system. A new two-plan model was thus adopted. Law 19.990 was passed in 1973, creating the National Pension System (SNP), which covered all private-sector workers and many civil servants. Law 20530, enacted in 1974, organized the pension system for special groups of civil servants, maintaining the kind self-financing and administration characteristic of the old pension system. While the new model covered all employees in one of two possible plans, there was wide latitude for various groups to receive special treatment, so much so that the previous inequalities were not completely eliminated.

1.3 The SNP was a pay-as-you-go scheme, managed by the Peruvian Institute of Social Security (IPSS). It was financed by employers and employees, with a total contribution rate of nine percent of gross wages. The benefits included retirement at age 60 for men and 55 for women, with a minimum of 15 and 13 years of contributions, respectively, and with provisions for early retirement, disability, and old age.

1.4 In the mid-1980s SNP covered almost 35 percent of the registered labor force but the subsequent decline in the economic situation during the late 1980s affected the extent of coverage. By 1992, only 27 percent of the labor force was protected by the SNP. More important, these figures indicated the number of workers registered in the IPSS, and not necessarily the number that made actual contributions each month, which was probably less than half.

1.5 The decline in the coverage of active workers did not create a financial problem, thanks to the relative youth of the system's participants. Pension expenditures were very low, at around one percent of GDP in the early 1990s, and the system was financially equilibrated. Of course, given the trends of an aging population and loss of contributors, the ability of the SNP to self-finance would be challenged in the medium term.

1.6 The system approved in 1974 by Law 20530—known as *Cédula Viva* (CV)—covered special groups of civil servants. CV is not truly a single system, because it gives the authority to each unit and local government to grant retirement benefits to its employees under very generous rules. The requirements to qualify for benefits include a

minimum number of years of service (12.5 years for women, 15 years for men) and no minimum age requirement. Benefits are equal to the wage received in the last position the retiree held, and benefits are adjusted whenever wages are adjusted. Law 20530 authorized the national government to set a maximum pension, which was implemented in 1992, but it was ruled unconstitutional by Peru's Constitutional Court in 2001.

1.7 The CV system has no central management of any kind. Benefits are granted by each institution, ministry, local government, or public enterprise, and paid for from the unit's own budget. The Pension Normalization Office (ONP) was given power to supervise and organize these benefits, but much of its authority was cancelled by the Constitutional Court. The lack of control, together with the fact that benefits are linked to the last position the retiree held, regardless of how long he or she was in that position, makes the whole system highly vulnerable to abuse. By 1996, ONP estimated that there were 60,000 active workers and 261,000 beneficiaries in the system, receiving benefits from 806 different governmental offices. Expenditures were estimated at 30 to 50 percent (this figure is higher than SNP's expenditures), despite the fact that it had fewer beneficiaries.

Reforms

1.8 Peru's pension reform was a special process, both in its motivation and development. After a major crisis caused by failed public policies in the late 1980s, a new president with no link to traditional political parties was elected. Alberto Fujimori took office in 1990 and implemented deep structural reforms in an attempt to rapidly expand market-oriented policies and attract international investors.

1.9 The pension system was fiscally stable, although the quality of its benefits (both for pensions and health, provided by the Peruvian Institute of Social Security) was strongly criticized. Pension expenditures were about 1.2 percent of GDP, less than half of what was expected based on the dependency ratio and GDP per capita of Peru.¹

1.10 The system's bad reputation within the society, together with strong support for privatization policies, cleared the way for the creation of a privately managed pension system. In this context, Peru's Minister of Finance Carlos Boloña became a strong promoter of pension reform. A decree was passed in 1991 creating a parallel funded pension scheme, which was scheduled to begin operation in mid-1992. Participation in this new system was to be optional.

1.11 However, in April 1992, President Fujimori suddenly suspended the Constitution, dissolved Congress, and established an authoritarian regime backed by the military. After these events, the government decided to review the decree, with the aim of creating a more privately oriented plan. After publishing a new draft law and then discussing

¹ This estimation is based on a regression of pension expenditures as a percentage of GDP against the old-age dependency ratio and GDP per capita prepared by the World Bank using data collected by Palacios and Pallares (2000).

several alternatives, Decree-Law 25879 was passed in December 1992, thereby creating a new pension system.

1.12 The design of the new system had the technical and political support of Chile's former Minister of Labor Jose Piñera, who was responsible for implementing pension reform in Chile 10 years earlier. The political support of Piñera was critical in convincing President Fujimori to pass the new Decree-Law. In a statement by former Minister of Finance Carlos Boloña, he recounted.

1.13 At the time of the reform, the president of Peru was very concerned. He wasn't convinced that we should privatize the pension system. So we brought José [Piñera] to talk to him, to discuss what privatization had done for Chile. And, of course, José was able to convince him that privatization was in Peru's best interest. The reform might not have been signed into law without José's assistance (Boloña 1997).

1.14 As a result of Mr. Piñera's role, Peru's new pension system was strongly influenced by the Chilean model. The new system was a single-pillar scheme, fully funded and managed by privately run pension fund management companies (AFPs). The old system was not shut down though, and workers could choose either to join the new Private Pension System (SPP) or stay in the old SNP. This option was also open to new workers; those in the SNP could move to the SPP at any time (but not in the other direction after 1996). The system is compulsory for employees in the private sector and for those in the public sector who are not in the CV program. Self-employed workers can join voluntarily.

1.15 Contributions to the SPP were 10 percent of wages (later reduced to 8 percent), plus a commission to cover AFP costs as well as disability and survivors insurance. Workers with a history of contributions before the reform could request a "recognition bond," which was deposited into the worker's individual account. These bonds are price indexed but pay no interest.

1.16 The system had some serious problems in the first few years of operation, which made it unstable and in danger of being closed down. After a strong start, the pace of new memberships in the AFPs decreased by mid-1994 to less than 5,000 new members per month. Some of the problems included the following:

- Personal contributions to SNP were only 3 percent of gross wages. Workers joining the SPP saw their contribution rate increase from 3 percent to about 14 percent of their gross salary. This was compensated for by a compulsory salary increase, but this increase was not always paid and, when it was, it meant higher costs to employers, who did not support the new model.
- Retirement age was five years later for the SPP than the SNP, and the minimum pension for beneficiaries in the SPP was not implemented for several years.
- Contributions to pension funds were not tax deductible.

- The government did not transfer the contributions of its employees for several months after the system started.
- The government was not able to issue the recognition bonds, owing to the lack of reliable individual records.

1.17 These problems were solved within the first few years, however. The face value of recognition bonds was defined by a formula based on the age of the worker at the time of the reform. Some additional changes were introduced in the legislation in 1995, including setting contribution rates at 11 percent² and the minimum retirement age at 65 for both systems. These changes generated renewed interest in the AFPs, and by the end of 1995, new memberships reached 25,000 and were growing rapidly.

1.18 When these new changes to the SNP were introduced, the government decided to close down the independent IPSS and replace it with the ONP—an agency under the Ministry of the Economy—with responsibilities to handle the residual SNP, pay the recognition bonds, and supervise the CV system.

1.19 The CV system underwent a few changes in the 1990s. While it still grants benefits to civil servants and is directly financed through each office's budget, Law 26835 established that ONP was the only entity with power to recognize pension rights. The same law gave authority to ONP to audit existing benefits. However, the parameters are still too generous, with vesting periods of 15 years for men and 12 years for women, no minimum age requirement, and high replacement rates.

1.20 After a few years of adjustment in its design, Peru's social security system consisted of the three main systems: SNP had approximately 800,000 active members and 270,000 beneficiaries; CV had 60,000 active members and 260,000 beneficiaries; and the SPP had 2.5 million members and 4,500 beneficiaries. Some smaller programs still existed as well, such as for the military.

1.21 The introduction of the fully funded pension system occurred simultaneously with a rapid weakening of the labor market during the 1990s. The informal sector grew fast, owing to a reduction in public sector employment and the size of the formal private sector. The National Household Survey (ENAHO) shows that the percentage of Lima's labor force working as "permanent" workers declined from 66 percent in 1990 to 27 percent in 1997. While unemployment was stable (oscillating between 7 percent and 10 percent), wages suffered a sharp decline of almost 50 percent, in real terms, between 1990 and 1997.

1.22 One of the most serious problems of the pension system in Peru was and continues to be its low rate of coverage. Regardless of the different institutional arrangements, labor force participation in the pension system is very low. Among the 3.4 million workers enrolled in any of the three main systems, less than 1.5 million pay their contributions. With a labor force of almost 13 million, actual coverage is, therefore,

² For the SPP, the contribution rate was set at 8 percent plus AFP fees, which were about 3 percent at the time.

below 12 percent. Available data shows a slow increase in coverage over the last few years, but the data on the SNP is not completely reliable and could be overestimating the number of contributors.

1.23 Pension reform in Peru transferred more risks to the future pensioners, both in the original design and after the various reforms. The SPP is a single-pillar scheme, with future benefits exclusively dependent on the financial health of the pension funds. There is no first pillar (as in other countries, such as Argentina, Uruguay, or Colombia), and minimum benefits and return guarantees have been introduced and removed from legislation several times.³ These characteristics may result in a more competitive system and lower fiscal costs, but they also create greater risks for future pensioners.

³ The original law included a minimum benefit, but it was never implemented. In early 2002, Law 27617 created a new minimum. (Minimum-return regulations had been changed several times, until a clear guarantee was established in 2000.)

2. Bank Assistance since the Late 1980

Strategy

2.1 During the 1990s, the Bank's attitude was supportive toward the pension reforms in Peru as a matter of policy, but there was little involvement during the design and implementation stages. The Bank supported the early reform project (which was later replaced by Decree-Law 25879). This position did not change during the decade, and was reinforced in several documents and loans.

2.2 Several World Bank documents during the 1990s refer directly to the pension system, including a 1994 public expenditure review, a working paper on the 1995 pension reform (Kane 1995), and a second working paper (Queisser 1997). Nonetheless, a review of these documents shows that the pension system has never been a high priority for the Bank's strategy in Peru. In fact, the Bank's country assistance strategies contain almost no references to pensions.

2.3 A 1994 public expenditure review did consider the fiscal implications of pension reform. The main concern was the cost of the recognition bonds, which were estimated to have a total cost of US\$5 billion, though they would mature mostly between 2013 and 2017. Consequently, the present value of these bonds was estimated to be about \$600 million.

Table 2.1: World Bank Studies on Pension Reform in Peru

| <i>Document</i> | <i>Main findings</i> | <i>Main proposals</i> |
|---|--|--|
| Peru Public Expenditure Review (World Bank 1994) | Present value of recognition bonds is estimated at \$600 million. The CV program is also very expensive. | Review the CV system. |
| Peru: Options for Pension Reform (Kane 1995) | Main problems identified in the system are: fiscal cost of CV program, inequity across programs, disincentives to join the SPP, and CV indexed to public sector wages. | Proposes unification of different schemes and elimination of inequities. |
| Pension Reform and Private Pension Funds in Peru and Colombia (Queisser 1997) | Review of the reform process and early performance of the private pension system. | Does not present policy proposals. |

2.4 The main concern of the report in the area of pensions was the CV program. The report estimated that the pension bill was equal (in 1993) to 64 percent of the wage bill for the public sector, and that only 5 percent of expenditures were financed with contributions. These problems were blamed on both design and abuse. The report did not

have explicit policy recommendations, except, of course, the need to study and review the CV program.

2.5 In 1995, a detailed working paper called “Peru: Reforming the Pension System” was published as an Education and Social Policy discussion paper. In that document, Cheikh Kane assessed the system after the 1993 reform, identifying five major problems:

- SNP and CV are unfunded and fiscally unsustainable in the long term.
- Different pension systems create different contributions and benefits for individuals with similar socioeconomic profiles, thus violating horizontal equity.
- Strong disincentives existed for workers to join the SPP, owing to its higher contribution rate and later retirement age.
- CV benefits were indexed to public sector wages. This limited possible public sector reforms, owing to the high cost of any changes in salaries.
- Payroll taxes to finance pensions contributed to what is considered a very high marginal effective tax on labor, thus promoting informal activities.
-

2.6 Based on the diagnosis and analysis, Kane made six policy recommendations that were the clearest proposals made by the Bank in strategic terms:

- Adopt a unified pension system—this includes requiring new workers to join the SPP, transforming the SNP into a flat social assistance scheme, and phasing out the CV scheme.
- Accelerate the phasing out of the CV regime—it is recommended that employees of privatized companies be transferred to the SPP, that a recognition bond be created for active workers, and that they also be transferred to the SPP.
- Fiscal incentives—pension contributions should be exempt from income taxes.
- Contributions level and structure—it is proposed to keep the contribution rate at 10 percent for the SPP and to equalize contributions in the SNP, without affecting net salaries.
- Investment regulations and minimum return—increase the foreign-assets limit to at least 10 percent and simplify the minimum-return rule.
- Appropriate budgetary allocations—the transition to a unified pension system would produce significant debt flows if recognition bonds were issued. Explicit budgetary allocations should be made, and provisions for these liabilities must be prepared.

2.7 In mid-1997 the Bank was prepared to consider a second-stage Pension Reform Adjustment Loan, without indicating what the goals of such a loan would be or any diagnostics to justify it. At the end of 1997, Monika Queisser of the World Bank Financial Sector Development Department published a working paper, which presented a detailed description of the system after the 1995 and 1996 reforms were enacted, including the equalization of contribution rates and the elimination of the minimum return guarantee. There were no policy recommendations in this paper, except for the general statement that “. . . a more balanced sectoral diversification of investment would be desirable . . .” (Queisser 1997, p. 21).

2.8 The final document reviewed was the 2001 Country Assistance Strategy Progress Report. This report defined the interim Bank strategy for the transition period from the Fujumori regime to the new government. There are no references at all in the report to the social security system, neither in the background nor in the strategy sections. The lack of references is an indicator that pensions were not considered a relevant issue at the time of the report’s preparation.

Instruments

2.9 The Bank granted four loans to Peru that touched on pensions during the 1990s. These were the 1992 Structural Adjustment Loan (SAL), the 1992 Financial Sector Adjustment Loan (FSAL), the 1996 Pension Reform Adjustment Loan (PRAL), and the 1999 Second Financial Adjustment Loan (FSAL II).

2.10 Among these loans, only the PRAL was specifically about pensions, while the other loans had a wider approach and pensions were only one component of the whole policy program. The evaluation of the loans made by IEG refers to all aspects, and not just pensions. In that context, we cannot reevaluate the performance or outcome considering solely the pensions component. We instead discuss and evaluate the programs considering their link to pensions, but we refrain from reassessing the loans in their totality.

2.11 The SAL was part of a three-loan package (including FSAL and a privatization adjustment loan) granted in the early 1990s to help Peru’s economy recover after the crisis in the late 1980s. It was a US\$300 million loan that included a wide spectrum of structural reform conditions, including fiscal, social sectors, privatization, agricultural, labor, and social security issues.

2.12 The social security goals involved implementation of Decree 724 (which created the SPP) and improvements in the administration of the IPSS, including contributions collection, separation of accounts for health and pensions, audits, physical assets administration, and human resources management. Support for these policies did not include any technical assistance.

2.13 The SAL was executed as planned and most of its objectives were achieved. The overall evaluation of SAL by IEG is very positive, considering the importance it had in the stabilization process in Peru. Evaluating the social security component, we find that

the program had a constructive role, but it was not as significant as the overall analysis. The main difference is with regard to relevancy of the goals, a problem that goes beyond this specific loan and affects the overall strategic approach. The SAL aimed to implement the funded pension scheme and improve administration at the IPSS. These were legitimate goals but other problems that were critical to the pension system, such as the low coverage of the system, were not considered at all.

2.14 The same problem explains a difference in the assessment of the Bank's performance because quality-at-entry is affected by the partial analysis and poor identification of the pension system's main problems. Finally, sustainability, with regard to the pension component, cannot be evaluated mainly because these reforms have a long-term effect and, given the serious problems that still need to be addressed, it is uncertain that political or financial reforms will not reverse the changes.

2.15 The FSAL was a two-tranche US\$400 million loan aimed at supporting financial sector reform, and it was to be implemented in 1992–93. This was a large operation, and the objectives included (i) macroeconomic policies, (ii) reforms in monetary policies, (iii) banking reform, (iv) privatization of public banks, (v) banking regulation and supervision, and (vi) capital market reform.

2.16 Pensions were only marginally present in this loan as part of the capital market objective and related to the implementation of Decree 724, issued in 1992, which opened the possibility for private pension funds. The specific conditions regarding the pension system were very general. For loan signing, these were to (i) adopt enabling regulations to make Decree 724 effective including the setting up of investment guidelines for private pension funds, and (ii) prepare legislation to make the office of the superintendent of AFPs operational. For second tranche release, (i) IPSS should issue recognition bonds to members who switch to private pension funds, and (ii) the Office of the Superintendent of AFPs should be made operational.

2.17 Although Decree 724 was replaced and the timing was longer than expected, the conditions set in the FSAL were all met. Issuing the recognition bonds took longer than expected because of the lack of reliable contributions records before the reform, but this was finally solved with new legislation in 1996.

2.18 The promotion of pension reform and the development of private sector funds were determined to be substantial under the FSAL, but potential future weaknesses in the capital market were also revealed. While the AFPs had become large suppliers of medium and long-term capital, the range of investment opportunities was limited. The solution proposed for this potential problem was the international diversification of investments.

2.19 IEG had a very positive view of this operation. We agree, in general terms, with that evaluation, except for the problems already mentioned in the SAL program. Pension funds were considered only in their role as financial intermediaries, and not as part of a major social protection program. While this is to be expected in a financial sector loan, the problem is that the partial approach handicapped the effect of proposed policies.

There is no discussion of whether the private pension funds were actually providing the services required of them, that is, old-age income security. All of the policy goals referred to the improvement of capital markets, reducing, in our view, the relevance of the program and the quality-at-entry of the Bank. Consequently, we would rate, with regard to the pension component, the outcome and the Bank's performance as satisfactory, instead of the highly satisfactory rating assigned overall by IEG. Also, sustainability cannot be evaluated at this time, not because there are doubts about whether the applied reforms will be sustained in the short term, but because the actual effect of them will only be measurable in a couple of decades, and many political or financial problems could occur before then.

2.20 The third instrument was the PRAL, presented to the Executive Board in November 1996. This was a US\$100 million, to be disbursed in one tranche. The loan aimed to support the deepening of the pension reform, and the policy matrix included the following measures:

- Reform the CV system by fully implementing reforms already approved by Decree-Law 817, allowing for the audit of claims and creating incentives to transfer from the CV to SPP.
- Reform SNP by encouraging migration of workers from SNP to SPP and reducing the contingent liabilities (this was done in 1995, when the law equalized SNP and SPP).
- Reform SPP by increasing investment options to pension fund members, promoting a more transparent disclosure of risk, and reviewing the regulatory structure to reduce costs.
- Develop a framework for pension asset and liability management: pension reserves of the SNP and CV must be estimated periodically and a trust fund created and funded.

2.21 With most of the conditions satisfied before the loan was granted, compliance was satisfactory. Some of these policies were the result of discussions held during the preparation stage of the project, while others required further work.

2.22 The reform of the CV program had the most difficulties. After the loan was disbursed, the Peru's Constitutional Tribunal limited the authority that Decree 817 had given ONP to review the benefits. The government reacted by preparing and obtaining approval of Law 26835, which gave some of the authority back to ONP.

2.23 The reform of SNP was more successful because Law 26504 and Decree 874 eliminated inequities between SNP and SPP and improved the recognition-bond granting process. By the end of 1997, ONP had issued almost 37,000 recognition-bond certificates and was processing requests without significant delays. The reduction of contingent liabilities was less successful, mainly because there were no reliable data on the number and demographic profile of SNP participants.

2.24 The goal of improving the SPP by increasing investment options and generating a more transparent disclosure of risk was partially achieved. A number of changes in the regulatory framework strongly softened the minimum-return guarantee and expanded the investment options. The same decree required that returns should be reported net of expenses. These changes did not have a significant effect, however, because portfolio composition, by the end of 1998, was still very similar among the pension funds, and the net-return reporting was never implemented.

2.25 The goal to develop a framework for pension asset and liability management was limited by the difficulties in obtaining reliable, basic data needed for running actuarial simulations. ONP assets were organized in a reserve fund, which began receiving money from privatizations, and ONP created and improved a CV register to process information on current beneficiaries.

2.26 Bank evaluations of the PRAL have been positive. There were some implementation problems, but the general result was clearly successful. We would only change the sustainability rating, for the same reason we did in the previous loans—the difficulty of assessing the sustainability of the SPP in the medium term. The main concern we have is linked to the general strategic approach and not to this specific loan.

2.27 Finally, the fourth instrument was the second Financial Sector Adjustment Loan (FSAL II), approved in 1999. This was a US\$300 million loan, to be disbursed in two tranches. The loan policy matrix covered four areas: banking sector reform, capital markets reform, pension system reform, and social protection and vulnerable population programs. The pension reform area included first- and second-tranche conditions for both the SPP and the SNP.

Table 2.2: Performance Ratings: Pension Reform Adjustment Loan Program

| <i>Ratings</i> | <i>Internal project Assessment</i> | <i>IEG</i> | <i>This report</i> | <i>Reasons for differences</i> |
|---------------------------|------------------------------------|--------------|--------------------|--|
| Outcome | Satisfactory | Satisfactory | Satisfactory | |
| Sustainability | Likely | Likely | Not rated | Sustainability of SPP cannot be rated at this point, given the low coverage and possible political changes in the future |
| Institutional Development | Partial (modest) | Substantial | Substantial | |
| Borrower Performance | Satisfactory | Satisfactory | Satisfactory | |
| Bank Performance | Satisfactory | Satisfactory | Satisfactory | |

- For the SPP:
 - Improve collections by giving the Pension Supervisory Authority (SAFP) wider powers to inspect employers with contributions arrears, and to correct current misdirection of public employees' contributions from SNP to the corresponding AFPs.
 - Expand investment options, mostly by allowing international diversification.
 - Increase SPP attractiveness to workers by reducing costs and increasing competition.
- For the SNP and the CV program:
 - Improve the accounting, cost control, and collection for SNP and CV programs by introducing individual accounts system.
 - Fund the future liabilities of SNP and CV by improving the reserve-fund management, prepare reliable actuarial studies, report 10-year projections, and define a strategy to annually review the actuarial projections.
 - Reduce the liabilities of SNP and promote migration to SPP, by offering recognition bonds to those who want to transfer.
 -

2.28 FSAL II can be considered successful, judging by the achievement of the different goals. The SAFP increased the number of inspections, trying to reduce employers' arrears. New regulations to expand investment opportunities were adopted, and a cost reduction plan to reduce AFP fees was implemented.

2.29 On the SNP side, the tax authority started collaborating with ONP to identify misdirected contributions. ONP prepared projections of future pension expenditures and the reserve fund hired an investment consultant to help manage assets.

2.30 However, we should also consider the actual effect of the policies, in particular, for the SPP. The reforms introduced in the collections procedure had no significant impact on the number of workers with contributions. The policies to reduce costs were successful, as operational costs of the AFP declined from 27 percent of collections in 1998 to 17 percent in 2001, but fees remained unchanged, boosting the return on equity from 23 percent in 1998 to 59 percent in 2001. These high earnings may be the result of low competition in a market with only four AFPs.

2.31 The evaluation of FSAL II shows an important divergence between the IEG assessment (more critical) and an earlier very positive assessment. The major

disagreement is related to not considering the deteriorating institutional and governance environment. We agree with this consideration, but we also think that the problem of relevance is serious. SPP reforms, while aiming to improve the system, were minor and had little effect. SNP reforms may have had a better result, but were also oriented toward secondary problems. We believe that it is a critical deficiency of the loan (and of the Bank's quality-at-entry) that seven years after the reform, the SPP was able to attract only about one million workers as regular contributors, out of a labor force of 11 million workers, and that no plan was set up to address the situation.

3. An Assessment of Development Impact

3.1 Our assessment of the development impact will consider the Bank's assistance as a whole and not individual projects as in the previous section. With that goal in mind, we consider several dimensions, following IEG's criteria in assessing any project.

Outcome

3.2 The outcome of the pension policy approach of the Bank in Peru can be assessed by considering how relevant it was to the main problems, and whether the Bank was able to address these problems with efficacy.

3.3 The Bank's strategy for pensions in Peru has been very consistent. Early in the 1990s, the Bank assessed that the main problems of the pension system were its long-term fiscal cost, the inequity created by different pension schemes (in particular, the CV regime) and the need for efficient pension funds that would mobilize the capital market.

3.4 Every economic and sector work document, as well as the different loans granted during the period, is based on and supports this approach, and all policy proposals are consistent with the diagnosis. While there were some timing and implementation problems, it is clear that Peru's social security system has moved in the direction that the Bank considered most appropriate and, consequently, it is possible to rate the efficacy of the strategy as substantial.

3.5 We believe, however, that more careful consideration of the relevancy of the policy goals is necessary. Discussions about the future fiscal costs of the system and the inefficiencies, abuses, and inequalities of the CV scheme are extensively presented in the available documents. After the pension reform was enacted, operational and incentive problems were evident and the diagnostic was generally correct. Our main concern relates to the general focus of the diagnosis and, within it, the assessment of the fiscal problems.

3.6 Pension systems are supposed to provide income security for individuals retired from the labor market and their dependents. There are many possible theoretical and practical approaches to the question of how to design a system that satisfies this goal without creating serious fiscal problems or labor-market distortions. A large literature exists with significant contributions from the Bank. Debate about the best design is far from being concluded (and is outside the scope of this report), but it is clear that, whatever the chosen approach is, its efficiency must be measured against the original goal—to provide income security for individuals retired from the labor market and their dependents.

3.7 A review of the situation of Peru's social security system at the beginning of the 1990s shows a very inefficient system, with very low coverage levels. Good-quality data are not available, but a simple estimation based using figures from 1996 indicates that the number of retirees receiving benefits from the social security system (that is, any of the several programs) was about 500,000. Considering that the population of Peruvians older

than 60 years numbered close to 1.5 million, the system covered only one-third of the aged population.

3.8 The situation was even worse when considering coverage of the labor force. By 1995, monthly contributors to the SNP, CV, or SPP were close to 10 percent of the total labor force, and this figure has had no significant improvement since then. As in other countries, the percentage is higher than the ratio of contributors to the labor force because of survivor and disability beneficiaries, and also because many current retirees obtained their benefits under less strict rules.

3.9 Introducing a funded pension system with fiscally sustainable costs and appropriate incentives and supervision for employers and employees are valid objectives. However, developing such a system to cover only 10 percent of the labor force (and, more significant too, only the top 10 percent, which could probably protect themselves without a compulsory pension system) seriously calls into question the relevance of the overall strategy. The Bank, of course, is not responsible for the low coverage of the system, but it gave little if any consideration to this problem during the period. Based on this point, we rate the relevance of objectives as modest.

3.10 The Bank identified the old system (and, especially, the CV scheme) as a major problem, but little analysis of it was made or was required from Peru's government. Ten years after the reform, data on the current status and perspectives of both public systems is not reliable and subject to controversy, but this has never been identified as a problem requiring correction measures.

3.11 The efficacy of the Bank's strategy in Peru was substantial, because its main objective (supporting the implementation of the new funded system) was achieved. In short, the objectives of the overall strategy were modestly relevant at best, because most efforts were focused on a relatively minor aspect of the system. The Bank had reasonable efficacy in achieving the proposed objectives, but their minor relevance resulted in an overall rating of the strategy outcome as moderately unsatisfactory.

Institutional Development Impact

3.12 The institutional development impact of the Bank's assistance has been modest. The Bank offers political support for the creation and institutionalization of two very important agencies, the Superintendent of Pension Funds (which was later merged with the Superintendent of Banks and Insurance) and the ONP, but little was done in practice. At the beginning of the period, the only social security institution in Peru was the Social Security Institute (IPSS), which had no capacity to administer the system or to manage reserves. In 2000, the SAFP was merged into the Superintendent of Banks and Insurance (SBS) in a move that could be considered a setback for the institution, but the accumulated knowledge and supervisory expertise was transferred together with most of the highly trained staff.

3.13 We believe the Bank missed the opportunity to promote the development of a strong agency responsible for social security as a whole. As will be discussed later, there

is no agency directly responsible for social security in Peru's government. ONP and SBS act as reasonably efficient managers of their specific programs, and both report directly to the Minister of the Economy and Finance. Nobody in the government is formally in charge of developing a strategic policy approach for pensions, but this is done mostly as part of fiscal or capital market policies. This problem cannot be attributed to the Bank, but we believe it represents a serious institutional problem and the Bank never addressed it. All things considered, we rate the institutional development impact of the strategy as modest.

Sustainability

3.14 As discussed in the previous section, sustainability of the reforms implemented in this period is difficult to assess because most of the effects will manifest several decades in the future, and it is possible that many changes will occur before then. This problem cannot be avoided as it affects the evaluation of any policy with long-term effects.

3.15 Some of the policies introduced in Peru's pension system in the 1990s, with the support of the Bank, appear to be sustainable in the short term, because they generally produced improvements in the operation of the system. One important point to support this view is that at the end of Alberto Fujimori's presidency, and the start of Alejandro Toledo's administration, there was no discussion about whether the reform should be reversed. We believe that the most serious problem in the system—the very low rate of coverage—creates conditions for a debate about whether the current pension system is the most appropriate for Peru. Such a discussion may occur in the medium term, and could result in significant changes to the current model.

3.16 Considering the nine factors that compound the sustainability analysis, four of them (financial resilience, social support, other stakeholder ownership, and resilience to exogenous influences) should be rated as modest. The financial situation of the pension system continues to be a source of fiscal problems for the government because the CV program was never shut down and the potential cost of minimum pensions is high, if they are ever implemented. Social support for the reform has never been significant, and several stakeholders (including unions, some political parties, and social organizations) do not support the new system. Finally, there is significant risk for the current system if an external shock to the capital markets or a fiscal crisis occurs.

3.17 The combination of the long-term nature of the policies supported by the Bank, the risk of having a new round of reforms because of the inadequacy of the current system, and the modest ratings of the four factors discussed above lead us to conclude that overall sustainability of the strategy is unlikely.

4. Results

Bank Performance

4.1 Our evaluation of the Bank's performance on pensions in Peru during the 1990s is based on two criteria: quality-at-entry and supervision. Quality-at-entry refers to the quality of economic and sector work, consistency of proposals over time, choice of instruments, and how realistic are the proposed policy goals. Supervision refers to criteria such as the commitment of the Bank to follow up and support the implementation of proposed policies, timely identification of problems, and the effectiveness of actions.

4.2 Quality-at-entry of the overall pension strategy in Peru is, in our view, its weakest aspect. In the early 1990s, the Bank was too quick to adopt a diagnostic proposing that the main problem of the pension system was the long-term fiscal costs, without having prepared a detailed analysis of the existing system. The fiscal problem could be significant in the medium or long term, but no study supports this, and given the relatively small size of the pension system at the time (covering less than one-third of the aged population, with a total expenditure of less than 1.5 percent of GDP), it could hardly be considered the main problem.

4.3 The Bank's strategy never aimed to improve the provision of income security for retired workers. The approach was to support and promote the pension reform designed by Peru's government by trying to accelerate the transfer of workers from the national system to the private system. This position never considered the particular risks that were transferred to the workers, especially considering that the funded pension had no first pillar or minimum benefit until early 2002. Based on these considerations, we believe the quality-at-entry was unsatisfactory.

4.4 The supervision can be rated as satisfactory because, based on the diagnostic available, most loans were reasonably completed and conditions were satisfied. The proposed policies were effective within the proposed goals, and the Bank carefully monitored the implementation of agreed policies.

4.5 Overall, considering the weak quality-at-entry and the better supervision, we rate the Bank's performance as unsatisfactory.

Borrow Performance

4.6 Borrower performance is rated based on three criteria: preparation, implementation, and compliance. Based on documents and interviews, we believe that the weaker aspect of the Borrower's performance was the preparation.

4.7 The Peruvian government's preparation was unsatisfactory. During the 1990s, the government applied an approach based on a simple diagnostic: pensions represent a potential fiscal threat, and privatization of the system will reduce this threat and promote capital market development. This analysis was developed under the strong influence of Chile's experience in the 1980s and with the support of international institutions.

4.8 We believe that the diagnostic was not based on any careful review of the real situation in Peru and that the policy proposal was completely disconnected from the country's experience. The government did not have a strategic view of its social security system, and that is reflected in its institutional organization. Two autonomous agencies, the ONP and the SAFF (now merged into the SBS), are responsible for managing the public and private systems respectively, but there is no institution responsible for policy design.

4.9 ONP, SAFF, and SBS report to the Ministry of the Economy. There is no office in the ministry, however, that is responsible for pension policy overall. Negotiations with international organizations, including the Bank, are conducted by an advisor to the minister, and while this individual's knowledge of pension issues is solid and his analytical ability excellent, he is not responsible for pension policy design.

4.10 Implementation and compliance of agreed pension policies with the Bank was highly satisfactory. Peru's government systematically implemented the measures defined in the various loans' policy matrices with no significant shortcomings. In short, given that both implementation and compliance are rated as satisfactory even though preparation is considered to be unsatisfactory, the overall Borrower's performance is rated as satisfactory.

Other Contributors and Counterfactuals

4.11 The design of the new pension system in Peru was mostly done by local experts, with support from government officials and technical advisors from Chile. Involvement by other multilateral agencies or donors was minimal, with no specific projects in place to support the development or implementation of the pension policy.

4.12 The question of what kind of pension system would have evolved in Peru if the Bank had not intervened is relevant for understanding whether the overall effect of the Bank's activities was positive or not. Of course, it is always difficult to answer this question because there is no actual counterfactual to observe, and a number of assumptions must be made.

4.13 Given the timing of Peru's reform and its political environment, it is safe to assume that the reform would have gone ahead regardless of the Bank's role because the pension reform in Peru was designed and enacted well before the Bank had a clear position on this issue. The report (World Bank 1994) that provided the conceptual basis for the Bank's interventions in other countries was published two years after Peru's reform. As discussed earlier, the Bank did little to study or to promote reforms with regard to some of the most difficult problems in Peru, such as the low rate of coverage, and it, therefore, had no relevant effect in those areas. In other areas, it is reasonable to assume that the Bank had a positive impact because it promoted policies that improved the overall efficiency of the private system.

Table 4.1: Performance Ratings: Bank Assistance to Peru for Pension Reforms

| <i>Category</i> | <i>Rating</i> | <i>Main reasons for assessment</i> |
|----------------------------------|---------------------------|--|
| Outcome | Moderately unsatisfactory | The approach to pensions was not integrated and ignored problems such as the low rate of coverage. Relevancy was very weak, but efficacy on other, less important goals was high. |
| Institutional development impact | Modest | When SAFP and ONP were being created and developed, the Bank offered political support, but no technical assistance. The creation of an agency or office responsible for strategic policy design would have been an important addition, but it was never proposed by the Bank. |
| Sustainability | Unlikely | Problems concerning relevancy may lead to a new wave of reforms that could reverse policies supported by the Bank. |
| Bank performance | Unsatisfactory | Quality-at-entry was unsatisfactory because the Bank tried to apply a predefined formula without in-depth analysis. Supervision was good. |
| Borrower performance | Satisfactory | The Borrower was weak on preparation, but implementation and compliance were satisfactory. |

5. Lessons Learned and an Agenda for Further Action

5.1 Understanding the Bank's experience in Peru provides an important opportunity to avoid repeating the same mistakes in other countries as well as a chance to identify better practices.

5.2 We believe that the biggest problem the Bank had in Peru was in applying a pre-formulated policy without enough consideration of the local environment. The political climate in Peru in the early 1990s was strongly pro-privatization, and what was seen as a reasonable policy in other areas was automatically applied to pensions.

5.3 Opening up the pension system to private providers and moving toward a funded scheme were reasonable steps and (after solving a few problems) were relatively well implemented. The problem was not what was done, but rather what was *not* done. The kind of policy that was implemented is a reasonable policy to apply in a country with an old population and a large, expensive pension system. However, application of this approach in Peru—where the population was relatively young and the pension system was small and inexpensive—did not solve the system's major problems, simply because these were never identified.

5.4 The main problem regarding Peru's pension system was not that it was spending 1.2 percent of GDP (a figure that was very low, by international standards and among countries with similar age structures and GDP per capita) but, rather, that coverage was so low that the basic goal of a pension system—to provide income security to the old—was far from being accomplished. Low coverage could not be solved by privatization or by funding the pensions. What was needed was a redefinition of the pension system to expand its coverage.

5.5 One possible reason to explain why the coverage rate was not viewed as a significant problem was because the pension system was never included as a central component in the Bank's strategy. Throughout the 1990s, the Bank made almost no references to pensions, and related policy goals under the various loans were defined in the context of financial and capital markets reform, which generated a one-dimensional approach to the problem.

5.6 Finding a solution to Peru's pension system problems is not easy, but this does not relieve the Bank of the responsibility to search for one. The Bank should have supported the development of an integrated system, with much better coordination among components and strategic design at the government level. Poverty-alleviation programs that operate in conjunction with contributory pension systems exist elsewhere, and while creating a universal benefit scheme could be fiscally unsustainable in the short or medium term, at least this one and other options should have been explored and second-best policy measures proposed to the Peru's government.

5.7 In this context, the main lesson we can take from Peru's experience is that pension policy has to be considered as integral to social protection policy and not simply tacked-on to some other policy area. Social security systems have important effects on a

country's fiscal and financial situation, but policy goals regarding them should always be defined within the context of a specific analysis of the needs of the vulnerable population. To do that, the Bank should always prepare an integrated assessment of the pension system and promote the creation or empowerment of a counterpart in the client country responsible for pension policy in general.

5.8 A number of positive lessons can be drawn from the Peruvian experience. One very effective result was that the Bank had a strong, long-term commitment to one goal—pension reform—and various loans supported several stages of this reform. Commitment to the goal, along with flexibility to change aspects of the implementation when necessary and maintaining close contact with the Borrower, was the critical factor that allowed for successful results.

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