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## How Ticos Turn DC Savings to Income

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By Kerry Pechter      Thu, Feb 16, 2017

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*Retirees can take a monthly income equal to 1/12 of the earnings on their DC savings, or they can take a "scheduled withdrawal" where their accumulation is divided by their life expectancy, and they receive that amount each year.*

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Jason is not a typical Costa Rican, but his story is instructive. A computer engineer by training, the 28-year-old, who is fluent in English, used to write code at the factory of a U.S. electronics giant here. He was well paid by local standards (the median income here is under \$15,000). But like many Costa Ricans, he accumulated a lot of credit card debt.

He decided to drop out. Unhappy at work and unwilling to lead a dog's life of quiet desperation, he quit his job. Before or after that, he pierced his face, tattooed his forearms and gauged his earlobes. When his revolving debt became unsustainable, he defaulted. Under a friend's name, he opened a drug paraphernalia shop. The day I met him, he was sitting on a box outside his store, reading a book and smoking.

Retirement is too distant for Jason (not his real name) to imagine. But, like many of his U.S. contemporaries, he doubts that his country's pension system will be solvent when he reaches age 62—or 65, or 70, or whatever the full retirement age might be then. As a self-employed person, he may or may not be contributing to the mandatory DC system. Like everyone else here, he knows from the media that U.S. ratings agencies have reduced his country's bond ratings to BB and that Costa Rica's national defined benefit pension, the IVM, is on the verge of "collapse."

"I expect there to be a financial catastrophe here in about five years," he told me. Sounding like a Millennial in the U.S., he added, "By the time I retire, I don't think there will be any benefits for people like me."

### **The Costa Rican DC system, or ROP**

Jason, of course, is not a pension expert or an economist. But his comments were not so different from what I heard from Hector Maggi Conte (right) and Suguey Gomez Cortez, the managing director and commercial director, respectively, of the OPC CCSS, one of the six

Complementary Pension Operators (OPC), that run the money in the “ROP,” Costa Rica’s mandatory defined contribution plan. It was set up in 2000 to supplement the IVM, which, thanks to the country’s falling birthrate and increasing lifespans, faces either major reforms or insolvency.

The DC system here resembles ours in some ways but not in most. Contributions here are deducted from salaries and the system covers about half of the working population. It is relatively new; ours (excluding TIAA) dates to the 1980s.



Unlike our DC plans, Costa Rica’s is mandatory and has a fixed contribution rate (4.25%). Participants may contribute more, but most don’t. “Most Costa Ricans don’t want to save voluntarily in the OPCs,” Maggi told *RIJ*. “They don’t feel confident in the private pension companies. Also, the plan was never explained properly. A lot of people think the money will just fall from heaven when they retire, but that’s obviously not true. You need to save in order to have the best retirement.”

The money is inaccessible prior to retirement, except in the cases of disability or death. Each person has an individual account with an individual balance that grows over time. The accounts are merely *notional*, however. Participants don’t choose from among a range of mutual funds or manage their own money. Fund managers at the six OPCs do the investing, according to the restrictions established by a Superintendent of Pensions. Fees are fixed, uniform and low; the expense ratios in small and large plans are equal.

### **Turning accumulation into income**

The OPCs invest cautiously. The OPC CCSS (a branch of the Costa Rican Social Security Fund or “Caja”) invests only about 2% of its assets in U.S. mutual funds, Maggi told *RIJ*. Its holdings include Vanguard’s S&P 500 ETF, State Street Global Advisors Health, Energy and Technology ETFs, and Franklin Templeton funds. The selections are based on information from Morningstar and Bloomberg.



“We need to know when to get in and when to get out,” said Maggi, voicing the concern of a publicly-employed pension fund manager who will likely face heavy criticism from his risk-averse clients for choosing any investment that fails, even over the short term. Consequently, the OPCs tend to invest most of their contributions in Costa Rican bonds.

Costa Rican bonds currently pay upwards of 13% interest. That’s how much the bonds have to pay to overcome inflation risk (inflation is currently low but expected to rise, given excessive government borrowing) and, for overseas lenders, the risk of currency depreciation.

Unlike our system, Costa Rica’s system has two formal distribution methods. Retirees can take a monthly income equal to one-twelfth of the earnings on their (notional) accumulated savings, leaving the principal untouched as a bequest. This is called the “permanent income” method. Alternately, they can take a “scheduled withdrawal.” Each retiree’s notional accumulation is divided by their years of life expectancy, and they receive that amount each year for as long as the money lasts.

There are two other withdrawal options. If the payout from the two formal methods is equal to or less than 10% of the payout from a retiree’s defined benefit pension, then the accumulation can be taken as a lump sum. Given the short history of the ROP, this method has been common. If accumulations are large enough—\$50,000 or more—they can be applied to a life annuity from the National Insurance Institute, or INS, a state-sponsored monopoly since 1948.

## **Rising debt**

Maggi and other officials and academics here hope that Costa Ricans will contribute enough to the ROP to raise their income replacement rate by about 20 percentage points and turn their income from the national DB plan (which currently replaces 40% to 60% of income but which is ailing, due to a fast-rising dependency ratio).

The big problem is that, individually and as a nation, Costa Rica is sinking farther into debt. The national debt grew by 14% last year, thanks in part to the cost of paying for unfunded \$20,000-a-month pensions for certain judges and officials. Personal credit card debt grew by 20%, as Costa Ricans struggle to afford luxuries like cellphones and automobiles. Even as they earn up to 13% on pension savings from government bonds, Costa Ricans can pay more than 50% annual interest on credit cards issued by government-owned banks.

The automobile, a symbol of prosperity as well as a practical necessity, weighs heavy on Costa Rica. Most Costa Ricans can't easily afford new cars without long-term credit, but they are buying them anyway. In only a few years, automobile ownership has jumped to 37% of households from 14%. The government discourages the purchases of new automobiles by levying a 52.3% sales tax; a Toyota Corolla that cost \$25,000 in the U.S. costs \$37,500 here. Taxes on older cars are higher. The government doesn't want to encourage the import of clunkers.

Many of the main highways are still two lanes, which creates long lines behind 18-wheelers on hills. By car, the 153-mile cross-country trip from Puntarenas to Limon takes four and a half hours. Buses are plentiful, but they seem to contribute more to congestion than relieve it. To go any significant distance, you have to change buses several times and buy a separate ticket for each ride. "It's very inconvenient," Maggi said.

In 2013, a committee of five engineers was created to study the feasibility of building a metro linking San Jose with exurbs of Guadalupe to the north and Desamparados to the south. Costa Ricans currently spend about an hour commuting to San Jose from those places; a metro would cover the distance in an estimated 10 minutes.

People use the existing light rail that teeters across the breadth of the city, stopping at the quaint old station in central San Jose, but the train, ironically, is the slowest method of urban transport here. The christening of a 14 km subway in neighboring Panama four years ago generated subway envy here. The instability of the local geology—Costa Rica is a Hawaii-like necklace of dormant volcanoes—may require surface rail or elevated rail rather than a subway. Given the country's fiscal problems, the rail project may be several years away.

But who knows? Maybe the Chinese will build it, just as an American named Minor Keith built a now-vanished railroad to carry coffee from San Jose to Limon in the 1870s and '80s. To feed his Jamaican workers, Keith planted bananas along his railroad's right-of-way. When the banana trade flourished, Keith started the United Fruit Company—a firm widely known

today as Chiquita.

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