Capital Markets in Chile

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Outline

1. The Charge
2. The Approach
3. AFPs
4. Asset Management
5. Other Markets
6. Conglomerates
7. Conclusions
1. The Charge

• The report should identify:

1. The role that barriers to entry play in hampering competition in the financial sector

2. How the interconnections between the financial and non-financial sectors in Chile (with particular reference to large conglomerates) enhance or endanger an effective allocation of financial resources.

3. Based on the previous findings, provide valuable and concrete proposals that contribute to enhancing competition in the financial sector
Markets Analyzed

1. The Private Pension Market (AFP)
2. The rest of the Asset Management Industry
3. Bank Deposit Market
4. Consumer Credit Market
5. Credit Card Market
6. Residential Mortgage Market
7. Industrial Credit Market
8. Conglomerates
2. The Approach

1. Identify the market
2. Analyze price and quality also in comparison with similar markets in other countries
3. Analyze market concentration and other measure of competition (e.g., Lerner index)
4. Analyze the profits level, cost structure, investments, and entry
5. Evidence of market power if any
6. Possible solutions
3

AFPs
Equivalent Asset Fee of Chilean AFPs in 2020

<table>
<thead>
<tr>
<th>Fund</th>
<th>Hypotheses on salary growth and real return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>g=3%</td>
</tr>
<tr>
<td></td>
<td>r=5%</td>
</tr>
<tr>
<td>Capital</td>
<td>0.94%</td>
</tr>
<tr>
<td>Cuprum</td>
<td>0.95%</td>
</tr>
<tr>
<td>Habitat</td>
<td>0.85%</td>
</tr>
<tr>
<td>Modelo</td>
<td>0.69%</td>
</tr>
<tr>
<td>Plantivtal</td>
<td>0.82%</td>
</tr>
<tr>
<td>Provida</td>
<td>0.97%</td>
</tr>
<tr>
<td>Uno</td>
<td>0.61%</td>
</tr>
<tr>
<td>Average</td>
<td>0.83%</td>
</tr>
<tr>
<td>VW average</td>
<td>0.91%</td>
</tr>
</tbody>
</table>
Pension Fund Income divided by AUM

Source: Tuesta (2014)
### Table 5a: Cost Structure of the Various AFPs in 2019

<table>
<thead>
<tr>
<th>AFP</th>
<th>Capital</th>
<th>Cuprum</th>
<th>Habitat</th>
<th>Modelo</th>
<th>PLANVITAL</th>
<th>Provida</th>
<th>Industry Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales costs</td>
<td>2.32%</td>
<td>2.01%</td>
<td>1.12%</td>
<td>0.11%</td>
<td>0.91%</td>
<td>1.96%</td>
<td>1.43%</td>
</tr>
<tr>
<td>Other personnel costs</td>
<td>1.75%</td>
<td>1.54%</td>
<td>2.20%</td>
<td>0.75%</td>
<td>2.28%</td>
<td>3.81%</td>
<td>2.12%</td>
</tr>
<tr>
<td>Depreciation costs</td>
<td>0.30%</td>
<td>0.33%</td>
<td>0.39%</td>
<td>0.02%</td>
<td>0.13%</td>
<td>0.33%</td>
<td>0.27%</td>
</tr>
<tr>
<td>Commercialization costs</td>
<td>0.26%</td>
<td>0.21%</td>
<td>0.44%</td>
<td>0.30%</td>
<td>0.39%</td>
<td>0.24%</td>
<td>0.32%</td>
</tr>
<tr>
<td>Computerization costs</td>
<td>0.69%</td>
<td>0.42%</td>
<td>0.23%</td>
<td>0.24%</td>
<td>0.81%</td>
<td>0.63%</td>
<td>0.48%</td>
</tr>
<tr>
<td>Administrative costs</td>
<td>1.59%</td>
<td>2.19%</td>
<td>2.01%</td>
<td>0.28%</td>
<td>0.19%</td>
<td>2.27%</td>
<td>1.56%</td>
</tr>
<tr>
<td>Other costs</td>
<td>0.70%</td>
<td>0.10%</td>
<td>0.06%</td>
<td>0.40%</td>
<td>1.12%</td>
<td>0.47%</td>
<td>0.41%</td>
</tr>
<tr>
<td><strong>Total Cost</strong></td>
<td>7.60%</td>
<td>6.80%</td>
<td>6.45%</td>
<td>2.10%</td>
<td>5.83%</td>
<td>9.70%</td>
<td>6.58%</td>
</tr>
</tbody>
</table>

**Source:** Author’s calculation from data from Superintendencia de Pensiones
Market Structure

• The provision of pensions is composed of four separate activities:
  i) collection of contributions,
  ii) investment of those contributions,
  iii) voting on the shares owned
  iv) disbursements of pensions.

• Activities i) and iv) are characterized by large economies of scale, plus they have large synergies between themselves.

• Activity ii) does not enjoy major economies of scale except in the indexing case.
• In most markets, activities i) and ii) are undertaken together not for efficiency reasons but for market pre-emption reasons.

• This combination limits the exploitation of the economies of scale, imposing a higher cost on the system.

• Not in Chile. The centralization of the collection of contributions through Previred has eliminated duplications in the network and significantly reduced the cost AFPs have to pay to collect the contributions.

• If everybody had access to the same infrastructure network, competition would take place on marketing expenses or on price (i.e., cost of managing the assets).
Peculiarity of Chile

• The Chilean market has a very unique peculiarity: workers pay upfront for the cost of managing their assets.

• All the competition is aimed at capturing new contributions, not at capturing assets to manage.

• The most direct effect of this peculiarity is that later in life – when workers have more assets in their pension funds and become more sensitive to the cost of managing them – they have reduced incentives to move their assets and AFPs have no incentives to attract them.

• Combined with the natural inertia of pension contributions (Mandrian and Shea, 2001), this peculiarity prevents competition from putting pressure on costs.
• In Chile, however, the introduction of an auction forces AFP to compete on price for the newcomers.
• The winner of the auction gets all the new entrants for the following two years, roughly 680,000 new clients.
• Since clients tend to be relatively sticky, these new clients are likely to stay even after the former winner loses out and is not the cheapest AFP anymore.
Bidding

• If we assume that clients are sticky, by bidding a price $p$ a winning bidder will gain

   Gain on New Clients: $(p - c) \times 680,000 \times \text{Mean salary}$

where

• $c$ is its cost per contribution,
• 680,000 is the number of new entrants
• mean salary is the average salary of the new entrants.

• At the same time, an existing player that is currently charging $P$ will lose

   Loss on Existing Clients = $(P - p) \times \text{N. of contributors} \times \text{Mean salary contributors}$. 
## Optimal Bid

<table>
<thead>
<tr>
<th></th>
<th>Fee as % of income</th>
<th>Fee as % of contrib</th>
<th>Cost as % of contrib</th>
<th>Bid at 0.69% Cost bn CLP</th>
<th>Bid at 0.69% Benefit bn CLP</th>
<th>Bid at 0.57% Cost bn CLP</th>
<th>Bid at 0.57% Benefit bn CLP</th>
<th>Total bn CLP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>1.44%</td>
<td>12.59%</td>
<td>7.30%</td>
<td>(453)</td>
<td>(32)</td>
<td>(485)</td>
<td>(529)</td>
<td>(70)</td>
</tr>
<tr>
<td>Cuprum</td>
<td>1.44%</td>
<td>12.59%</td>
<td>6.47%</td>
<td>(365)</td>
<td>(1)</td>
<td>(366)</td>
<td>(427)</td>
<td>(39)</td>
</tr>
<tr>
<td>Habitat</td>
<td>1.27%</td>
<td>11.27%</td>
<td>6.06%</td>
<td>(480)</td>
<td>15</td>
<td>(465)</td>
<td>(582)</td>
<td>(24)</td>
</tr>
<tr>
<td>Modelo</td>
<td>0.77%</td>
<td>7.15%</td>
<td>2.08%</td>
<td>(50)</td>
<td>163</td>
<td>(112)</td>
<td>(124)</td>
<td>124</td>
</tr>
<tr>
<td>Plantivtal</td>
<td>1.16%</td>
<td>10.39%</td>
<td>5.71%</td>
<td>(161)</td>
<td>28</td>
<td>(133)</td>
<td>(203)</td>
<td>(10)</td>
</tr>
<tr>
<td>Provida</td>
<td>1.45%</td>
<td>12.66%</td>
<td>9.38%</td>
<td>(521)</td>
<td>(109)</td>
<td>(629)</td>
<td>(607)</td>
<td>(147)</td>
</tr>
<tr>
<td>Uno</td>
<td>0.69%</td>
<td>6.45%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>202</td>
</tr>
</tbody>
</table>
1. A Worker-Owned Previred

- Previred, which collects workers’ contributions, is jointly owned by the main legacy AFPs
- It acts as a barrier to entry in two ways
  - i. By charging non-linear contracts to participants that penalize new entrants

![Graph showing percentage fees paid to Previred by Modelo from 2010 to 2019]
i. By overcharging everybody, benefitting the legacy AFPs that receive the extra profits in the form of a rebate, and preventing new entrants from undercutting incumbents in the auctions

• **Solution:** To create a not-for-profit cooperative owned by the contributing workers, with a very clear mandate to maximize the welfare of all contributors spelled out in the charter.
2. Spreading the Benefits of the Auction

- The auction has been highly beneficial in reducing fees
- Yet, it benefits only the new contributors and the legacy contributors of the winning bidder,
- It also discourages incumbent players from bidding.

Solution:

To mandate that a fraction of the legacy workers be reallocated to the new low-cost bidder, allowing them the option to switch back at any time.

The advantage of this solution is twofold
1. It does not force people into buying a product that they do not like
2. It increases the rewards of winning the auction, increasing the number of participants.
Asset Management
• The asset management industry does not suffer from excessive concentration or disproportionate barriers to entry.

• Yet, behavioral biases impede price competition to work effectively at minimizing costs.

• I do not think that any single measure alone could fix the problem, but a combination of initiatives could go a long way in this direction:

  i. **Fight Obfuscation:**

• Limiting the type of fund fees to two: load and management
ii. Positive Nudge
To discourage investors from paying for active management

iii. Facilitate switching
“account portability” that makes it easy for an investor to switch from one asset manager to another

iv. Fostering Competition
cross-border marketing of managed funds (also known as fund Passporting)

iv. Governance
the fiduciary responsibility of these board members should become to avoid excessive fees
5
Other Markets
1. Deposits

• Difficult to explain the insensitivity of deposit rates to the MPR without some degree of market power

• Interestingly, some sensitivity starts to manifest itself only after the 2016 merger between Itau and Corpbanca

• The entry and diffusion of online banks are likely to challenge the position of incumbent deposit banks anyway.

• The other technological change that might reduce the banks’ mark-down on deposits is the development of a central bank digital currency (CBDC).

• Chile should seriously consider this alternative, also imitating Brazil’s digital payment system PIX.
2. Consumer Credit

- The consumer loan market in Chile is not highly concentrated nor unusually profitable for the incumbents.

- The only doubts arise from the high and persistent level of adjusted spreads, which seem to suggest unexploited lending opportunities.

- The ultimate proof that the consumer loan market is relatively competitive is provided by a natural experiment created by a change in Chilean legislation (Cuesta and Sepulveda (2021)).

- The lack of evidence of market power does not necessarily imply that the consumer loan market in Chile works well. Credit markets are plagued by informational friction.
Consumer Credit -2

• The law creating a consolidated debt registry, which includes both banks and non-banks is a major step forward to reducing the degree of adverse selection that banks and other retailers face.

• It is crucial that the new law incorporates new Fintech lenders in both the reporting requirement and the access to the registry.

• To promote better lending and new entry the CMF should make available to potential new entrant the stock of past data, so that they can train algorithms.
Consumer Credit -3

• The state-owned Banco Estado should be used to promote competition and new entry
  • Sharing of historical data
  • Subsidizing experimentation to create a credit history for new clients

• Open Application Programming Interface
Analysis of Conglomerates

• The analysis of the effects of conglomerates is much more complex since there is no established method.

• Understanding the costs and benefits of conglomerates is tantamount to understanding why conglomerate exists

• I start with theory
A. Efficiency Reasons:

1. Replace missing markets
   i. Financial
   ii. Labor
   iii. For service

2. Economies of scale and scope

3. Increased ability to borrow internationally

4. Improved Corporate Governance
B. Rent Seeking Reasons

1. Tunneling

2. Too-big to fail

3. Market Power
   i. Effect of common ownership
   ii. Cross-directorships
   iii. Multimarket contacts
   iv. Reduced entry
   v. Other forms of collusion

4. Political Power
Evidence

- Banks do not offer lower rates to the member of the conglomerate group

**Interest Rates Comparison between Conglomerate and Non-Conglomerate Firms (%)**
Rejection Rates

**Conglomerate**

- 2019
- 2017
- 2015

**Non Conglomerate**

- 2019
- 2017
- 2015
Evidence -2

2. Market Power:
   i. Unilateral effect of common ownership
      • Not a major issue in Chile
   ii. Cross-directorships
      • Prohibited since 2017
      • We checked whether any violation
      • Very rare
      • Family connections: cross-directorships are rare
   iii. Multimarket contact
      • We checked how frequently two conglomerates are present with their companies in the same two markets (Paulíman and Solari, both with banking, retail and home improvement)
      • Biggest conglomerates are often present in the financial sector and some other regulated sector
      • Similarities in the structure are rare
Prices

• I use Numbeo, the world’s largest cost-of-living database, to compare the prices of some basic items in Chile and in surrounding Latin American countries (excluding Argentina, since inflation makes the revelation of prices more difficult there).

• When translated into dollars, prices of items purchased in supermarkets are on average 10% higher in Chile than in the rest of Latin America.

• This difference might reflect higher distribution costs in Chile.

• Yet, items sold in department stores are 13% cheaper in Chile vis-à-vis the rest of Latina America.

• While this evidence is consistent with possible collusion, it is certainly not sufficient evidence to infer collusion.
• It is worrisome, however, that the Fiscalia Nacional Economica has recently found evidence of collusion in the supermarket sector.

• The Chilean Competition Tribunal (TDLC) found that between 2008 and 2011, Cencosud (Paulmann), SMU (Saieh) and Walmart, which together control 92.5% of the supermarket category in Chile, “consciously adhered to a common scheme that substituted the risks of competition for a practical cooperation between them”, in order to “regulate the market” and “prevent a price war”.

• Interestingly, this scheme was discovered by accident when the FNE was investigating the collusion between fresh chicken producers.

• Risk of excessive concentration
4. Political Power: Campaign Financing

• In 2021, the Public Prosecutor’s Office secured a conviction for bribery of Jaime Orpis, a former senator, Marta Isasi, a former congresswoman, and the company Corpesca (Angelini Group).

• Isasi and Orpis received payments from Corpesca “to favor the interests of the company in the performance of their duties as a representative of Congress, during the discussion of a bill to regulate the fishing industry, enacted in 2013.”

• Interestingly, while both Orpis and Isasi served a jail sentence, Corpesca paid a very small fine (US$670,000),
• In 2015 it was revealed that SQM (of the Ponce Lerou group) contributed between US$ 1 to US$ 10 million during each electoral campaign.

• One of the largest beneficiaries of these payments was Senator Pablo Longeira Montes. It was revealed that in 2010 Senator Longeira discussed with the then general manager of SQM Patricio Contesse the text of several new laws, leading to changes favorable to SQM.
## Revolving Doors

### Revolving Doors among Ministries

<table>
<thead>
<tr>
<th></th>
<th>Public sector</th>
<th>Top 25 Groups</th>
<th>Others</th>
<th>Total on boards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>in 2 years</strong></td>
<td>7.1%</td>
<td>11%</td>
<td>1.4%</td>
<td>19%</td>
</tr>
<tr>
<td><strong>in 5 years</strong></td>
<td>8.6%</td>
<td>15%</td>
<td>5.0%</td>
<td>29%</td>
</tr>
</tbody>
</table>
## Revolving Doors Among Top Bureaucrats

<table>
<thead>
<tr>
<th>Institution</th>
<th>Total</th>
<th>Corporate Boards</th>
<th>Top 25 conglomerates</th>
<th>Connected to a Bank</th>
<th>Public Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N°</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Central Bank</td>
<td>13</td>
<td>92%</td>
<td>62%</td>
<td>69%</td>
<td>38%</td>
</tr>
<tr>
<td>SBIF</td>
<td>8</td>
<td>88%</td>
<td>50%</td>
<td>50%</td>
<td>25%</td>
</tr>
<tr>
<td>SVS</td>
<td>8</td>
<td>75%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>
Other Legal Forms to Gain Influence

• During the 2013 presidential campaign, Natalia Compagnon, married to Sebastian Davalos, the son of then-presidential candidate Michelle Bachelet, secured a bank loan for 6,500 million pesos (around $11 million at the time) to buy land on behalf of a company (Caval) that Compagnon half owned and had only 6 million pesos in equity.

• The loan was secured after a meeting with Andronico Luksic, Banco de Chile vice-president and member of the family that controls the bank. The land was resold thirteen months later at a 46% higher price.

• Transaction legal
• The fact that there was nothing illegal in this scheme is exactly the source of the problem.
• This was not a standard loan, as reiterated by the SBIF superintendent.
• As it is not standard that investors can have a return of 370 times the invested capital in thirteen months.
• The very fact that a meeting with the bank vice-president was needed and that Bachelet’s son was present at that meeting suggests that it was not a standard loan,
• as was the fact that Santander had earlier rejected an application for the same loan
• This is exactly the kind of soft power a conglomerate can provide.

• The combination of future job offers, loans, and business opportunities gives large Chilean business groups a legal way to reward and punish key politicians and regulators.

• It is certainly a coincidence that, around the time this loan was negotiated, four key people of the Luksic group entered the Bachelet Government.

• Yet, it illustrates that conglomerates have a possibility of arranging sophisticated quid pro quo, not available to individual firms.

• This additional power has the potential of blocking new entries and distorting competition.
Conclusions

• No smoking gun
• The efficiency rationale for the existence of conglomerates in today’s Chile is very weak.
• All factors seem to point in one direction: the critical resource that gives conglomerates a comparative advantage is the connections with the political establishment.
• The scandals that exploded in the last decade seem to confirm this view.
• Cost-benefits analysis suggests that reforms aimed at reducing the advantages of conglomerate form have some benefits and no costs
Suggestions:

1. Separation of Banking from Industry

- The case for an ownership separation between banking and commerce is strong.
- How could such a separation be implemented?
- The first step would be a prohibition of cross-directorship so that any director, manager, or controller of an industrial firm could not sit on the board of a bank and vice versa.
- Then, one could pass a norm sterilizing the voting rights of any investor who owns more than a certain threshold of a bank.
- The combination of these two norms should be sufficient to isolate the governance of banks from the governance of other firms without forcing a divestiture.
2: Pigouvian Taxation

- If pyramidal business groups are not efficient but are mainly rent-seeking then an argument can be made to introduce a form of Pigouvian taxation, to reduce the negative externalities produced by these pyramids.

- In the United States, any layer is subject to an additional corporate tax, unless the parent owns 80%. This threshold eliminates any incentive for company.

- According to Morck (2005), this is the main reason why pyramidal structures are very rare in the United States.

- Introducing a similar rule in Chile would penalize a large concentration of control rights in a few hands.
3. Transparency

• The first recommendation of the 2015 IMF conglomerate supervision report reads “Use the recently approved financial stability law to gather more information on the conglomerates’ structure, business opportunities, and risks.”

• Almost 10 years went by and not much has been done on this front. The time has come to do something, but what?

• The first step is to mandate full transparency of the ultimate ownership of any company operating in the country or owning assets (whether financial or real) in the country.

• The G20 is already moving in this direction and thus Chile will be forced, sooner or later, to go in this direction.

• The sooner this decision will be made, the better will be for the economy of Chile.
4. Revolving Doors

• One simple way to reduce the risk of quid-pro-quo is to create a black-out period after the end of their public office, where former ministers and top bureaucrats cannot go work in private firms affected by the actions of the agencies or ministry they were heading.

• It would be useful to have some restrictions also on the other side of revolving doors.

• In 2008 U.S. President Obama issued an executive order requiring all appointees entering government not to “participate in any particular matter involving specific parties that is directly and substantially related to my former employer or former clients” for a period of two years from the date of the appointment.”

• Extend this rule to all companies in a conglomerate
Overall Conclusions

• Capital markets in Chile are highly developed
• In many dimensions, they are an example for many countries to follow
• The major problems I encountered are related to two issues traditional economics does not deal very well
  1. Behavioral biases and inertia
  2. Political power
• My report provides incremental reforms that could easily address these problems without destroying the efficiency of capital markets