

# A Centralized Auction Mechanism for the Disability and Survivors Insurance in Chile

Gonzalo Reyes H.

Pensions Supervisory Authority of Chile  
greyes@spensiones.cl

**Abstract.** As part of the pension reform recently approved in Chile, the government introduced a centralized auction mechanism to provide the Disability and Survivors (D&S) Insurance that covers recent contributors among the more than 8 million participants in the mandatory private pension system. This paper is intended as a case study presenting the main distortions found in the decentralized operation of the system that led to this reform and the challenges faced when designing a competitive auction mechanism to be implemented jointly by the Pension Fund Managers (AFP). In a typical bilateral contract the AFP retained much of the risk and the Insurance Company acted in practice as a reinsurer. The process to hire this contract was not competitive and colligated companies ended up providing the service. Several distortions affected competition in the market through incentives to cream-skim members by AFPs (since they bear most of the risk) or efforts to block disability claims. Since the price of this insurance is hidden in the fees charged by AFPs for the administration of individual accounts and pension funds there was lack of price transparency. Since new AFPs have no history of members' disability and mortality profile the insurance contract acted as a barrier to entry in the market of AFP services, especially when D&S insurance costs reached 50% of total costs. Cross-subsidies between members of the same AFP, inefficient risk pooling (due to pooling occurring at the AFP rather than at the system level) and regulatory arbitrage, since AFPs provided insurance not being regulated as an insurance company, were also present. A centralized auction mechanism solves these market failures, but also gives raise to new challenges, such as how to design a competitive auction that attracts participation and deters collusion. Design features that were incorporated in the regulation to tackle these issues, such as dividing coverage into predefined percentage blocks, are presented here.