

INFORMATION NOTE

The Chilean Pension System

1. The Former Social Security System in Chile

Background

1.1 The social security system was launched in 1925. As time went by, the system had been modified. In general, the social security system was structured traditionally with various pension schemes coexisting simultaneously, in each case they were destined to satisfy requirements of different occupational groups, besides providing for a range of benefits to affiliates.

1.2 In the 1970s, the common feature of the social security funds was that they all operated under the pay-as-you-go pension system. This meant that retirement pensions were funded with contributions paid in by active affiliates and, therefore, the survival of the system was permanently subordinated to the prevailing workforce/pensioner ratio of the population.

Problems of the Former Social Security System

1.3 During the early years of operation, the proportion of active affiliates was sufficient to fund pensions of the retired or passive members. However, demographic factors experienced changes, reflecting in a steady decrease in the birth rate and an increased life expectancy. This reversed the above ratio and caused negative impacts in the financing of the system. To illustrate the problem, while in 1960 there were nine passive pensioners for every 100 active affiliates, by 1980 this ration changed to 45 passive pensioners for every 100 active affiliates. In other words, the cost of active affiliates increased by five-fold in twenty years.

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1.4 The problem of financing was constituted by the strong temptation to evade payment by both compulsory employer/employee in making contributions to the pension funds, given that workers and employers found it economically advantageous to pay just the legal minimum values. They were only concerned in paying the real values corresponding to each affiliate during the last few years of active working life, when actual contributions were taken in computing the amount of monthly retirement pensions. This situation forced the government to increase pension fund contributions, and caused higher evasion of dues.

1.5 The social security system was also marked by its lack of equanimity. As there was no direct relation between worker's contribution and benefits obtained, marked differences emerged among various groups covered. The extent of benefits relied on the capacity of political powers.

Pension System Reforms

1.6 In 1980, the Chilean government created a new pension system to resolve the problems in the old social security system. Decree Law 3500 (DL 3500) introduced the following reforms to the pension system: a uniform system was established, based on individual capitalization, with set contributions, private administration of funds, compulsory for salaried workers joining the workforce, and voluntary for those affiliated to the old system, and for self-employed workers. There was a transition stage as both pension systems coexisted until May 1986.

Transition Stage

1.7 All participants who were involved in the old system at the time of the change had the option to retain their existing coverage until May 1986. At that time, if the workers were still actively employed, they were obliged to join the new system. New employees hired as of January 1983 could only join the new system.

1.8 In 1984, approximately 19% of the individuals who participated in the old social security system, principally older workers near retirement, elected to stay in the old system. As the old social security system did not disappear and affiliates switched massively to the private pension system, the government had to bear the funding deficit.

2. Mechanics of the Chilean Pension System

Membership

2.1 Since 1983, membership to the current pension system is **compulsory** for all salaried workers (i.e. affiliates) and **optional** for self-employed workers¹ and those who are registered under the old pension system. This comprises both private sector and government employees but not members of the armed forces. By affiliating to a private fund administrator (AFP), the worker is incorporated into the pension system until retirement, even when the worker changes jobs, becomes unemployed, or for any reason retires from the active workforce (e.g. disabled).

Individual Capital Formation

2.2 The Chilean pension system is based on individual capital formation. Each affiliate owns an individual account with an AFP where the affiliate contributes monthly pension payment. The capital accumulates as successive contributions are paid and as investments of the AFP produce yield.

2.3 Upon completion of the affiliate's active working life, the capital is then returned to the affiliate or to the surviving beneficiaries. The amount of pension will depend on the amount of the savings and the investment return from the AFP. Hence, there is a direct relationship between the personal effort and the amount of pension obtained.

2.4 Each affiliate is given an AFP passbook and receives a regular government statement showing the amount of money accumulated in the retirement account and the investment performance of the AFP. In the branch offices of many AFPs, there are simplified computer terminals that permit the affiliate to calculate the future pension amount, based on the amount of money in the individual investment account and the date at which the affiliate plans to retire.

¹ For self-employed workers, if the earnings are higher than the minimum salary fixed by the government, they are given the option to join the system.

Procedures of Contributions

2.5 An affiliate is required to contribute 20% of monthly earnings up to a ceiling of 60 Unidad de Fomento² (UF) of which 13% is used for retirement, and disability and survival pensions, and a mandatory 7% for health insurance. An affiliate can also make an additional 10% of the earnings as a form of voluntary savings³ into the individual capitalization account⁴. The UF is an indexed monetary unit restated on a daily basis according to changes in the consumer price index (CPI) in the preceding month. In other words, the UF has constant purchasing power.

2.6 Monthly contributions deducted from wages are made directly by the worker's employer. The employer has to file a form with each AFP for the employees having accounts. The employer then provides a cheque or cash to the AFP in the aggregate amount of contributions made for the listed employees.

2.7 Self-employed workers joining the pension system file their own monthly forms together with a cheque or cash for the contribution amount and related fees to the AFP. This form identifies each worker for whom a contribution is being made and the amount of the contribution.

2.8 Mandatory contributions are only required for a month in which an affiliate has actually earned wages. Self-employed individuals who voluntarily become affiliates are not obliged to make monthly pension contributions regardless of their income situation for that month. The decision regarding the timing and amount of a self-employed affiliate's contributions is at the discretion of the affiliate, but such contributions are subject to the same 60 UF maximum monthly limit described above.

Pension Fund Administrators (AFPs)

2.9 The AFPs are corporations specially established for the sole purpose of administering the pension funds for their affiliates. There are 21 AFPs, several of which are related to organizations engaged in various sectors of the economy such as copper mining, teaching, banking, and construction. Others have ties to international banks or insurance companies. The remaining AFPs belong to several private Chilean corporate groups. The AFPs are supervised by a government authority, the Chilean Superintendent of Pension Funds (SAFP).

² It is equivalent to approximately US\$1,980. The exchange rate is 1 UF = US\$33.

³ Contributions into voluntary savings accounts are not tax deductible. Accumulations in the account are not taxed until withdrawn.

⁴ Chile residents are subject to tax on all income, including pensions source. The tax rates are progressive and vary from 5% to 45%. The 45% rate applies to employees with monthly wages exceeding US\$6,400.

2.10 AFPs' services include collection of affiliate contributions, management of individual capitalization accounts, investment of the affiliate contributions into a single collective pension fund managed by the AFP, the provision of disability and survival benefits for affiliates, and the provision of retirement benefits, all as required by the DL 3500. AFPs are required to enter into insurance contracts with licensed Chilean insurance companies whereby these companies insure the obligation of the AFP to provide disability and survival benefits.

2.11 In order to commence operations, an AFP must have a minimum capital equal to 5,000 UF (US\$165,000), which increases in accordance with the number of affiliates amounting to 20,000 UF (US\$660,000) for AFPs with over 10 000 affiliates. All AFPs are subject to extensive and continuous regulatory review.

Fees and Commissions

2.12 An AFP is permitted to charge a fee for (i) mandatory contributions into the affiliate's individual capitalization account to fund its retirement pension; (ii) voluntary savings withdrawals; (iii) transfer of account balances from another AFP; and (iv) payments of programmed withdrawals. However, no AFP currently charges fees for anything other than (i), i.e. mandatory contributions into an affiliate's individual capitalization account. At present, the AFPs are mainly financed by 1.5-2% commission on wages (i.e. 15-20% of contributions).

2.13 Each AFP is allowed to set the level of fees it charges to its affiliates. Fees may be changed at any time by an AFP upon three months' notice to affiliates, the SAFP and the public, yet the DL 3500 requires that each AFP charges the same level of fee to each of its affiliate. Although there is no legal limit on the fees which an AFP may charge, competitive pressures have resulted in a narrow range for fees charged by different AFPs.

Free Choice of AFP

2.14 Under the Chilean pension system, the affiliate is free to choose amongst the 21 AFPs. The affiliate can also change from one AFP to another. Furthermore, given that the affiliation to the system is permanent, if a worker changes the employment there is no obligation for the worker to change the AFP. For this reason there is keen competition among the AFPs to provide a higher return on investment, better customer services, or a lower commission. In 1995, there were 15 432 sales agents working in the industry for this purpose.

2.15 It should be noted that membership in the system is based on individual employee, as opposed to collective or through an employer, giving the affiliate full discretion both in selecting an AFP initially, as well as in transferring from one AFP to another. At present, transfer between different AFPs are cost free to affiliates and the only restriction is a limit of one transfer every three months. No AFP may reject a properly documented request by a worker to transfer to another AFP.

3. Pension Benefits of the Chilean System

Retirement Benefits

3.1 All affiliates reaching the legal retirement age stipulated by law - 65 years of age for men and 60 years of age for women - are entitled, but not obliged, to take out a retirement pension. No other requirements, such as length of period in the pension system, are needed for receiving this pension.

3.2 The law allows for an early retirement, provided that the affiliate can obtain:

- A pension equal to or higher than 50% of the average of the indexed taxable earnings⁵ during the last ten years of work; and
- A pension equal to or higher than 110% of the government guaranteed minimum pension⁶.

Disability and Survival Benefits

3.3 In addition to retirement pensions, there are the total or partial disability pensions, and the survival pensions, which are financed by the AFP by taking out a disability and survival insurance. Since all workers face the risk of disability or death, AFPs are obliged to use 3% of the monthly earnings to provide this insurance for their affiliates.

3.4 In the case of **disability** (which must be declared by a Medical Committee appointed by the SAFP) of the affiliate before legal retirement age, there are total or partial disability pensions.

⁵ The index is pegged to the CPI, having the real values.

⁶ The government provides a minimum pension to employees whose pension fund produces a monthly income of less than US\$115. Employees must have at least 20 years' coverage to be eligible for the minimum pension.

- On total disability (the loss of at least two-thirds of their capacity to work), the AFP provides a pension of 70% of average indexed earnings during the last ten years.
- On partial disability (the loss of more than 50% and less than two-thirds of their capacity to work) the pension is 50% of average indexed earnings during the last ten years.

3.5 **Survival** pensions are awarded to the beneficiaries surviving after the death of the affiliate⁷. These pensions are financed by the resources saved by the affiliate, and by the transfer of funds from the insurance company with which the respective contract was signed.

4. Outcome of the Pension System

Performance of the System

4.1 The pension system evidenced a remarkable development in Chile's financial sphere through the investment of its accumulated funds. The actual annual average of the yield was 12.2% in 1981-1996. The AFPs became Chile's main institutional investors. However, it should be noted that actual annual yield suffered a minus 2.5% yield in 1995 and only managed to have a 3.5% yield in 1996, after high yield rates of 16.2% in 1992 and 18.2% in 1993.

Value of Pension Funds

4.2 The value of the pension funds increased from US\$9,108.18 million in 1990 to US\$28,382.95 million in 1996, growing 311% during the time period. This represented a large amount of internally-generated capital for Chile. Relative to the Chilean economy, pension funds increased their share from 0.9% of the Gross Domestic Product (GDP) in 1981 to approximate 42% in 1995. (See Appendix for the general information on Chile).

⁷ The case may be spouse, children, or parents.

Membership

4.3 The number of affiliates⁸ of the AFPs increased from 3.74 million in 1990 to 5.32 million in 1995, which rose by 42% in five years. The number of contributors increased from 2.64 million in 1990 to 2.96 million in 1995, an increase of 12% in the time period. Hence, the ratios of the number of contributors to the number of affiliates dropped from 70.7% in 1990 to 55.7% in 1995, indicating the change in age profile of the population.

Number of Pensions Paid

4.4 Up to 1995, the system awarded 216 478 pensions. By categories, 33% were pensioned off with early retirement pensions⁹, 26% with retirement pensions, 17% with orphanhood pensions, and 8% with total disability pensions.

Impact of the System on the Economy

4.5 Pension funds have played an important role in developing the Chilean economy. The system has had a significant impact on the domestic savings; consequently, their contributions to the capital expenditures are higher.

4.6 The system also has exerted a positive influence on the housing market. The institutional investors have fostered the development of the housing market, particularly through a substantial contribution of funds for buying mortgage bonds, aimed at financing mortgage loans for housing purchases. Moreover, the institutional investors have invested a large amount of capital in infrastructure works, helping the Chilean government to develop many of these projects. At the same time, the pension funds have also had an impact on the capital and insurance markets due to the system's interaction with these sectors.

⁸ The 1996 figure was 5.57 million, a 49% increase in six years.

⁹ This type of pension increased rapidly during 1990-1995. The annual total increased from 5 790 to 70 640 during the respective time period.

Appendix

General Information on Chile

Chile is a long narrow country along the west coast of South America, between the Andes Mountains to the east and the Pacific Ocean to the west. It borders Peru to the north and Bolivia and Argentina to the east.

The population is approximately 13.9 million, growing at an average annual rate of 1.7%; it is largely urban, with 85% of the population living in cities. Approximately five million people (about 35% of the total population) reside in Santiago, its capital and the largest city.

The official language is Spanish, although English is widely spoken in the business community. Literacy stands at 95%.

For the past twenty years, the Chilean economy has been characterized by its strong free-market orientation and the private sector's intense participation in national economic life. In 1995, the GDP amounted to US\$67.3 billion, and the per capita income averaged on US\$4,840. In 1996, the GDP in real terms rose by 6.6%, while inflation was 6.1%. The unemployment rate hovered at 5.0%.

Industrial and agricultural activities are concentrated in the central valley. Mining, agriculture, fishing, and lumber are the major industries and also the principal items for export. The main export is copper. Tourism has become a significant industry due to the recreational facilities provided by the mountains, rivers and ocean.

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