INFORMATION NOTE

Roles of the Government in the Chilean Pension System

1. Regulatory Role

1.1 Under the current pension system, the Chilean government plays a significant regulatory role. The government is represented by the Superintendent of Pension Funds (SAFP), which is the authority responsible for the technical supervision and control of the pension fund administrators (AFPs).

Superintendent of Pension Funds (SAFP)

1.2 The SAFP's office has about 120 officers, of which 80% are professionals. The Chief Executive Officer (CEO) of the SAFP is designated by the President of the Republic, and is responsible for planning, organizing, directing, coordinating, and controlling the SAFP's operation, ensuring the efficiency of the service.

1.3 The functions of the SAFP comprise the financial, executive, legal, and administrative areas, and it reports to the government through the Ministry of Labour and Social Security, by way of the Undersecretariat of Social Security. Its main functions are as follows:

- Approve or reject projects for the creation of an AFP, approve its by-laws, and authorize its existence.
- Supervise the operation of the AFPs as far as legal, administrative, and financial aspects are concerned.
- Ensure compliance by the AFPs with minimum capital and cash reserve requirements.
- Propose legal or regulatory reforms to improve the system's operation.
- Interpret current laws and regulations and provide compulsory rules for application by the AFPs.

- Levy fines and, when applicable, enforce winding up of the AFPs in accordance with the law.

1.4 The regulations governing the operation of the system cover three main areas:

- Investment of pension fund resources.
- Operation of the AFPs and awarding of benefits stipulated by law.
- Administration of the affiliates' (i.e. salaried workers) personal accounts, collection of contributions, clearing and transfer processes when the affiliate decides to change from one AFP to another, recovery of late payments, collection of commissions and delay payments.

Fund Investment Controls

1.5 To ensure that the AFPs are in compliance of the investment rules, the SAFP monitors the daily transactions of the investments made by AFPs through a computer system connected to the Stock Exchange and the related investment agencies.

1.6 AFP's are also required to submit their monthly financial statements and regular operation reports to the SAFP. The AFP's annual report, including its financial statements for the year and the report from its independent auditors (for the pension fund and the shareholders fund separately), must also be submitted for review by the SAFP.

Other Controls

1.7 In practice, the AFPs are also regulated by the **Central Bank**, which by law is required to hold physical custody of at least 90% of the investment securities invested by the pension fund managed by each AFP. In addition, AFPs that are listed on a stock exchange are regulated by an independent **governmental agency** that regulates the securities and insurance industries. Furthermore, the **Risk Rating Commission (RRC)**[1], determines whether or not certain securities qualify as acceptable instruments for pension fund investment. The Central Bank fixes limits among various types of permitted investment for AFPs, subject to ranges of maximum percentages established by law.

[1] The RRC is the agency with jurisdiction over risk rating and approval of instruments for purchasing by the pension funds. The RRC is chaired by the CEO of the SAFP and includes the CEOs of Superintendent of Stocks and Securities and the Superintendent of Banks and Financial Institutions, plus four members representing AFPs.

2. Guarantee of Minimum Yield

2.1 The government guarantees a minimum yield for the affiliates. The government also plays a subsidizing role by awarding minimum pensions to those workers who do not accumulate sufficient funds in their pension account with the AFP to finance a pension higher than that of the minimum amount prescribed by law.

2.2 Moreover, the government guarantees any additional contributions needed to make up the balance required to finance the disability pensions and the payment, among others, of life annuity pensions contracted by affiliates with life insurance companies, in the event the latter go into bankruptcy. Cover provided by this guarantee oscillates between 100% of the minimum pension in force and 75% of anything above it, with a maximum of 45 UF (US$1,485) for every retired person or beneficiary.

2.3 Hence, under the AFP system, **the government guarantees a minimum pension and serves as the insurer of last resort**. It should be noted that the guarantees are funded out of general revenues, not the contributions from the affiliates. As a result, the government is not required to set up a compensation fund by imposing levies.

<u>Minimum Yield</u>

2.4 Every month, the AFPs are responsible for ensuring that the actual yield over the last twelve months of the pension funds whichever they administer is not less than the lower of the following two measures:

- Average actual yield over the last twelve months of all the funds, minus two percentage points, and

- 50% of the average actual yield over the last twelve months of all the funds.

2.5 For example, if in a given month the average actual yield of all the funds is 3%, then no pension fund can have an average actual yield over the last twelve months of less than 1% (i.e. 3% minus 2%). On the other hand, if the average actual yield over the last twelve months of all the funds is 10%, then no pension fund can have an actual yield over the last year of less than 5%.

2.6 However, should a fund achieve a yield below the legal minimum defined above, the following mechanisms stipulated in the law will come into effect in order to achieve the minimum yield requirement. The operation of the minimum yield system is presented in Figure 1.

Yield Fluctuation Reserve

2.7 This is a cash reserve made up of a pension fund's actual yield surpluses that over the last year exceeded the average actual yield of all the funds for that year by more than two percentage points or by more than 50%, whichever is higher. In practical terms, if one pension fund does much better than the others, then it keeps some of that profit in reserve to meet any future contingencies. As of April 1996, two funds had such reserve.

Cash Reserve

2.8 This is an asset which is equivalent to at least 1% of the value of the pension fund and paid using the AFP's own resources (i.e. out of shareholders fund) rather than the affiliates', and is used for completing the minimum yield as an alternative to the yield fluctuation reserve.

Government Guarantee

2.9 If, once the yield fluctuation reserve and cash reserve have been applied, the minimum yield has still not been made up and the AFP does not have additional financial resources available, the government will make up the difference and proceed to wind up the AFP.

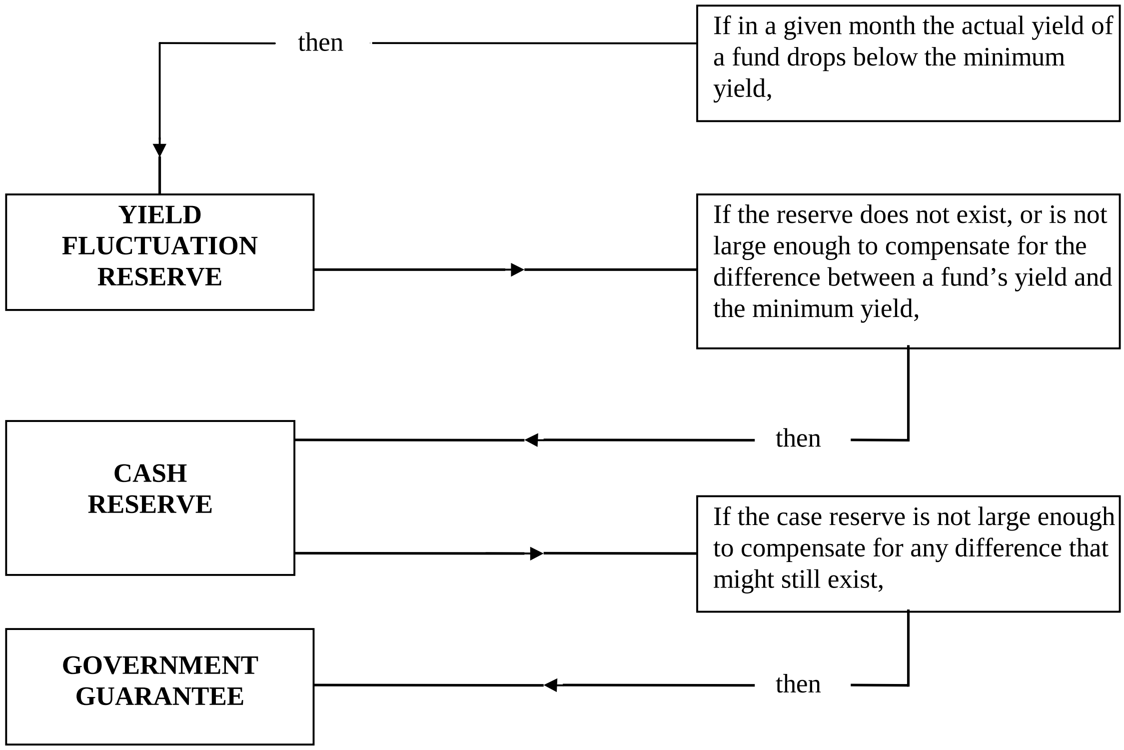
Dissolution and Liquidation of AFPs

2.10 Any AFP that fails to cover the difference between the average actual yield of all the pension funds and its pension fund's actual yield on investment, or that does not replenish the reserve fund within the established time limits, will be dissolved.

2.11 Once the AFP is dissolved or declared liquidated, the AFP's affiliates have 90 days to join another AFP. If an affiliate does not do so, a receiver appointed by the SAFP must transfer the individual account balances to another AFP.

2.12 In liquidation, the Chilean government covers the difference for the amounts not paid by the AFP being liquidated.

Figure - Operation of the Minimum Yield System



Source: SAFP.

3. Safeguarding the Investments of Funds

3.1 Given that the resources invested by the AFPs are owned by the workers, DL 3500 has incorporated stringent rules which aim at safeguarding the investments of the system. The main features are as follows.

<u>Eligible Investment Instruments</u>

3.2 The government prescribes the types of investments and ranges of maximum percentages in which fund assets can be invested. Pension fund investment can only be made in publicly offered securities placed at the local and in specified international markets. Financial hedging operations are allowed using resources from the pension funds.

3.3 The goal of the regulation is to stipulate the types of assets in which the resources may be invested, whose main common feature is that they are financial assets on public offer. In other words, when they are not government-issued instruments, their issuers are also controlled by the Superintendent of Stocks and Securities or by the Superintendent of Banks and Financial Institutions, as applicable.

Risk Rating

3.4 The risk rating process has dual purposes:

- To provide a risk measurement that will enable the agents involved to distinguish between eligible and non-eligible instruments.

- To enforce the limits on the make-up of the pension funds' portfolio as a function of the instruments' risk rating.

3.5 Financial instruments issued by private institutions are subject to a process of risk classification which is carried out by private agencies (such as Standard and Poor's) and subsequently approved by the RRC.

Investment Limits

3.6 The composition of the pension funds' investment portfolio is determined by several types of investment limits set by the Central Bank and the SAFP within the ranges stipulated by law. The limits stipulated by the Central Bank are maximum limits. In general terms, the law stipulates that pension fund resources should be invested with a view to securing adequate yield and security.

3.7 The maximum investment limits are determined in terms of investment instruments and issuers. The purpose of the limits to **instruments** is to achieve an adequate diversification of the pension funds' portfolios, by defining the possible combinations of yield and risk. The aim of the limits to the **issuers** sets a percentage of the funds' value, which restricts the concentration of pension fund investments in instruments issued or guaranteed by a single institution. This limit is set to a percentage of the issuer's assets or equity, which aims to prevent the pension fund from dominating the issuer's decision.

3.8 There are different limits per issuer depending on the economic sector involved. These are divided into the financial sector, the foreign sector, investment funds, the government, and the private companies. Likewise, each one of these sectors includes different limits according to the type of instrument.

Authorized Markets

3.9 Transactions of financial instruments involving resources of pension funds can only be carried out in markets expressly authorized for that purpose, and which comply with certain minimum requirements. These requirements are basically the simultaneous presence of buyers and sellers of instruments for determining the price, the availability of information to the general public, the establishment of mechanisms for negotiating instruments, and internal rules of procedure.

3.10 This stipulation is to ensure the necessary transparency and equality in the transactions of securities involving resources from the pension funds.

Safe-keeping of Securities

3.11 Another provision which provides for a greater degree of safety for the funds stipulates that those securities which represent at least 90% of the value of the pension funds must be kept in safe-keeping in the Central Bank, or in the foreign institutions authorized by it, and in private stock deposit companies. The purpose is to protect securities representing pension fund investments.

Regulating Conflicts of Interest

3.12 Directors, officers and all employees involved in the investment process must file reports to the SAFP disclosing their investments in eligible securities, and cannot use information related to investments of the pension fund for their own or a third party's benefit. By law, the AFP must indemnify the fund for damages caused to it by the misuse of non-public information by any of the parties mentioned above or by the AFP itself.

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