INFORMATION NOTE

Comparisons of the Proposed Mandatory Provident Fund System in Hong Kong with the Chilean Pension System

1. Characteristics of the Chilean Pension System[1]

Individual Capitalization

1.1 The affiliates have a free choice in choosing their pension fund administrator (AFP). The AFP becomes accountable to the affiliates. The **individual capitalization account approach** of the Chilean pension system has the advantage of easy administration in terms of preservation and portability. The system establishes a direct link between contributions and benefits, and exerts pressure on AFPs to compete and operate efficiently.

Guaranteed Benefits

1.2 All affiliates meeting certain requirements are entitled to a minimum pension, guaranteed by the government, even though the balance in their individual capitalization account is not enough. Hence, the Chilean pension system can ensure a stable income for those workers who have come to the end of their working life, and ensure that this income is as close as possible to the income earned during their active working life.

1 Please refer to the set of Information Note (IN 3 / 96-97) and (IN 4 / 96-97) for the details of the Chilean Pension System.

1.3 Moreover, in case of cessation of payments or bankruptcy of an AFP or an insurance company, the government guarantees a minimum pension for every retired person or beneficiary. In other words, the government serves as the insurer of last resort. The guarantees are funded out of general revenues, not the contributions from the affiliates. Hence, the government is not required to establish a compensation fund for the pension system. It should be noted that since the establishment of this pension system, the Chilean government has not used the general revenues to save any AFP or insurance company. The remarkable performance of this pension system has been attributed to the stable political situation in Chile and effective regulation and supervision.

Transfers

1.4 The affiliates can transfer their account balances from one AFP to another through their own choice. In other words, the affiliates are not required to transfer their account balances if they change their employment. There is no penalty to an affiliate for a transfer as the AFPs have ceased to charge commissions on such transfers as a result of competition among AFPs.

Full Portability and Employment Mobility

1.5 In addition, the Chilean government does not need to establish **industry schemes** for high labour mobility industries as the affiliates have their individual capitalization accounts. The Chilean pension system has the benefit of being fully portable - the retirement account is tied to the worker, not the employer.

High Operating Costs

1.6 A point of concern of the Chilean pension system is high operating costs, which comprise marketing costs and account switching costs. At present, between 1.5% and 2% of gross wages (or 15-20% of contributions) is used to cover the operating costs.

1.7 To compete for affiliates, the AFPs have to increase their sales force and provide a large volume of advertising materials. As a result, the marketing expenses and administrative costs have increased. The AFPs have to maintain high variable commission rates for monthly contributions covering the high operating expenses.

1.8 Since the AFPs are operating in a highly regulated environment, the AFPs are keen to establish certain relationships with unions, trade associations, insurance companies, banks or corporations that may provide competitive advantages. In practice, competition is based on services provided, intensity of sales efforts, fees charged and, to a lesser extent, return earned by the managed fund.

1.9 The Chilean government has relaxed certain investment rules allowing the AFPs to increase their overseas investments. The AFPs now can invest in overseas securities, though actual holdings of such securities are restricted to less than 5% of total assets. In order words, the affiliates may have more combinations of risk and expected yield in choosing the AFP.

1.10 The number of annual transfer increased from 306 819 in 1988 (about 10% of the total affiliates) to 1 328 410 in 1995 (about 25% of the total affiliates), which represented a growth of 433% in seven years. The major reason for the increase was the workers were no longer required to personally present themselves in the AFP office in order to file a transfer.

1.11 In restricting the frequency of the right to transfer accounts so as to control the operating costs, the Chilean government continues to mandate a basic three-month cycle in the transfer mechanism. Thus the affiliates can only transfer their accounts four times a year.

2. Comparisons of the Proposed Mandatory Provident Fund System in Hong Kong with the Chilean Pension System

Pension Fund Administrators

2.1 In both Hong Kong and Chile, only private fund administrators are authorized to administer the pension funds.

Contributions

2.2 In case of Chile, only the employee contributes. Employer withholds a certain percentage of the employee's salary and deposits to the AFP chosen by the employee. In Hong Kong, the employee contributes 5% of the earnings matched by a 5% contribution by the employer.

Basis of the System

2.3 The Chilean pension system is employee-based: it allows the affiliate the freedom of choice in choosing the AFP. The mandatory provident fund (MPF) in Hong Kong is an employer-based system. As a result, the employees in Hong Kong do not have the autonomy in choosing their pension fund administrator.

Transfer of Account during Change of Employment

2.4 The Chilean worker is not required to change the AFP because of having a new employment. However, in Hong Kong, the employee must join the new employer's scheme after change of employment for contributions derived from the new employment.

Portability of Accrued Benefits

2.5 In Chile, when a worker chooses another AFP, the accrued benefits would be transferred to the new AFP. In Hong Kong, when an employee changes or ceases employment, the accrued benefits can be transferred to a new scheme or retained in a registered scheme which is a master trust scheme[2].

Costs of Transferring Benefits

2.6 As a result of competition, the Chilean AFPs have ceased to charge the affiliates when transferring their accounts. The costs of transferring benefits are already covered in the fees payable on monthly contribution.

2.7 In Hong Kong, no administrative fees, except those in relation to redemption of investment, will be charged by trustees for any transfer of MPF accounts.

Industry Schemes

2.8 In Chile, the accounts of the affiliates are fully portable. Hence, there is no industry scheme in the country. In Hong Kong, the Government is studying the setting up of industry schemes for industries with high labour mobility, including the construction industry and the catering industry.

Guaranteed Benefits

2.9 The Chilean government guarantees a minimum pension, and serves as the insurer of the last resort. The guarantees are funded out of general revenues, not the contributions from the affiliates. Hence, the Chilean government is not required to set up a compensation fund.

[2] Master trust scheme means a registered scheme (other than a registered scheme which is an employer sponsored scheme) which is open to membership (i) the relevant employees of more than one employer, (ii) self-employed persons, or (iii) other persons with accrued benefits in a registered scheme.

2.10 The Hong Kong Government does not guarantee a minimum pension, and is not the last insurer of the MPF. Instead, the MPF Authority may establish a compensation fund to compensate any scheme member for any loss in the MPF accrued benefits caused by misfeasance or illegal conduct determined by the court. The Authority may impose levies for establishing and administering the fund. In addition, all MPF schemes will be required to provide a capital preservation product as an investment option which would ensure MPF benefits would not be eroded by fees or negative investment return.

Table - Comparisons of the Proposed Mandatory Provident Fund System in Hong Kong with the Chilean Pension System

	Proposed MPF in Hong Kong	Chilean Pension System
Pension fund administrators	Contributions are managed and invested through the private sector.	Contributions are managed and invested through the private sector.
Choice of pension fund administrators	Employer chooses the pension fund administrator.	Employee chooses the pension fund administrator.
Coverage	The MPF system covers all employees between age 18 and 64, and all self-employed persons of age 64 and below.	Compulsory membership for all salaried workers and optional for self-employed workers.
Contributions	Employee contributes 5% of earnings matched by a 5% contribution by the employer. Self-employed persons have to contribute 5% of their relevant income.	Only employee contributes. The employer withholds a certain percentage of the employee's salary and deposits to the AFP chosen by the employee.
Transfer of account during change of employment	The employee must join the new employer's scheme after change of employment for contributions derived from the new employment.	The worker is not required to change the AFP because of having a new employment.
Portability of accrued benefits	When an employee changes or ceases employment, the accrued benefits can be transferred to a new scheme or retained in a registered scheme which is a master trust scheme.	When a worker chooses another AFP, the accrued benefits would be transferred to the new AFP.
Costs of transferring benefits	No administrative fees will be charged by trustees for any transfer of accounts.	AFPs have ceased to charge a commission on transferring benefits due to the intense competition.
Industry schemes	The Government is studying the setting up of industry schemes for industries with high labour mobility, including the construction industry and the catering industry.	The government does not have to set up any industry scheme as the pension system is based on each individual. The worker can have the same AFP after change of employment.
Last insurer of the pension system	The Government does not serve as the last insurer of the system.	The government serves as the last insurer of the system.
Compensation fund	The MPF Authority may establish a compensation fund to compensate any scheme member for any loss in the MPF accrued benefits caused by misfeasance or illegal conduct determined by the court. The Authority may impose levies for establishing and administering the fund.	The government guarantees pension benefits. The guarantees are funded out of general revenues, not contributions from the affiliates. Hence, it is not required to set up a compensation fund.
Guaranteed pensions	The Government does not guarantee a minimum yield for the system. However, all MPF schemes will be required to provide a capital preservation product as an investment option which would ensure MPF benefits would not be eroded by fees or negative investment return.	The government guarantees a minimum yield of the system.
Supervisory role	MPF Authority monitors the operation of MPF schemes.	Superintent of Pension Funds (SAFP) is the major government authority responsible for the technical supervision and control of the AFPs.

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