Economics Research Department & Pension and Insurance America BBVA

Pensions Observatory

March 31st, 2008

Joaquín Vial
Head economist
Global Trends Unit
jvial@grupobbva.com

Adjustments to the Chilean pension system

The present government came to power with a clear mandate to make adjustments to the pensions system. When President Ms Michelle Bachelet, took up her position in March 2006, one of her first initiatives was to appoint an expert committee, led by Mario Marcel, with the goal of making a preliminary diagnosis and proposals after a period of wide-ranging and open consultations. This Commission's Final Report was submitted in July 2006[1]. In December of that same year, the government submitted to the National Congress a bill including the main elements of the proposal of what was known as the Marcel Commission[2]. Over the course of one year, the bill was debated and analysed in both chambers of Congress. A protocol agreement was signed with the opposition, which settled almost all the issues under discussion facilitating endorsement of most congressmen to support the project; the bill was dispatched before the summer recess and was enacted as law early this March.

The new law introduces a series of modifications and adjustments to the pensions system. The foundations of the system are not altered, but some of the shortcomings which had been detected (in the Marcel Commission report and in other studies, such as that carried out by BBVA in 2006) have been addressed. Generally speaking, these modifications can be divided into four areas: reinforcing the welfare component of the pension system with a higher state contribution, institutional changes to foster greater competition and flexibility in the pension fund management business, reinforcing incentives for pension saving, both compulsory and voluntary, and, lastly, modifications in disability and survival insurance.

1. Reinforcing the welfare pillar

This is the aspect of the project which received most support and represents the most significant change in comparison with the previous regime. The central pillar of the pension system implemented in 1981 is that individuals are responsible for constructing their retirement pensions through their contributions to the pension system, and for overseeing fund managers to obtain competitive costs, high returns and appropriate levels of risk. Thereafter, individuals also have a great deal of responsibility, as they choose the time they wish to retire and their pension scheme. This was a radical shift from the conventional wisdom upheld in the world at that time, whereby the government was responsible for underwriting old age pensions.

1 Presidential advisory council for Pension Reform: "El derecho a una vida digna en la vejez. Hacia un Contrato Social con la Previsión en Chile" ("The right to a dignified life in old age. Towareds a Social Contract for Pensiosn in Chile"). July 2006.

2 For further details of the contents of the bill and the amendments made during the proceedings in Congress, refer to the Congress Library website: http://www.bcn.cl/carpeta_temas_profundidad/temas_profundidad.2007-04-11.7191033638/temas_profundidad_view

However, the new system did contain an important welfare element, as the Government ensured a minimum pension for persons who made contributions to the system for 20 years or longer. There was also a Welfare Pension to support the poorest members of society during old age, when they did not qualifiy for a pension, for example, because they did not comply with requirements concerning contributions to the minimum pension insurance.

The project approved acknowledges that this insurance net was insufficient: after 25 years of experience with this system, it is evident that a very high percentage of members are unable to contribute sistematically to comply with the 20-year requirement. Accordingly, the Welfare Pension Contribution (Aporte Previsional Solidario) system was created, applying solely to low and medium income households. This contribution supplements self-financed pension income when this income is below $ 255 thousand (which is equivalent to US$ 490) a month (in fully functional set up) with a proportional formula, starting from $ 75 thousand (around to US$ 140) when individuals do not have a self-financed pension.

It is estimated that in fully deployed scheme, reinforcing of the welfare component of the system should represent a cost of around 1% of annual GDP, and it seems that such an amount could be absorbed without tax increase.

This system virtually ensures that there will be no elderly people living below the poverty line. Naturally, the provision of this security means less incentives for people to contribute and to take part in the formal job market in their daily life, but this could be partly offset by the growing shortage of workforce arising from lower demographic growth and incentives for formalisation included in the pension reform act.

2. Institutional changes to promote competition

An important element in the government's initial diagnosis was that the concentration and natural barriers on the entry of new pension fund managers (economies of scale) prevented competition, resulting in high costs for members. Although comparisons with the international fund management business suggest that costs are not overly high, this point became a high priority issue for the government. The proposal finally accepted adopts a broad approach, opening various ways of creating incentives for greater competition, but without threatening the sector's viability or encouraging further concentration. On the one hand, a mechanism for the bidding/awarding of the new affiliates entering the system is introduced, to push down commissions. On the other hand, it opens up the possibility of subcontracting services such as account management, for example, free of VAT on these transactions, as a way to cut entry costs and reducing the impact of economies of scale. While the bill was being processed, the prospect of banks creating subsidiaries for pension fund management was ruled out, as it was considered more important to maintain competition in capital markets and preventing conflicts of interest between third party fund managers and the funds themselves (banks). In fact, the new law has strengthened the separation between banks and pension fund managers, by introducing prohibitions to share resources. At the same time, control of investments was reinforced by creating the figure of the "inspector delegate".

3. **Reinforcing pension saving**

Under this principle several measures were introduced: from setting pension contributions of independent workers compulsory to providing incentives, using subsidies, to Voluntary Welfare Saving (Ahorro Previsional Voluntario, APV) of workers with incomes below 1.5 million pesos (near to US$ 2 900) per month. The law also opens up the possibility of collective APV (APVC), making it possible for workers and companies to agree on additional pension saving plans in collective contracts. These measures are very important, as they enhance the prospect of securing replacement rates in keeping with the actual income of members, something which was a remote possibility with independent workers and medium and high income workers whose compulsory contributions were limited by the ceiling of maximum taxable income.

4. **Adjustments in Disability and Survival insurance (SIS)**

This is one of the most important components of the pension system, and, at the same time, one of those least known and appreciated by workers. Until now, this insurance was contracted by the pension fund manager with specialised companies and the premium was charged as part of the pension fund manager's overall commission. Premiums have been rising over time due to the ageing of members – age is a very decisive factor in the disability rate – and the fall in interest rates, compelling insurance companies to contribute capital to offset the fall in the return of the reserves guaranteeing payment of the policies in force. The authorities feared that the pension fund managers would try to cut costs by privileging affiliation among low risk populations; accordingly, the proposal was made to separate the pension fund manager commission from the SIS premium, establishing an auctioning mechanism for these insurance policies. Although some people thought that this could lower costs for members, it soon became apparent that the combination of higher benefits and longer life expectancy (an area unrelated to pension reform) would lead premiums to rise. Consequently, the authorities accepted that said premiums should be paid by the employer, instead of being subtracted from the salary. Although the final cost is unchanged, these higher expenses for the employer will have an effect on the creation of formal jobs at the margin.

Perhaps the most important aspect of this new reform is that it has been approved with broad legislative support, giving the pension system a high degree of political and social legitimacy. This is essential in terms of the stability required by an organisation which is going to serve individuals throughout the course of their adult life, first receiving contributions and then paying benefits. Second, we must stress the strengthening of the social security network for the poorest members of society, which will also help to create a greater sense of belonging and responsibility with society as a whole. This comes at a price, and is associated with less incentives for formality and a commitment of considerable government resources, which could also be significantly increased due to possibly longer longevity in the future. However, looking at the situation overall, it is very likely that the net effect is positive.

Does this mean that the chapter on reforming the pension system in Chile is over? Possibly not. The vast majority of workers affiliated to the pension system are still in the funds accumulation phase, and very few employees have retired under the new system. Within a few years, the workers of the transition between the systems will begin to retire on a massive scale, and this is expected to give rise to new problems, making it necessary to apply new adjustments, focused on providing

security and efficiency to the withdrawal of funds stage. Aspects such as the quality of assessment when retiring, the rise in longevity and the rapid ageing of the population, the proper response needed for life annuities, or the need to limit tax commitments owing to rapid depletion as a result of planned withdrawals, are some of the matters that will make headlines in coming years. Compared with these issues, questions such as a the introduction of a state pension fund manager, about which there has been so much debate in recent years, will render irrelevant.

Can the reformed pension system be exported? The reform of the pension system in 1981 was the first step towards transferring power and responsibility for pensions from governments to individuals, drew a great deal of attention and estimulated very important reforms in other countries, many of which contained elements of Chile’s experience or were inspired by it, introducing adjustments to their local customs. With regard to the current reform, it might impact the discussion of the designs for the welfare pillars in several countries, especially in Latin America, as well as on discussions concerning saving incentives, two aspects which are already on the public agenda in several countries. However, as far as the former is concerned, other countries are unlikely to adopt Chile's Welfare Contribution scheme, for various reasons: first of all, it is very expensive, and these countries stand at a much earlier stage than Chile in the transition between systems, with their governments still facing growing tax commitments over the course of time owing to the aforesaid transition. On the other hand, no other government in Latin America (and indeed, only a few worldwide), can boast a fiscal position which is as solid as Chile's. Secondly, countries facing much more serious labour informality problems than those suffered by Chile must be very careful regarding incentives for informality. Proposals such as staggered access to a minimum state pension insurance, in which the insured pension is a fraction of the minimum amount established for 20 years of contributions, for example, has the twofold advantage of being cheaper and promoting labour formality to a greater degree.

The latter was one of the proposals which arose in the debate in Chile which were not implemented in the end. Another very interesting idea, which arrived too late to have a influence on the bill, was for the government to make a fixed contribution to each Chilean citizen at birth, calculated in order to ensure a minimum pension at the age of 65. This not only assures the pension threshold with a very low fiscal cost (65 years of capitalisation for the initial contribution), but also introduces automatic affiliation to the pension system. Anyone seeking inspiration in Chile's experience for future reforms of their pension systems, would do well to examine the law enacted and many of the proposals floated and discussed during the consultation period.