PENSION NOTES

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Analysis of the Chilean Pension Reform Bill of Law

Executive Summary

At the end of November 2018, the Chilean government submitted a pension reform bill of law, aimed at increasing the income of current and future pensioners. Pensions will be increased in the short term mainly by strengthening the Solidarity Pillar, while long-term increases will be achieved through mandatory pension savings.

The bill of law seeks to gradually increase monthly contributions from 10% to 14%, at the expense of the employer. Workers can freely decide whether to contribute all or part of this increase in the mandatory contribution to their individual accounts in the AFPs, or to individual accounts in agencies managing complementary pension savings plans (CSMs), which will be created for such purposes. This measure aims to increase competition in the sector. The Government has stipulated that all fund managers must have a sole line of business and be subject to across-the-board supervision and oversight by the Chilean Pensions Commission. The CSMs can charge a commission on the managed balance and must maintain a reserve of 0.25% of accumulated funds[1], to answer for any damages to members in the event of any infringement of their obligations. The creation of new agencies to manage the additional contribution is one of the most controversial points of the reform, since it is still not clear how these fund managers will operate and how the equality of conditions between them and the existing AFPs would be guaranteed.

The bill also seeks to strengthen the Solidarity Pillar, increasing the basic solidarity pension by 10%, or even up to 50%, depending on the age of the pensioner. The solidarity pension contribution will also increase by 15% immediately. Thus, the plan involves a financial commitment by the government of approximately US$ 3,500 million.

The reform also includes incentives for workers to voluntarily defer their retirement age.

Finally, the reform mandates the creation of an insurance policy for covering severe dependency situations, and a subsidy for

[1] The legislation currently in place requires the AFPs to maintain a reserve of 1% of the managed funds.

those who have not contributed and find themselves in a similar situation. The bill has already been submitted to the Chamber of Deputies for discussion.

This Pension Note analyses the main characteristics of this bill of law.

I. Introduction

In Chile, as in many parts of the world, the pension system is granting pensions below the expectations of the population.[2]. This is mainly due to conditions other than the administration of the system, such as demographic changes (accelerated aging of the population), low interest rates worldwide, changes in the labor market (informality and automation), without the corresponding adjustments in the basic parameters of the system, particularly, the retirement age and the contribution rate.

Hence, it is very important to implement a reform of the system that will enable increasing pension amounts, especially for those who face major difficulties in achieving savings that will allow them to self-finance an adequate pension. Thus, at the end of November 2018, the Chilean government submitted a bill of law for reforming the pension system that seeks to move in this direction, both from a short-term perspective, by increasing existing pensions (mainly by strengthening the Solidarity Pillar), and in the long-term, by increasing mandatory pension savings.

The reform is based on the following basic assumptions. First, the average replacement rate of all self-financed old-age pensions, without considering solidarity pillar benefits, is 52% of average income in the last 10 years. However, the replacement rate for those who contributed for more than 25 years is 78% of average income, and only 15% of average income for those who contributed for less than 4 years. The low number of years of contributions is worrying. On average, over the last 10 years, male pensioners contributed for 18 years and female pensioners for 12.7 years. In terms of coverage, 65% of the employed population contributes regularly. Despite the above, it is important to point out that these levels of coverage are the highest in the region.

The Government also acknowledges the contribution of the pension system to economic growth: according to estimates by Corbo and Schmidt-Hebbel (2003), between 8.5 and 14.5% of the country's economic growth between 1981 and 2011 can be directly explained by the development of the pension system.

With respect to life expectancy at the official retirement age, it is assumed that women have a survival rate of 30.4 years and men 20.3 years; i.e., both men and women contribute for a fewer number of years than the number of years of retirement. The situation of women is particularly worrisome, as they retire earlier than men, have low contribution densities and must finance a greater number of post-retirement years.

Another point worth mentioning is the sharp drop in the returns of the pension funds and the interest rate over time. Whereas in the 80s the real return of the pension funds was

[2] Valdés (2018) provides an excellent analysis of the causes of this difference between actual and expected pensions in Chile.

12.04%, in the 90s it dropped to 9.93%, in the first decade of this century it was 5.72% and from 2010 to date it has been 4.32%, i.e., the current rates of return are about one third less than they were at the outset of the system. It is worth mentioning that one percentage point less of real average annual return during working life, means between 18 to 20% lower pension.

With respect to the operation of the Solidarity Pillar, the replacement rate for the first income quintile (self-financed plus the contribution of the solidarity pillar) is 243% of the last income. It is 72% for the second quintile and 51% for the third quintile.

II. Purpose of the bill of law

As previously mentioned, the bill of law's main purpose is to increase pensions in the short and long term, through different mechanisms. In order to improve existing pensions, the bill of law proposes increasing the Solidarity Pillar and creating additional benefits for the middle class, women and seniors. This implies short term improvements for 2,197,000 people, rising to 2,600,000 people by 2027. On the other hand, in order to increase future pensions, the mandatory contribution will increase by 4 percentage points (at the employer's expense), and will be entirely allocated to the contributor's individual account.

It is worth mentioning that some have raised the idea of dividing the bill into two parts, with the aim of first legislating on increasing the Solidarity Pillar, and then the rest. As rightfully pointed out by Libertad y Desarrollo (2018), moving forward in this way would be "a grave error," since the non-contributory system (Solidarity Pillar) in Chile is fully integrated with the contributory system (individual savings) and its benefits depend on the level of benefits obtained with the self-financed part, so these pillars cannot be separated, and it cannot be assumed that they operate independently. Similarly, such a strategy would eliminate the new benefits incorporated for the middle class (focused on women and senior citizens). Dividing the bill of law would also entail focusing only on the part of the reform implying higher fiscal expenditure, without considering that in order to improve future pensions, workers must necessarily increase their savings as soon as possible. Libertad y Desarrollo (2018) points out that "dividing the bill of law would entail moving forward only in more popular aspects, once again postponing the necessary increase in the mandatory pension contribution rate, which has not changed since the commencement of the system."

The core elements of this reform are presented below.

II.1 Improvement of the benefits of the Solidarity Pillar.

Different mechanisms have been proposed for improving the Solidarity Pillar. First, by gradually increasing the amounts of current and future benefits, based on age. Five age brackets have been established, starting with the 65 to 69 age bracket, and ending with the 85 or more bracket. The value of the Basic Solidarity Pension (BSP)[3] and the

[3] The BSP is a monthly monetary benefit available to individuals who are not entitled to a pension in any pension system, are over 65 years old and are part of the poorest 60% of the population. The

Maximum Pension with Solidarity Contribution (PMAS)[4] increase in a differentiated way, depending on each age bracket. The PMAS will initially increase by 15% and the PBS by 10%, increasing between 15 and 47% and 10 and 42%, respectively, over the next 4 years, benefiting older age brackets more.

It also creates a longevity insurance for the Solidarity Pillar. Thus, Solidarity Pillar beneficiaries with programmed retirement will receive a constant final pension. This will first be financed by the balance of the account, and after it is exhausted, by a state subsidy.

It has been proposed that subsequent fulfillment of the requirements for the Solidarity Pillar should be authorized. Programmed retirement pensioners with a base pension higher than the PMAS, who fall within the highest age bracket (85 and above), and whose pensions drop below the amount of the PBS, will be able to access a supplement allowing them to receive a pension equivalent to the amount of said basic pension, if they meet the age, means testing and residence requirements.

The incompatibility between the PBS and the solidarity disability social security contribution will be eliminated when the pensioner receives a salary. A periodic review of means testing is also stipulated. The Social Security Institute (IPS) must review compliance with the means testing requirements for receiving the benefit every 3 years from the granting of the benefit,

The Government initiative proposes financing the improvement of the Solidarity Pillar from the general revenue of the nation and through means tested policies, which is entirely correct and in line with the general recommendations of international agencies such as the OECD, the IMF and the World Bank, which point out that the solidarity benefits of the pension systems must be financed with the State's general taxes. On the other hand, any proposal that suggests increasing current pensions at the expense of higher contributions from contributors, would imply distortions in the labor market (by introducing a tax on labor), in addition to having regressive effects.

II.2 Improvement of individually funded pensions

The bill of law includes a series of measures for increasing long-term pensions (individually funded), detailed below.

i. *Gradual increase of the mandatory contribution by 4 percentage points, to the expense of the employer.*

The total amount of the additional contribution will be assigned to the individual accounts of workers. Nonetheless, workers may freely decide whether their additional contributions will be wholly or

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current amount of the BSP is CLP 107,304 (USD 156). This benefit includes two types of pensions: old age and disability.

[4] The Old Age Solidarity Pension Contribution (APS) is the State-financed benefit available to individuals with a base pension greater than zero and less than or equal to the Maximum Pension with Solidarity Contribution (PMAS), who meet the age, means testing and residence requirements. The current amount of the PMAS is CLP 317,085 (USD 460).

partially managed by an AFP, or by a complementary savings manager (CSM), which may be set up for such purposes.

The CSMs may be subsidiaries of savings and credit cooperatives, family allowance compensation funds, life insurance companies, general fund managers and the AFPs themselves. These agencies may include rules and regulations prohibiting the distribution of profits to their shareholders. They must also have a sole line of business and be subject to across-the-board supervision and oversight by the Chilean Pensions Commission. Their management commissions will be charged on the managed balance. They must maintain a reserve of 0.25% of accumulated funds to answer for any damages to members in the event of any infringement of their obligations.

Complementary savings plans may be purchased individually or in groups. In the latter case, the commissions, duration of the plan and complementary social security services must be agreed with the respective agencies. In any event, the enrollment of workers in any plan will always be voluntary.

The investment regime of the complementary plans will be defined by the fund manager in accordance with the resolution issued by the Pensions Commission after the report of the Investment Review Board endorsed by the Ministry of Finance. They will only be allowed to invest in the same types of instruments authorized for the pension funds managed by the AFPs. On retirement, the balance must be consolidated with the savings in the member's individual account in the AFP.

The introduction of new stakeholders in the management of this additional contribution has been one of the most controversial proposals, particularly regarding the possibility of group negotiation of the management commission, since this could give rise to unacceptable collusion between the fund managers in order to win contracts.

ii. Improvement of current and future pensions of the middle class and women

An additional state contribution has been created for women with a minimum of 16 years and men with a minimum of 22 years of contributions. The monthly amount of the additional contribution for retirees when the law comes into effect will be 0.15 UF.[5] (approximately USD 6) per year of contributions equal to or above the threshold, with a maximum of 0.8 UF (approximately USD 32). For future pensioners, the monthly amount will be 0.15 UF per year of contributions above the threshold (with no cap).

Future pensioners who contribute after the official retirement age, without retiring, will also receive an additional monthly contribution of 0.075 UF (about USD 3) for each year of contributions after the official retirement age. Only periods with contributions after compliance with a required threshold will be considered for the purposes of this calculation.

The additional contribution for middle-class women (a monthly amount of 0.05 UF (about USD 2) per year of contributions equal to or

[5] 1 UF is equivalent to CLP 27,565 as of January 1st, 2019.

greater than 16 years, with a maximum of 0.2 UF (about USD 8) for pensioners when the law comes into effect), will be added to their previous contributions. Future pensioners will receive a monthly amount of 0.05 UF (about USD 2) for each year of contributions equal to or greater than16 years (with no cap on the number of years).

The years-of-contribution thresholds will come into effect gradually, starting at 20 and 26 years for women and men, respectively, reaching 16 years for women in the fifth year after the promulgation of the law and 22 years for men in the seventh year after the promulgation of the law.

The pension plus the additional contributions may not exceed 25 UF (approximately USD 1,000).

iii. Creation of a dependency subsidy and insurance

A dependency subsidy and insurance has been established for adults over 65 with severe functional dependency, who require permanent assistance from other people to perform the basic activities of daily life. This condition must be permanent.

a. Subsidy. The subsidy will be of a non-contributory nature and the following will be required to access it:

- Must be over 65
- Must be part of a family group within the poorest 60% of the population.
- Must be resident in Chile for at least 20 years.
- Must be rated as a severely dependent by medical commissions.
- Must not be entitled to dependency insurance.

The subsidy will be financed by the State and managed by the Ministry of Social Development. The amount of the subsidy will be CLP 80,000 (USD 116) for those within the poorest 40%; CLP 70,000 (USD 101) for those within the fifth poorest decile; and CLP 60,000 (USD 87) for those within the sixth poorest decile.

b. Dependency insurance. This insurance will be of a contributory nature and will be financed with a contribution of 0.2% of the worker's salary, to the expense of the employer. The requirements for coverage by this insurance are:

- Must be over 65 and retired.
- Must have paid the dependency insurance premium for 60 months or more (48 months or more in the case of women) prior to retirement, or up to 70 years of age, whichever occurs last.
- Must be rated as severely functionally dependent by medical commissions.

These contributions will be paid into a dependency fund managed by a corporation with a sole line of business, and will be used to pay the premium of the insurance companies that will pay the dependency benefits. The insurance provision service will be awarded by public tender. For the purpose of paying the benefits, the fund management company must take out an insurance policy in a bidding process, from the company that offers the best economic bid. The benefit will be paid as a monthly life annuity by the insurance company(s) that won the tender.

The benefit will amount to 0.2 UF (CLP 5,513 or USD 8) for every 12 months of contributions, with a minimum amount of 3 UF (USD 120). If members do not meet the 60-months-of-contributions requirement, their accumulated savings will be paid into their individual pension accounts when they turn 70.

The insurance and the dependency subsidy are mutually incompatible. Both expire on the death of the beneficiary and will not be considered when granting solidarity pensions.

iv. *Strengthening of Voluntary Pension Saving (APV)*

It has been proposed that workers should be able to engage in VPS in favor of their legal pension beneficiaries, receiving the corresponding tax benefits. Tax benefits are currently only granted when the VPS is for the worker himself.

The bill of law also seeks to encourage collective voluntary pension savings (CVPS), allowing employers to offer plans with automatic enrollment of workers, authorizing both the contributions of employers and the minimum period of permanence for the worker to acquire ownership of these contributions to be determined on the basis of the length of service of the worker in the company. Contracts may include automatic increases in the contribution of the employer and its employees, as well as increases linked to salary increases.

v. *Insurance for covering pension gaps*

The 14% contribution to the mandatory individual account, charged to the Solidarity Unemployment Fund, will be used for reducing the pension gaps of workers who have chosen to finance their benefit with their individual unemployment account. The premiums for the disability and survival insurance and the dependency insurance that the bill of law seeks to create, will be financed from the same fund. The amounts received by beneficiaries will be exempt from commissions.

vi. *Collection of contributions and alleged default*

This involves the creation by the AFPs of a centralized pension contribution collection management system for generating economies of scale and scope in the collection process.

The Pensions Commission will regulate the minimum procedures that agencies must comply with to determine whether it is appropriate to file a complaint, based on presumption, which includes notification to the member, queries to the unified collection contribution system, the Internal Revenue Service, the Labour Directorate and collecting agencies. The Pension Commission will determine the minimum conditions that fund managers must comply with before clarification procedures are understood to be exhausted, in order to initiate or reject collection due to presumed default. Members will have 5 years to submit their claim, counted as of the date that the fund manager notified them of its of decision not to sue. This right will prescribe thereafter.

vii. Incentives to postpone the retirement age

Individuals who carry on working beyond the official retirement age will be authorized to withdraw an amount equivalent to 50% of the difference between the accumulated balance in their individual accounts and the balance required for financing their pensions if they had retired at the offical retirement age. An annual maximum of 200 Monthly Tax Units (MTU) (USD 13,874) of these withdrawals will be tax-free,[6] with a total maximum of 1,200 MTU (USD 83,244), or alternatively of 800 MTU (USD 55,496) for one year. These amounts will be considered together with the withdrawals of Freely Disposable Surpluses[7] for the aforementioned tax benefit.

The AFPs and the CSMs are authorized to establish commissions for people who carry on contributing after the official retirement age. 76,140 contributors are currently old-age and disability pensioners, and 43,167 members have already reached the official retirement age.

viii. Promotion of life annuity and deferred life annuity

Pensioners can now acquire one or more deferred life annuities from a life insurance company with part of their pension savings. Workers who are 10 years or less from the official retirement age can take out a life annuity that will start being paid at the official retirement age, or at a later date. It will be mandatory to acquire it through the Pension Amount Consultation and Offers System (SCOMP).

The balance of the mandatory contributions used for taking out the life annuity will be considered part of the pension savings balance for calculating the additional contribution that the insurance companies must pay into the individual account in case of disability, survival or death.

Furthermore, in order to facilitate access to life annuities for pensioners with lower balances, the current minimum pension amount requirement for accessing a life annuity from the BSP has been reduced[8] to 3 UF (about USD 120).

ix. Modifications to the SCOMP

The main modification consists in eliminating the external offers made directly to members by the insurance companies after the pension amount offers certificate has been issued.[9]. Members will also be allowed to request offers of pension amounts, directly accessing SCOMP, without having to do so through an AFP, an insurance company or a pension adviser, and the Pensions Commission or the Financial Markets Commission (FMC) may establish additional information to be transmitted to SCOMP,

[6] 1 MTU is equivalent to CLP 48,353 (USD 69.37).

[7] Freely Disposable Surplus is defined as the balance remaining in the member's individually funded account after retirement, provided that the member meets the requirements.

[8] The current amount of the BSP is CLP 107,304, approximately USD 156.

[9] At present, most of life annuities taken out correspond to an offer external to the SCOMP system, which must necessarily be for an amount greater than that offered by the life insurance company through SCOMP, but may be less than the offers submitted by other companies.

such as the socioeconomic characteristics of members, so that bidders may submit pension offers that better suit their characteristics, without them losing their anonymity.

x. Improvement of disability and survival pensions for younger workers

The amounts of the disability and survivor pensions generated by the DSI are currently calculated by dividing the sum of the taxable income of the last 10 years by 120. Thus, those with less than 10 years of membership only obtain partial insurance coverage. In order to correct this effect on workers with less than 10 years of membership, the standard prior to 2008 is reinstated, whereby the effective contribution period is considered to be 24 months.

xi. Economic compensation for divorce, beneficiaries of common-law marriages and same-sex cohabitants

The judge can order the transfer of funds from the individual pension savings account of the spouse obligated to compensate into the pension account of the spouse receiving the compensation. The proposal provides that the funds from the additional 4% contribution must be considered in the compensation.

Furthermore, the parents and children in the common law marriages of originators, who lived at their expense and had the marital status of divorcees on the date of the death of the latter, are included as beneficiaries in the survival pension. Only mothers, fathers or children of common-law marriages, who are single or widowed, can currently access this benefit.

Likewise, the bill of law provides for the equalization of benefits and duties between spouses and common law partners in a civil partnership (who may also be same-sex cohabitants).

II.3 Encouraging competition

In addition to the possibility of new actors (CSMs) entering the market, the bill of law seeks to promote competition within the industry through different mechanisms.

a. The AFPs and the CSMs are authorized to share customer service premises with social security agencies and licensed VPS agencies. Each agency must have its own personnel, demarcating the physical space. However, the AFPs and the CSMs will not be allowed to directly or indirectly share customer service units.

b. AFP sales personnel are authorized to sell individual or collective VPS of other agencies with which the AFP has agreements for such purposes. The sales personnel of licensed agencies offering VPS plans will also be allowed to sell the services of the AFPs and CSMs. In general, the sales personnel of the AFPs and the CSMs will be allowed to market the products of other agencies. The only prohibition is the joint sale of mandatory and voluntary products by the AFPs and the CSMs.

c. The AFPs and the CSMs are authorized to outsource customer services and the processing of benefits.

d. The AFPs, CSMs and agencies licensed to offer VPS are authorized to establish subsidiaries or form part of the ownership of companies whose line of business is the operational management of individual pension accounts. These companies can be incorporated by individuals or bodies corporate other than the AFPs, complementary pension savings managers and agencies licensed for managing VPS.

e. Allow the AFPs and CSMs to create joint stock companies that do not distribute profits among their shareholders, with the profits being distributed among members to increase their individual accounts.

f. The reserve requirement for the AFPs is reduced from 1% to 0.5% of the managed fund. This is expected to reduce this barrier to entry into the industry.

g. Bidding for members is modified as follows. First, the period in which the winning AFP receives the flow of new members is increased from 2 to 3 years, although the period in which new members must remain in the winning AFP is still 24 months. Second, a bid lower than the lowest existing bid must be submitted in order to be able to participate in the bidding process, excluding the one on which the last tender was awarded. Third, the Pensions Commission may reject offers in which the commission does not ensure the economic solvency of the bidder. Fourth, when there is no winner, new members will be assigned to the AFP charging the lowest commission and must remain in it for 24 months.

h. The AFPs and the CSMs are authorized to offer discounts for permanence or for group enrollment. The agencies offering these discounts must publish the commissions based on the number of participants and the time of permanence on which the discount is based. Terms of permanence can be: 12, 36 or 60 months, and more. Groups of participants can comprise: from 2 to 49, from 50 to 199, from 200 to 499, from 500 to 999 and 1000 or more. The discounts will be made effective through monthly refunds paid into the account.

II.4 Improving pension education and information and increasing transparency

One of the major shortcomings that has been detected in the Chilean pension system is the lack of pension information and education for its members and the population in general. In order to correct this problem, the bill of law stipulates that the AFPs and the CSMs must allocate 0.25% of the annual commissions collected to educational projects designed by the fund managers individually, in association with one another or with third parties, and the projects must be approved by a Technical Committee.

The bill of law also seeks more accountability in transfers (between funds and between fund managers) for which the Pensions Commission is empowered to stipulate the maximum number of times in a calendar year that a member can switch between AFPs, CSMs or both. It is also authorized to define the term in which the changes between one plan and another will materialize. Furthermore, when members select a fund other than the one assigned by default, according to their age, the AFP must periodically request members to confirm their decision. If members do not reply within the term defined by the Pensions Commission, the AFP must transfer them to the fund corresponding to their age.

The bill of law also introduces a series of measures for increasing the transparency of the system. These include:

a. The AFPs and CSMs must provide their members with a public account of their activities in the previous calendar year.

b. Both the AFPs and the CSMs must report on the brokerage commissions charged to the funds in their annual reports, in the monthly statements and on their websites. They must report their own commissions and those of the other fund managers of the industry. This information must also be sent to the Committee of Users.

c. The conflict-of-interest resolution policy of the fund managers must indicate the criteria for the selection of the asset managers. The directors of the fund managers must express an opinion on these matters and the handling of possible conflicts of interest.

d. It makes the position of internal auditor, comptroller and compliance officer, among others, exclusive. This rule is also applicable to the CSMs.

e. The bill makes it mandatory to inform the Pensions Commission of any change in share ownership whereby a shareholder or group acquires a stake equal to or greater than 10%. Likewise, changes in the control of any company that directly or indirectly holds 10% of its capital, must be reported.

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