



PENSION NOTES

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The role of the pension funds in promoting better corporate governance standards

- Sound CG practices increase the value of companies by between 15% and 30%.
- The pension funds, as informed and influential minority investors, have improved the CG standards of the companies in which they invest.
- There are emblematic cases in Chile and Colombia in which the AFPs have directly defended the interests of all minority shareholders.

Executive Summary

Corporate Governance (CG) is a set of rules, practices and procedures that determine and regulate actions within a company, by stipulating the rights and obligations of the different parties involved. Sound CG practices enhance the integrity of companies, financial institutions and markets. The companies adopting such practices increase their efficiency, reduce costs, limit risk and become credible in the eyes of society and the markets, resulting in increased competitiveness and capital cost reductions, thus increasing their value.

There is evidence that enhanced CG practices increase the value of companies by between 15% and 30%.

Studies also show that the shares of companies in which the AFPs invest are worth 14% more than the ones in which the AFPs do not invest.

The pension funds play a fundamental role in developing capital markets and enhancing the quality of the CG of the companies in which they invest, due to the obligation of their managers to serve the interests of members and to protect the savings and future benefits of retirees.

The effect of the individually-funded system on the CG of companies in which it invests has been generally positive, and has materialized through three channels:

- (i) The reforms to the legal framework and supervision of companies have improved the mechanisms for regulating CG.
- (ii) The growth of the funds and their transactions has increased the liquidity of the capital market, the professionalization of the financial intermediaries, and the adoption of more efficient transaction technologies.
- (iii) Direct supervision and involvement by the AFPs, exercising their rights as minority shareholders and/or bond holders, have contributed to improving the internal CG mechanisms of companies, thereby avoiding damages to workers. Due to the maturity of the system, there is an extensive history of involvement of the AFPs in Chile, and the first most renowned case is the so-called Chispas case in 1997. Experiences in Colombia are more recent, but there are equally relevant emblematic cases.

The AFPs must comply with requirements and procedures for the election of candidates to independent director in companies in which the pension funds are invested. It is already common practice to engage headhunting firms to seek out candidates for the position of director.

The Latin American AFPs will become increasingly important in capital markets in future, as they continue to manage growing volumes of pension funds, and they will be a key factor in improving the CG standards of the companies they invest in.

Introduction

Sound CG practices have enormous advantages for companies and the economy as a whole. The companies that adopt these practices increase their efficiency and reduce costs, which finally raises their value. Hence, from the standpoint of institutional investors, particularly the Pension Fund Managers (AFPs), which must invest part of their member's resources in instruments that enable obtaining attractive returns with limited risks, investing in companies with sound CG practices and exerting influence for improving the CG standards of the companies they invest in, is essential, since the ultimate goal of the AFPs is to provide adequate pensions for their members.

This brief document first describes the meaning and scope of sound CG practices of companies for institutional investors, particularly for the AFPs. Secondly, it mentions cases in some countries like Chile and Colombia, where the AFPs have contributed to improving said CG practices.

I. The importance of Corporate Governance (CG) and the role of institutional investors

According to Blume (2014), CG has been a special concern for the Organization for Cooperation and Economic Development (OECD), because one of his conclusions is that good CG leads to better operation of the capital markets, which in turn become more capable of attracting investment and improving the performance of companies. Thus, the OECD's Principles of Corporate Governance (2004) set out guidelines governing these matters, as well as guidelines for their implementation, that can be adapted to the particular circumstances of each country or region.

Good CG practices are essential for the integrity of companies, financial institutions and markets, and are a key factor in the health of economies and their stability. According to BBVA (2009), companies adopting such practices increase their efficiency, reduce costs, limit risk and become credible in the eyes of society and the markets, resulting in increased competitiveness and capital cost reductions, thus increasing the value of companies and contributing to the economic growth of the country.

According to the OECD (2009), between 2005 and 2007, the companies belonging to the Companies Circle of the Latin American Corporate Governance Roundtable (promoting best CG practices) had a Capital Performance Index (net income over book value of capital) of 21.7%, 5 percentage points higher than the companies listed on the stock exchange in Latin American (comparison group). The companies in this Circle, in turn, had a 61% higher Price/Book Value (share price against share book value) between 2005 and 2007 than the companies of the comparison group.

Best CG practices also have a positive effect on the behavior of the value of companies in times of

financial crisis. In fact, the evidence shows that the Price/Book Value of the companies of the aforementioned Circle was 133% higher than the Price/Book Value of the companies of the comparison group in the midst of the economic crisis in 2008. During the crisis, in turn, the prices of the shares of the companies of the Circle dropped less than those of the companies of the comparison group. It is also noteworthy that there was an average increase of 8% in the prices of the shares of all of the companies of the Circle after CG improvements were announced in the media.

Role and influence of the pension funds in the CG of the companies in which they invest

According to Ferreiro (2006), in the countries that have incorporated mandatory individually-funded programs, the pension funds play a fundamental role in developing capital markets and enhancing the quality of the CG of the companies in which they invest the resources saved by their members in their individually-funded accounts.

This is because the pension funds manage mandatory savings in these countries, and are therefore responsible for serving the interests of their members, and overseeing the protection of the savings and future benefits of retirees. In Latin America, in particular, the low liquidity of the markets, the existence of controlling shareholders in most companies, and the long-term horizon of pension fund investments, are powerful reasons for their managers to adopt sound CG practices, thus improving the value of the companies.

The AFPs must ensure the quality of the CG of the companies they invest in, in order to comply with the legal mandate of assuring adequate returns and safety for their members. For example, Article 45 of Decree Law 3,500 - the Pensions Law in Chile - states that "the sole purpose of investments made with the resources of a pension fund will be to obtain adequate returns

and safety." Article 147 of the same Law also states that "fund managers must take all the necessary steps for safeguarding the obtainment of adequate returns and safety in the investment of the pension funds they manage." From the above, it follows that the AFP are indirectly obligated, by the aforementioned legal mandate, to promote improvements in CG practices, since the empirical evidence shows that these improvements enable the companies adopting them to obtain a "market reward" which would have a positive impact on the returns of the pension funds that invest in them, with the resulting positive effect on the accumulated balances of the individual accounts of members, and ultimately on pension amounts and replacement rates.

Apart from Chile, the laws regulating the individually-funded systems in all jurisdictions impose similar mandates on the pension fund managers, enforced in different ways, but in general obligating them to invest the pension resources in the best interests of their members and beneficiaries and/or to seek maximum, balanced or adequate returns, safety, diversification and liquidity of the pension funds (FIAP, 2011).¹

In Peru, for example, representatives must be appointed who exercise rights and obligations in stocks and securities that grant proprietary rights, on behalf of the pension funds, subject to good

¹ In some countries, other goals not directly related to the results of the pension funds are incorporated into the mandate. For example, in Costa Rica, the regulations state that the fund managers should seek to invest in instruments that enable the participation of members in the ownership of production factors. In Mexico, fund managers must also consider increasing domestic savings and the development of a market of long-term instruments, and investments must be channeled predominantly to promote domestic productive activity. In the Dominican Republic, on the other hand, the AFPs must prioritize activities that optimize the impact on the generation of employment, construction of housing, and the promotion of industrial and agricultural and livestock farming activities.

CG practices, also promoting their adoption in companies. The AFPs are obligated to express an opinion at meetings, stating their votes for the record. The Superintendency regulates the conditions that representatives must meet, the rules for electing company Directors, and sanctions.

As Ferreiro (2006) points out, the pension funds are also required to promote best CG practices as a matter of policy. Any problem in any companies in which they invest, resulting from flaws in their CG, causing a loss to investors, however small it may be, will most probably be considered by the public as the result of the failure of the AFPs to fulfill their fiduciary role. This situation could encourage different types of questioning of the legal framework governing the pension funds, and possibly regulatory modifications that negatively affect their future returns (FIAP, 2011).

In the individually-funded programs, responsibility for the management of a growing volume of funds requires developing new knowledge, promoting the modernization of the market and ongoing defense of the interests of the pension funds in the issuers in which they have invested, which contributes to improving corporate governance, legislation protecting minority shareholders and the transparency of the transactions of these issuers.

Vittas (1996) and Iglesias-Palau (2000) state that the participation of the pension funds in the stock market has had a positive impact. In particular, the numbers of independent members on the Boards of companies traded on the stock exchange have increased, oversight costs have fallen as a result of the better quality of the information provided by companies to the market, and the companies in which they invest the pension funds are under continuous public scrutiny. In the same vein, Impavido and Musalem (2000) argue that the AFPs monitor the firms in which they invest, and bring pressure to bear for

improving their integrity and transparency to ensure the maximum possible returns on investment.

The experience of Chile and other countries that have implemented individually-funded systems, shows clear examples of how the existence and development of the pension funds have enhanced CG standards. The international evidence indicates that companies that have a relevant minority investor among their shareholders, such as the AFPs, tend to be more valued by the market, since they play a role in monitoring corporate decision-making that can affect the value of their investment. In fact, there is evidence that best CG practices increase the value of companies by between 15% and 30% (McKinsey, 2002), and that the shares of companies that the AFPs invest in are worth 14% more than the shares of the companies in which the AFPs do not invest (Lefort F. and Walker, 2007).

II. Examples of good practices of the pension funds that have successfully improved the corporate governance of the companies in which they invest.

1. Chile

According to BBVA (2009) and Lefort (2007), the effect of the individually-funded system on CG in the Chilean market has been positive, and has materialized through three channels. First of all, the reforms to the legal framework and oversight of companies have improved the CG regulatory mechanisms. These reforms were most probably carried out to ensure that the pension funds are invested with the greatest degree of safety, in an enhanced regulatory environment. Second, the growth of the funds and their transactions has increased the liquidity and depth of the capital market (Corbo and Schmidt-Hebbel, 2003), the

professionalization of financial intermediaries, and the adoption of more efficient transaction technologies. Third, the direct oversight and intervention of the AFPs, exercising their rights as minority shareholders and/or bond holders, has contributed to improving the internal CG mechanisms of companies.

Development and deepening of the capital market

The pension funds have incorporated huge volumes of resources into the capital market. To December 2016, the AFPs managed resources of MUSD 174,480, of which MUSD 106,433 (about 47.8% of GDP) are invested in the domestic market. The growth of transaction volumes has enabled using economies of scale to advantage, contributing to the development of an ever more complete financial industry, deepening the financial market, generating greater information and reducing oversight costs.

Direct protection of minority shareholders

Despite the size of the pension funds, the diversification per issuer that the AFP's must abide by in their investments, makes them

minority shareholders (with high levels of knowledge and information and high-visibility shares) that must defend their interests before the controlling groups of the companies in which they have invested the pension resources. The regulations prohibit the direct participation of the AFPs in the management of the companies in which they have invested, so their opinions and interests must be stated in the Shareholders' Meetings, and their influence on management is indirect through the election of a fraction of independent directors in the companies in which they invest.

The history of the involvement of the AFPs in the companies in which they invest is extensive, with the first renowned case being Chispas in 1997. In that year, the AFPs opposed the purchase of the electricity company Enersis by Endesa Spain, since they considered that the benefits of the operation were unequally distributed among the shareholders (see Table No. 1 for the details of this and other emblematic cases).

Table No. 1: Chile - Emblematic cases of the AFPs defending minority shareholders (1997-2012)

Chispas (1997). The senior management of Enersis negotiated an agreement with Endesa Spain (EE) for the takeover of Enersis, which generated a difference of more than 1000% in the price of the Series A and B shares, to the detriment of all shareholders. The AFPs and other minority investors disputed the agreement and the Superintendency of Securities and Insurance (SVS) finally refused to authorize the transaction and fined the senior management of Enersis more than MUS\$ 60 for infringing their fiduciary duties. This is one of the more emblematic cases among corporate transactions in Chile, and perhaps the one that gave rise to the CG issue. This is also the case which to a great extent drove the approval of the Law governing Public Bidding for the Acquisition of Shares (OPAs Law No. 19,705, of December 2000). EE subsequently launched a takeover bid for Enersis, from which all shareholders benefited.

Sale of the cell-phone business to Telefónica Móviles (2004). The AFPs called for a Special Shareholders' Meeting for modifying the terms of a transaction between Telefónica CTC and its related company Telefónica Móviles S.A.. The pressure exerted by the AFPs led to a MUS\$ 50 increase in the selling price, and the payment of a special dividend of MUS\$ 800 million to the shareholders.

MASISA - Terranova Merger (2004). The AFPs negotiated the exchange ratio and conditioned the approval of the merger between Terranova and MASISA to the payment of a special dividend of MUS\$ 54.

Change of Soquimich Bylaws (2005). This example shows the role of the AFPs as meaningful minority shareholders in the struggle for the control of SQM. In this case, the AFPs supported Potash Corporation in amending SQM's bylaws and achieving the unification of the rights of both stock series, and the imposition of the maximum voting limit of 37.5% of the right to vote of each series, on the votes by related shareholders acting in pursuit of the same interests.

Pampa Calichera - Kowa Covenant (2006). The AFPs objected before the Superintendency of Securities and Insurance to some of the clauses of a shareholders' agreement designed for achieving control of SQM. Said clauses were removed.

Public Tender Offer (OPA) by Telefónica (2008). Telefónica's takeover bid on 55.1% of Compañía de Telecomunicaciones de Chile (CTC), consisted in the payment of CLP 1,000 for the Series A shares and CLP 900 for the Series B shares, involving a total investment of about MUS\$ 985. The AFPs rejected the offer from the outset, considering it insufficient, but Telefónica ruled out the possibility of improving it, arguing that it involved an award of more than 30%. The AFPs continued criticizing the bidding price, until Telefónica finally gave way and increased its offer by 10%, to CLP 1,100 and CLP 990, respectively, per series A and series B share, which entailed an investment of close to MUS\$ 1,100.

Pharmacies Collusion (2009). The AFPs strongly criticized the Board of Directors; the financial statements were not approved and the pertinent legal measures were taken.

Supermercados del Sur - La Polar Merger (2009). The proposal was rejected because it was not considered a good opportunity for the investors in La Polar.

La Polar Scandal (2011). The AFPs actively prosecuted the parties responsible for the fraud in court.

SQM's Related Companies (2012): The SVS was asked to investigate the transactions between SQM's related companies, seeking to prevent future damages to minority investors. The SVS fined 8 executives and a stock broker. The fines amounted to a total of MUS\$ 164, the highest levied by the SVS in decades. In March 2016, the broker negotiated a settlement with AFPs Capital, Cuprum and Habitat to rescind the complaints filed against the broker and its executives, paying almost MUS\$ 3.5 into the pension funds of the three AFPs.

Enersis capital increase (2012). Strong dispute by the AFPs regarding the form and substance of the proposed transaction. They were able to improve the form and substance of the transaction. On July 25, 2012, Enersis announced a capital increase of up to MUS\$ 8,020, which the AFP refused to accept. After months of negotiations, the shareholders approved an increase of MUS\$ 5,995 on December 20, 2012.

Source: FIAP based on: (a) [Study Series No. 66](#) Chilean Association of AFPs (2008); (b) [Study series No. 85](#) Chilean Association of AFPs (2013); (c) [Column](#) of Klaus Schmidt-Hebbel (2013); and (d) Wigodsky, Teodoro (2008).

Election of independent directors

In general, Latin American companies listed on the stock exchange have a controller, reflected in a majority of members of the Board of Directors. The advantage is that the controller will always focus on the success of the company, without diverting its benefits in favor of the managers or stakeholders instead of the company's shareholders, as occurs in organizations in which there is not such a concentrated interest. This view differs from what occurs in the United States, for example, a country where the absence of controllers is supplemented by the management, often supervised at a greater distance by the Board of Directors.

The predominant historical trend of Chilean controlling shareholders has been the representation of all of the shareholders, under the conviction that they are the ones who best interpret the strategy to be followed by the company. This vision has been changing, partly because the legislation has weakened what was considered a fundamental principle some time ago: one share, one vote. This is why independent directors have acquired a status that favors their standing in their election and their presence on the Board of Directors, and their special participation in decisions that involve transactions in which the controller is an interested party. There have also been recent legal changes making it mandatory to elect at least one independent director in open joint-stock companies ([Law No. 20.382 of 2010](#), which introduced improvements to the rules and regulations governing the CG of companies, and amended the Company Law and the Securities Market Law). In addition, the political and communicational clout acquired by institutional investors, particularly the AFPs, has transformed them into stakeholders whose opinion is considered by the controller when making decisions in which there is dissent.

In the Chilean case, it has been observed that the AFPs contribute to electing an important fraction of the independent directors of companies, a percentage that has been increasing as the invested resources increase. In 1998, 10% of the independent directors of companies had been elected by the AFPs (Iglesias - Palau, 2000); data from 2007 indicate that that percentage stood at 16%.

Among the requirements that directors of joint stock companies elected by the AFPs must meet, are the following: (i) solid academic background; (ii) significant managerial experience; (iii) independence²; (iv) do not have conflicts of interest; (v) ability to contribute to the strategic discussion of the company; (vi) availability of time; (vii) not related to an AFP; (viii) not having been a former Executive of an AFP, or related to the AFPs in the last 12 months; (ix) be registered in a registry kept by the Superintendency. 320 individuals were registered in the Directors Registry to December, 2016 (Amrop MV Consulting, 2016).

Furthermore, for more than a decade now, the AFPs have appointed a headhunting company to seek out candidates to the position of director, in order to make the election of independent directors more professional. The company selected must have relevant experience in the selection of directors or general managers of companies of a similar or larger size than the companies in which the pension funds are invested.

² Independence entails that in the last 18 months these directors have not had any link, interest or economic, professional, lending or commercial dependency of any nature or relevant volume, with the company, the other companies of the Group it is part of, their controllers, or the senior executives of any one of them.

2. Peru

According to the legislation in force, the AFPs assume full fiduciary responsibility in their standing as institutional investors whose purpose is to provide the necessary resources for granting a pension, on the basis of the contributions paid in by members throughout their working lives. By virtue thereof, the AFPs must act with the diligence corresponding to their standing as investors, and are responsible for implementing sound CG and best practices in the processes involved in fund management.

In compliance with the principle of sound CG, the AFPs are mainly obligated to:

- i. Ensure that the Board of Directors is elected regularly in the companies in which they invest, and that its members can be removed. The AFPs must preferably encourage and support the renewal of independent directors for terms of not more than 6 years.
- ii. At all times seek to encourage the creation of committees in the companies they invest in, to directly report to the Board of Directors, for effective management and control of the company. The main committees that should be appointed are the Auditing Committee, the Appointments and Compensation Committee, sound, and sustainability issues. Efforts must be made for independent directors to lead those committees.

The AFPs themselves must also have at least 2 independent directors. These directors will be elected on the basis of their professional prestige, will not be involved in the management of the company or with the group that controls it, ensuring the defense of the rights of the fund, regardless of the interests of the AFP. These directors will also be subject to sound CG practices, and will encourage their adoption in the government agencies in which they hold the position.

Finally, for some years now, the Peruvian Association of AFPs has participated in the process of electing independent directors in the companies they invest in, with the help of headhunter companies that seek out candidates for directors in the companies in which they are required.

3. Colombia

In Colombia, the AFPs must document the analyses and instructions they impart to their representatives for exercising their political rights. This information must be at disposal of the regulator.

According to the law (Decree 2555 of 2010), the AFPs have the following main obligations:

- (i) Exercise the political rights corresponding to the investments made with the mandatory pension funds, when the participation of the four funds is understood to be "important";
- (ii) Ensure that the interests of their members always prevail, and exercise political rights in accordance with a policy approved by their Boards of Directors;
- (iii) Document the analyses and instructions they impart to their representatives for exercising their political rights; the AFPs shall appoint the representatives they consider necessary for exercising their political rights; these representatives must be individuals renowned for their responsibility and aptitude for the job, with proven experience in matters related to investments.
- (iv) Participate in the election of members of the Board of Directors of the securities issuers in which they invest;
- (v) Not control the activities of the members of the Board of Directors whose election they promote or support;
- (vi) Ensure that the issuers receiving investments from the mandatory pension funds have corporate governance standards in place

that comply with the internal policies of the AFPs;

- (vii) As part of their best CG practices, the AFPs must stipulate in their policies the maximum number of times that they will support the reelection of an individual as an independent member of the Board of Directors or the Administrative Council of the receiver of the investment.
- (viii) Incorporate the following points as minimum content in the policies applicable to conflicts of interest: (a) definition and identification of potential conflicts of interest arising from their standing as managers of third-party resources with access to inside information, (b) criteria to avoid incurring in situations that may entail conflicts of interest and affect the exercising of political rights, in all

circumstances protecting the interests of the AFP and its members; (c) procedures and rules of internal control that prevent the occurrence of conflicts of interest that may affect the AFP and individuals who, due to their position, have access to information regarding the investments of an AFP that has still not been divulged to the market.

According to ASOFONDOS, the AFPs in Colombia have been very pragmatic regarding CG issues, since in situations where there are no clear rules, the AFPs have preferred to sell their stake and not risk the resources of their members.

Three important cases involving the defense of minority shareholders by the AFPs are shown in Table No. 2.

Table No. 2 - Colombia: Cases in which the AFPs have defended minority shareholders
ETB (2007): The company ETB mistakenly calculated dividends. To address this issue, the AFPs filed a complaint for distributing the dividends correctly. They were subsequently distributed in proportion to the shareholders.
Pacific Rubiales Energy, Pacific (2013-2015): The AFPs asked Pacific Rubiales to include an independent member on the Board of Directors, in representation of the minority shareholders. However, since the company was listed in Canada, the inclusion was not legally enforceable. The request of the AFPs was unsuccessful. Since they were unable to exercise their political rights, the AFPs began withdrawing their investments. The company subsequently suffered financial problems due to its high indebtedness and the drop in oil prices, due to which it was considered timely to sell the assets, favoring the minority shareholders (2014-2015).
EDATEL: The AFPs sought the election of an independent member of the Board of Directors who would support the entity and safeguard the interests of shareholders in case of financial difficulties, illiquidity of assets and the need for structural changes raised by the AFPs. The request was not heeded, due to which the shares were negotiated and sold to the majority shareholder.

Source: ASOFONDOS, Colombia.

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