The AFP System
Myths and Realities

Research Department
The Chilean AFP Association

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THE CHILEAN AFP ASSOCIATION

Index

<u>Myth:</u> **The AFPs are responsible for the low social security coverage**

<u>Reality:</u> **More workers are protected by Social Security under the AFP System than in 1980, when the pay-as-you-go system was in force.**

DEVELOPMENT OF SOCIAL SECURITY COVERAGE
(Contributors in December/ Those in employment in the quarter Oct.-Dec.)

YEAR	INP	AFP	TOTAL (%)
1980	51,6		**51,6**
1981	30,6	21,4	**52,0**
1982	16,7	36,0	**52,7**
1983	14,9	38,3	**53,2**
1984	13,9	41,8	**55,7**
1985	13,0	44,1	**57,0**
1986	11,4	45,9	**57,3**
1987	10,9	50,6	**61,5**
1988	9,8	50,6	**60,4**
1989	8,7	50,8	**59,5**
1990	7,8	50,6	**58,4**
1991	7,6	53,7	**61,3**
1992	6,9	55,3	**62,2**
1993	6,0	54,7	**60,7**
1994	5,5	56,2	**61,7**
1995	5,5	57,2	**62,7**
1996	4,9	58,9	**63,8**
1997	4,3	61,3	**65,5**
1998	4,1	58,0	**62,0**
1999	3,8	60,4	**64,2**
2000	3,8	59,4	**63,2**
2001	3,3	63,0	**66,3**
2002	3,1	61,9	**65,0**
2003	2,8	63,8	**66,6**

Source: Research Department, AFP Association

Causes of the increase:

a) The AFP System is more economical than the pay-as-you-go system (12.3% of the gross wage as opposed to 19% under the pay-as-you-go system); b) In the AFP System money is deposited in an "individual capitalization account" belonging to the worker, while in the old system the money went into a common fund used for paying the pensions of the passive sector.

At present, Chile is the country with the best social security coverage in Latin America, after Uruguay (82%), a country where it has been made mandatory for self-employed workers to pay contributions. In our country about 70% of currently employed workers are covered by the social security systems. In order to increase this percentage, self-employed workers must be incorporated into the pension system.

The characteristics of the labour market are the main reason explaining the levels of coverage of the pension systems. Fostering economic growth and employment and raising the level of formality in employment enable that coverage to be increased. Furthermore, it seems sensible to establish incentives and eliminate certain obstacles so that self-employed workers will contribute.

Examples of obstacles: if self-employed workers are to have access to free state health services, they have to be declared destitute, and one of the conditions for this is not having paid social security contributions for more than 12 months in the past 2 years. If married women are employed (for example in seasonal jobs), they lose the family allowance that the working husband receives on their behalf.

<u>Myth:</u> The AFP system pays low pensions

<u>Reality:</u> The AFP system will pay pensions equivalent to 70% of the working wage, or more to workers who have contributed regularly throughout their working lives

In the AFP System, the amount of the pension is directly related with the efforts made by the worker to save during his/her working life. Monthly contributions go into an individual account and those savings receive the benefit of the yield on the investments. It is very important that there should be systematic saving in the early working years because it has a more significant effect on the amount of the pension than saving in the latter years.

It is important to distinguish between weaknesses of the Chilean labour market and problems with the functioning of the pension system. The AFP System is not responsible for the level of earnings, for unemployment or informal work patterns, nor for the difference in income according to gender, among other situations in the labour market.

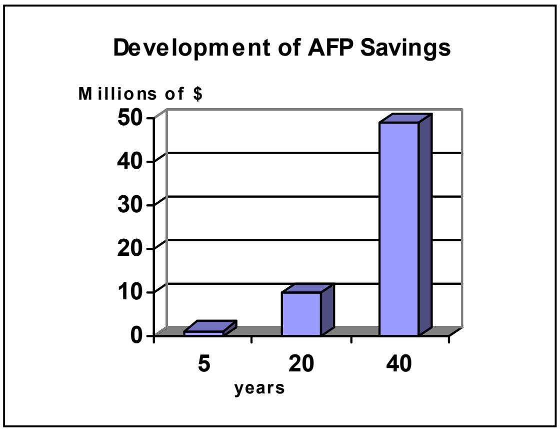
Almost 60% of old-age pensions paid are "early" (178,550 pensions). On average, women bring their pensions forward to 7 years before the legal age and men 9 years. In order to receive an early retirement pension, they must have enough savings to finance a pension of at least 50% of their average updated incomes for the last 10 years, or 110% of the minimum pension.

Most old-age pensions at the legal age are the result of savings accumulated in the AFP plus the recognition bond for contributions paid into the old system. Round about the year 2020 there will be "pure" pensioners, with contributions paid only into the AFP System.

Actuarial calculations show that a real annual yield of 4% is necessary to finance pensions that are 70% of the last income and this yield has averaged 10.2% over 23 years. For a worker who joined the AFPs in 1981, 66% of his fund corresponds to yield obtained.

If a worker has savings which are insufficient to finance a pension in accordance with his/her needs or aspirations as a result of periods with low earnings or long social security gaps (due to unemployment, voluntary withdrawal from the work force or independent work without contributing), he/she can solve the situation by "Voluntary Social Security Saving". The important thing is to plan today for the pension that one wants to receive in the future.

In the case of workers who contribute for 20 years or more and whose savings amount to less than the minimum pension, the State, in its subsidiary role, will supply the amount needed to make up the difference.



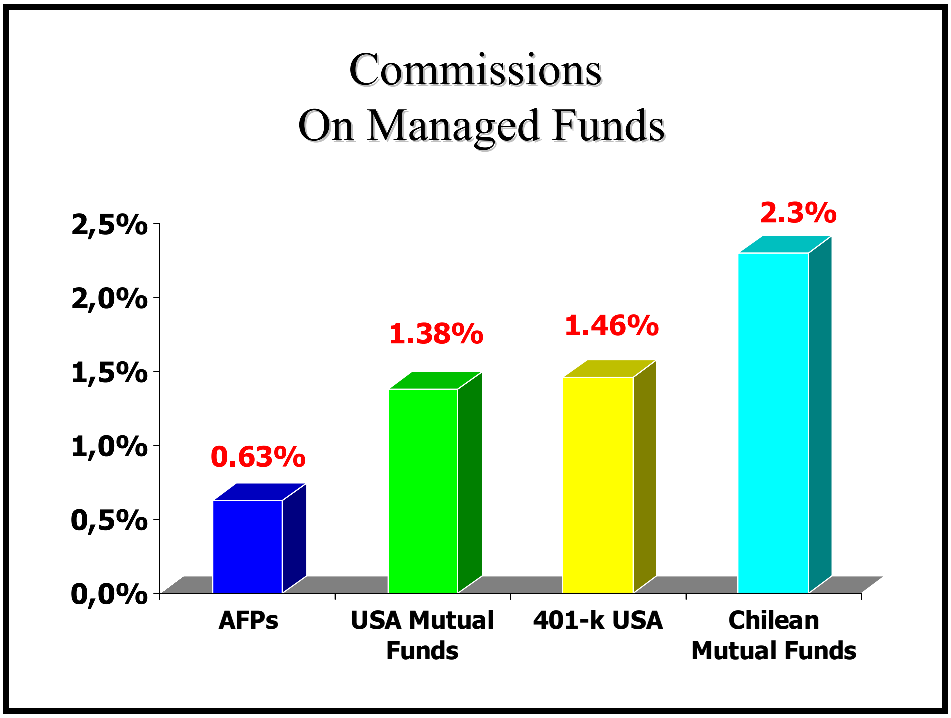
A male member aged 65, with an income of $320 thousand per month, obtains a pension similar to his wage.

In the chart it may be seen that the savings accumulate increasingly due to the greater impact of yield in the final period. The savings of 20 years represent only 20% of those accumulated after 40 years when legal retiring age is reached (after 5 years, savings amount to $1.4 million, after 20 years $10 million, and $49 million after 40 years of contribution.)

Assumptions: Yield 7% per year, does not contribute 40% of the time. Fixed Commission $538. Interest rate for Programmed Withdrawal: 4.6.

Myth: **The AFPs are expensive**

Reality: **The commissions of the AFPs are much lower than those charged by other institutions that manage savings**



The commissions charged by the AFPs for the service that they provide is equivalent on average to 1.48% of the worker's "taxable wage", excluding the cost of the Disability and Survivorship Insurance. If the commission charged by the AFPs is measured as a "percentage of the managed fund", it amounts to 0.63% per year. This commission is substantially lower than that of the other fund-managers, as is shown on the chart.[1]

If one compares the commissions of the Chilean AFPs with the AFPs of other countries in Latin America, Chile has the lowest commissions with the single exception of Bolivia, which has a special scheme with only two AFPs and also charges commissions on the managed funds, which reduces the difference with Chile.

In the Administration of Voluntary Social Security Savings (APV), where AFPs, Insurance Companies, Mutual Funds, Housing Fund Managers and other institutions are in competition with one another, the AFPs have the lowest commissions, with 0.5% on the managed funds.

What is more, the AFPs carry out over twenty extra functions, most of which are specific to social security and are free of charge, in addition to managing savings like the financial institutions. For example, managing the accounts of 3 million non-contributing members, 1 million voluntary savings accounts other than APV and 400 thousand compensation accounts belonging to domestic workers.

[1] Source: Research Series Nº 42, June 2004, AFP Association.

<u>Myth:</u> Fiscal spending on pensions will increase with the AFP system

<u>Reality:</u> Public spending on pensions will decrease as the payment of recognition bonds is gradually phased out and the number of INP pensions reduced.

89% of the fiscal budget for pensions (excluding the scheme for the Armed Forces and Police) is devoted to paying INP pensions and recognition bonds for contributions to the old pension system (4.2% GDP), 9% to welfare pensions for elderly people who are poor and disabled and have no social security (0.4% GDP, which is paid through local municipal councils) and approximately 2% to financing minimum pensions under the AFP system (0.1% GDP).

The Budgets Department of the Ministry of Finance forecasts that budget expenditure on pension systems will have fallen noticeably by the year 2010:

Civil Social Security Deficit Forecast

(Source: Budgets Department,
Macroeconomic Aspects of the Draft Law for the Public Sector, 2002)

Year	INP Pensions	Recognition Bonds	Welfare Pensions	Minimum AFP Pensions	TOTAL
2002	3% GDP	1.2% GDP	0.4% GDP	0.1% GDP	4.7% GDP
2010	2% GDP	1.2% GDP	0.4% GDP	0.27 GDP	4.7% GDP
Difference	**-1% GDP**	**0% GDP**	**0% GDP**	**0.17% GDP**	**-0.83% GDP**
REDUCTION OF FISCAL SPENDING ON PENSIONS: -0.83% of GDP					

Government figures show that fiscal spending on pensions will fall by 0.83% of GDP by the year 2010.

When the AFP System is fully functional (in the year 2037), there will be considerable fiscal slack under the heading of pensions, around 3.2% of GDP, due to the extinction of the state debt to the old system. State commitments with the minimum pensions of the capitalization system are forecast at between 0.5% and 1% of GDP, figures far lower than the current 4.2% of GDP, related with the deficit of the old pension system.

The design of the new pension system always took into account the participation of the State in a subsidiary capacity, through guaranteed minimum pensions to support workers who do not achieve sufficient savings to finance their own pension, as a result of low incomes, informal work and prolonged periods of unemployment.

<u>Myth:</u> The AFPs are responsible for the "social security damage" suffered by public employees who changed to the new system

<u>Reality:</u> It is the State which is responsible for the "social security damage" suffered by public employees, because as an employer it only paid contributions on part of the income they were receiving and undervalued the recognition bond.

"Social security damage" is the name given to the situation affecting certain workers in the public sector who changed to the capitalization system. The retirement pensions of this group are lower than those of workers who stayed in the old system and also lower than normal contributors in the present social security system.

The problem arose as a result of the State's practice, as an employer, of paying contributions on only a part of the wages of public employees, because there were allowances and bonuses that were not counted as income when calculating social security payments.

Two laws were passed in the years 1987 and 1993, which corrected the under-contribution of all public employees. Unfortunately, the benefit was not made retroactive, with the result that the contributions to individual savings accounts in the AFPs and the recognition bonds were considerably lower than they should have been.

In this way there was discrimination against a group of public sector workers who changed to the new Social Security System with less money saved in their individual accounts for two reasons: lower initial contributions and lower recognition bonds calculated on incomes that were less than the real ones.

By contrast, public workers who remained in the old system began as from 1987 and 1993 to receive a pension calculated on the basis of the last income, now corrected.

As can be deduced from the above, the problem of the public employees who changed to the AFP System is not the responsibility of the New Pension System, but of the State.

The AFP Association has proposed that the State provide a Supplementary Recognition Bond to rectify this situation. This proposal has been well-received by public employees and has formed part of their claims.

<u>Myth:</u> There is no competition between the AFPs

<u>Reality:</u> The AFPs compete strongly in yield, commissions and services

The AFP sector is a market that is open to competition. In fact, the requirements for setting up an AFP are low in terms of capital and as a result, 27 AFPs were set up between 1981 and the present. These have been reduced to six, due to factors of competition and the need to achieve economies of scale. These six are the most efficient and most economical and concentrate on achieving the best quality of service for their members.

As a result of this competition, the greater economies of scale and the efficiency achieved by the AFPs, commissions have fallen from 3% of taxable income in 1997 to 2.4% at present, despite a considerable increase in expenditure on the disability and survivorship insurance which increased by 69% in the same period. This increased cost was not passed on to members.

The competitive situation of the AFP sector is not too dissimilar to that found in other sectors of the national economy (banks, telecommunications, supermarkets, chemists, etc), the main characteristic of the sectors being the existence of fewer companies, but of greater volume, which results in benefits for the users.

<u>Myth:</u> There is political bias in the appointment of company directors

<u>Reality:</u> The AFPs have chosen qualified professionals as directors, who ensure that the companies are appropriately managed and that favourable results are obtained for the benefit of all the shareholders. Among them are people of the most varied political opinions.

The aim of the AFPs is to obtain adequate yield and security for the Pension Funds' investments. The law states that the AFPs must use their own net worth to cover any damage caused by failure to comply with any of their obligations. For this reason, the AFPs choose professionals to be directors who can make a contribution to the company, on the basis of their merits, abilities and experience.

During recent shareholders' meetings a wide range of professionals were elected to represent the Pension Funds. Among them are: Alvaro Clarke, former Superintendent of Securities and Insurance; Hernán Cheyre, consultant and partner of Econsult; Carlos Massad, former president of the Central Bank; Jorge Marshall, former advisor to the Central Bank; Carlos Díaz, academic, business administrator with a master's degree in economics; Ernesto Tironi, economist and company advisor; Sergio Guzmán, former managing director of Embotelladoras Chilenas Unidas; Felipe Larraín, economist; René Cortázar, former Minister of Labour; Sergio de la Cuadra, former Minister of Finance; Eugenio Valck, business administrator and company consultant; Carlos Mladinic, former Minister of Agriculture and of the General Government Secretariat, currently working as director of the Sistema de Empresas Públicas (SEP); Andrés Kern, industrial civil engineer and company consultant; Cristián Eyzaguirre, economist from the Catholic University of Chile; Isidoro Palma, business administrator and company consultant; and Nicolás Majluf, academic from the Catholic University of Chile, Felipe Montt, business administrator with a doctorate in economics and Albert Cussen, civil engineer with wide experience in the financial sector and as a company director.

Companies in which directors are elected with the AFPs' vote (Bulletin 174 SAFP)

- Endesa
- Enersis
- Colbún
- ENTEL
- Soquimich
- Almacenes París
- Cristalerías Chile
- Intasa
- Esval
- Terranova
- Copec
- Masisa
- Frimetal
- Besalco
- Fósforos
- Aguas Andina
- Parque Arauco
- Falabella

<u>Myth:</u> The entry of the banks will improve the pension system

<u>Reality:</u> With the entry of the banks, commissions will not be reduced and there will be tied sales and evident conflicts of interest in the management of savings. Furthermore, there will be an enormous concentration of the financial market.

The paper entitled "The Restricted Corporate Purpose of the AFPs and possible effects of the entry of banks into the mandatory savings social security market", by Jorge Tarziján, professor at the Catholic University, states that the entry of banks will "make the system and the cost of the social security service more expensive for members in exchange for greater possibilities of present consumption".

The costs of the system would rise, due to the need to increase expenditure on sales personnel in a scenario of greater rivalry, creating pressure to raise commissions. There must be standard commissions for members, by law and by public policy, which makes it very difficult for the greater competition to be channelled exclusively through these charges.

The entry of banks will produce "tied sales", in other words joint marketing of social security savings and banking products, a situation which will end up having an adverse effect on pensions because these occur in the long term, whereas banking products are for immediate use.

On the other hand, there are obvious conflicts of interest in the management of different funds which may have an adverse effect on the yield of the social security savings. The AFPs invest 29% of the savings in banking instruments; they also invest 22% in companies which are clients of the banks. A bank subsidiary with a single corporate purpose is not the solution, because the investment manager of the AFP will be answerable hierarchically to the manager of the bank.

Another problem is that there would be a massive concentration of financial assets, because the banks today manage assets worth over US$77,800 million, equivalent to 94% of GDP.

Financial Assets by Industry

INDUSTRY	Assets in MM US$	%GDP (1)
Banks	77,786	94%
AFP	46,690	60%
Insurance Companies	14,476	17%
Mutual Funds	8,377	10%
Investment Funds	1,852	2%
Foreign Capital Investment Funds (FICE)	728	1%
(1) Estimated GDP for 2003 – Central Bank of Chile: US$83,113 million		

The banks do not manage resources more cheaply than the AFPs. Proof of this can be seen in voluntary social security savings where the AFPs charge less than half the amount charged by the subsidiaries of bank mutual funds.

Various banking and insurance groups are currently taking part in the pension system, but they do so according to a legal structure which guarantees that the problems mentioned above do not occur. This is the case of the Santander group, Citibank, Penta, BBVA, ING, etc.

<u>Myth:</u> The AFPs make a profit even when the workers make a loss

<u>Reality:</u> The profits or losses of the AFPs do not bear much relation to the profits or losses of the Pension Funds. The law requires net worth separation between the funds belonging to the AFPs and those of the workers, thus ensuring their soundness.

The new Social Security System is based on a healthy net worth separation between the AFPs and the Pension Funds.

The Administrators provide a service with permanent costs which make it possible to carry out the investment function and payment of pensions, among many other tasks. These are covered by commissions paid by the enrolled workers. The AFPs obtain their profits and losses to a large extent as a result of the difference between the commissions charged and the expenses involved in paying the costs of their activity.

The yield of the Pension Fund is a consequence of the profits gained by the instruments in which the savings are invested, both in Chile and abroad.

The important thing for members to understand is that social security savings are invested in fixed income and equity securities that have "daily" oscillations, but in the long term they produce yields or profits. Thus in 23 years of activity the yield of the pension fund over the UF has been over 10% per year on average, a very positive result compared with any other fund manager, either in Chile or overseas.

The above shows that the profits and losses of the AFPs and Pension Funds are not closely related. On average, the AFPs charge an administration commission of 1.45% of the worker's monthly earnings and it is not linked with the managed fund.

Notwithstanding the net worth separation between AFPs and funds, the AFPs must invest capital equivalent to 1% of the fund they manage in the same instruments as the workers' funds. This 1% (known as "encaje") is a reserve that all administrators must keep in order to cover the "minimum yield". In other words, if the pension fund of an AFP has a yield which is much lower than the industry average, this 1% is used to compensate those members. In this way the shareholders or owners of the administrators run the same risks as the workers' pension funds and will also be affected when the fund obtains a negative yield. This encourages the AFP always to seek the best combination of risk and return for their members' funds.

By way of reference, if the yield of the AFPs were linked to the yield of the Fund, in a high-profits scenario the AFPs would very probably be bitterly criticized for the high profits, since there have only been two years with negative yield in the whole 23-year period.

<u>Myth:</u> The AFPs are not concerned when contributions are not paid by the employer

<u>Reality:</u> The AFPs do manage to ensure the eventual payment of contributions not paid by the employer by initiating pre-judicial and judicial proceedings.

The social security contributions are the property of the workers and if the employer does not pay them into the AFPs, this constitutes wrongful appropriation of funds. For that reason the AFPs are obliged to initiate judicial proceedings in order to collect the contributions that are owing.

These legal actions form part of the tasks which the AFP provides for the member free of charge and experience shows that over 70% of the debt is recovered before the judicial collection stage. 80% of the total is recovered within 12 months and 90% within 24 months.

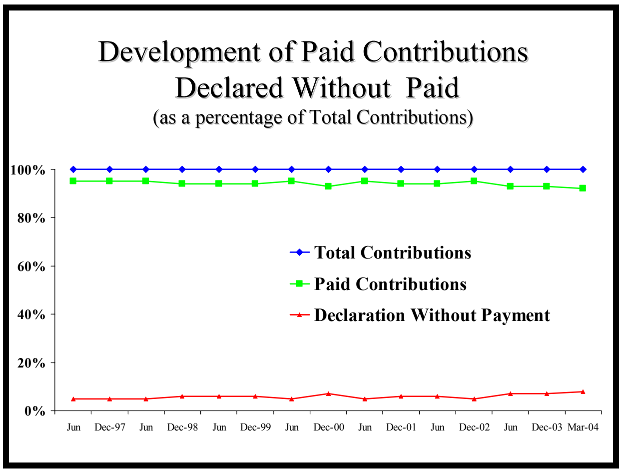
Most employers do comply with the obligation to pay social security contributions and the amounts involved in social security delinquency are comparatively low. Thanks to the legal definition which establishes the so-called “wrongful appropriation of funds”, the administrators are able to take steps to collect, including the application of penal sanctions, interest and fines.

In 1982, law Nº 18,137 authorized employers to “declare” while deferring the payment of social security contributions. This mechanism allows companies which are facing problems of liquidity to postpone the payment of their employees’ contributions. The Declaration Without Payment of social security contributions, while not being entirely satisfactory, is an efficient system which simplifies the recovery of the money involved, because it makes collection easier. Furthermore, funds that are deposited in arrears recover the yield that corresponds to them so that the worker’s savings suffer no ill effects.

The AFPs are interested in collecting the commissions that are owed by employers, because they can only charge the commissions for the service they provide once the savings have been paid in to the workers’ individual accounts.

The creation of specialised Social Security Tribunals and the modifications included in the draft law which is at present passing through Congress should mean that workers’ money can be recovered more quickly.

In March 2004, contributions that had been declared without payment in the AFP System amounted to US$426 million, equivalent to 0.84% of the Pension Fund. This amount should not be considered a stock, because employers do gradually pay off the contributions they owe over time, while others stop paying punctually.



<u>Myth:</u> The AFP System is less transparent than it should be.

<u>Reality:</u> There is a large quantity of information available. Due to a problem of social security culture, people concern themselves about this subject only when they are approaching retirement.

The creation of the AFP system in 1981 implied a profound cultural change for Chilean workers, because they moved from a mode in which people worried about this subject only when they were at the end of their working life to a scheme in which the pension will be the result of a period of saving and capitalization lasting 30 or 40 years.

The chief player in this system is the worker, who has to take an active part in building his/her pension and the benefits that the system can provide, even long before reaching retiring age, such as becoming acquainted with the disability and survivorship insurance.

The AFP system sends members a report every four months with social security information, showing the yield obtained and the commissions compared with the other administrators, a level of transparency unequalled by any other industry in the country. The AFPs invest $12,000 million pesos per year in sending out this personalized information. Furthermore, any member can approach the offices of the AFPs throughout the country, which must, by law, have all the information needed.

As from this year, a new Statement will be distributed, to make it easier to understand the information and compare the different AFPs. It is worth mentioning that the Superintendency of AFPs regulates the AFPs in everything concerning advertising, promotion and the method of delivering information to the members, in addition to that department's own task of providing information.

In addition, the AFPs have a series of extra services, such as websites and call centres, in which a large quantity of information is provided for members. Members have access to pension projection systems by Internet and through the agencies, so that each person can analyse the pension that he/she might receive in the future and calculate different possibilities of saving to improve it or to be able to retire early.

To summarise, there is plenty of information. What is lacking is people's interest in finding out more about their pension system.

Statements dispatched to members' homes by the AFPs each year

MONTH	Number	Sent to:
June	3.6 million	Contributors
October	3.6 million	Contributors
February	7.0 million	Members
	14.2 million letters	

Annual cost: $12,000,000,000

<u>Myth:</u> The AFP System has no place for solidarity

<u>Reality:</u> Although the AFP System is based on individual capitalization, it has various mechanisms to include solidarity.

If a worker does not accumulate the savings needed to finance a minimum pension, because of low income and/or large social security gaps, the State covers the difference. This solidarity mechanism in the system is funded with taxes charged by the State and paid by all Chileans. In order to give this subsidy, the system sets minimum requirements (20 years of contributions).

The AFPs are obliged to take out a collective insurance for Disability and Survivorship for all their members. This collective insurance has a percentage price that is the same for everyone, so no difference is made between groups with more or less risk. This creates a subsidy for the segments of higher risk, usually people with lower incomes and a smaller amount of savings.

On the other hand, the social security savings of members who do not contribute are managed free of charge, producing a subsidy from those who do contribute. In the same way, the percentage commission means that a member with a minimum wage pays nine times less for the management of his/her funds than the one who pays on the basis of the ceiling, 60 UF.

The aim of the pension system is to ensure replacement income for workers who finish their working life. These are not systems that redistribute income. There are far more efficient mechanisms for that, established by each State through its respective public policies.

Although the pay-as-you-go systems are based on inter-generational solidarity, where active workers finance the pension of passive workers, this creates problems for the countries because of the deep demographic changes that are taking place. In practice, with pension systems based on individual capitalization, one avoids the situation of a pensioner being a burden for his/her children and grandchildren.

Furthermore, in the old pay-as-you-go system, the worst pensions and greatest requirements corresponded to the Social Security Service (SSS) which included most of the workers and the very poor, while the best pensions, even including updating mechanisms, with fewer requirements, corresponded to bank employees and members of parliament.

Aspects of Solidarity in the AFP System

- Guaranteed minimum pension
- Standard cost of disability and survivorship insurance
- Insurance cover for the unemployed
- Standard commissions for contributors
- No-cost management for non contributors
- No-cost management of compensation account and account 2 (Voluntary saving)