*Recent Changes to the Chilean System of Individual Accounts**

Chile was the first country to replace its public pay-as-you-go system with individual accounts. Since its inception in 1981, the new program has undergone a number of changes that offer workers more choices than they had before. Recent modifications include:

- An increase in the type and number of funds from which a worker may choose for an individual account *(multifondos,* or multiple funds),
- More incentives for making additional voluntary contributions, and
- The introduction of a separate mandatory individual account for unemployment benefits.

Background

The Chilean system consists of mandatory individual accounts managed by pension fund management companies (AFPs). Workers must contribute 10 percent of earnings up to a maximum of 60 UF (currently about US$1,300) and an additional amount for administrative fees and survivors and disability insurance.[1] The employer is not required to contribute. Participation is voluntary for the self-employed. Workers may also make additional contributions to their individual accounts and may also set up separate, voluntary savings accounts.

The retirement benefit, payable at age 65 for men and 60 for women, is a choice of an annuity, programmed withdrawals scheduled to guarantee income over the retiree's expected life span, or a deferred annuity—a combination of the annuity and programmed withdrawal options. Annuities are purchased from an insurance company for an additional administrative fee, and most AFPs also charge a monthly fee for programmed withdrawals. The worker also contracts with an insurance company for a survivors and disability policy. The government guarantees a minimum benefit to two groups: workers who made 20 years of contributions but whose accumulated funds do not yield the minimum benefit set by law, and retirees who have chosen the pension option of programmed withdrawals and have exhausted their funds by outliving their actuarial life expectancy.

For the first 21 years of the program, individuals did not have meaningful choices among the AFPs. AFPs invested according to rather strict asset class and asset allocation limits and had to meet minimum profitability rules. Both requirements effectively forced all AFPs to adopt nearly identical investment strategies, commonly referred to as a "herd effect." As a result, AFPs had to set their investment policy for the short term, thus eliminating any longer-term and potentially more profitable strategies. Furthermore, AFPs were allowed to offer only one account, providing minimal choice for workers in terms of investment time horizons and risk tolerance.

When the system was first implemented, investments were restricted to government bonds, mortgage bonds, bonds of financial institutions, and a very limited amount of corporate bonds; investment in foreign securities was not permitted. As the system has matured and become better established, Chile has gradually liberalized investment rules, and restrictions on investments in foreign securities have gradually been eased. Through February 2004, AFPs are allowed to allocate between 20 percent and 25 percent of their portfolios to foreign instruments; in March 2004, the limit will be raised to between 20 percent and 30 percent (Ferreiro 2003).

The relative mix of investments in the combined AFP portfolios has changed dramatically since the program began. Table 1 shows the shares held by selected types of investments (investments through July 2002, just before multiple funds were established). The share invested in government bonds remains the largest and has been relatively steady, fluctuating between about 30 percent and 40 percent of all investments. Bonds of financial institutions represented the largest share at the inception of the program (about 62 percent) but by July 2002 had fallen to a very minor 2 percent. Mortgage bonds peaked in 1983 at 51 percent and since the early 1990s have fallen to between 12 percent and 18 percent

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of portfolio assets. Stocks, which were not permitted until the mid-1980s, have ranged from less than 4 percent to 32 percent; in July 2002, stocks represented only 9 percent of investments. Corporate bonds have ranged from less than 1 percent to a high of 11 percent. Finally, foreign investment has gradually increased from a low of 0.6 percent in 1992 to about 15 percent in 2002.

An AFP must maintain both a minimum and maximum rate of return calculated to reflect the average performance of all the AFPs over a 3-year period.[2] If an AFP's performance exceeds the average by a given percentage, it must place the excess earnings in a rate-of-return fluctuation reserve fund. An AFP must also keep 1 percent of the value of its pension fund as a separate reserve fund. Conversely, when returns fall below the average, an AFP must make up the difference from these reserve funds. If both of these funds are exhausted, the government makes up the difference and transfers accounts to another AFP.

Since 1981, AFPs have achieved an overall real rate of return of about 10.5 percent before administrative fees. However, rates of return have been much lower during the past several years. Contributions for survivors and disability insurance average 0.76 percent of the worker's earnings per month, and administrative fees average 1.6 percent (SAFP 2002d). Most AFPs also charge a flat monthly fee. The net result is that lower-income workers pay a higher percentage of their salaries in fees than higher earners.

Account holders must pay additional fees for the various retirement options. Average up-front fees are about 6 percent of the value of the annuity; most AFPs charge an average of about 1 percent of the monthly withdrawal for the programmed withdrawal option (SAFP 2002d; *El Diario* 2002).

From the inception of the program until March 2000, each AFP could manage only one pension fund (Fund 1). A second allowable fund (Fund 2) was then mandated to be invested in fixed-rate instruments (protecting the purchasing power of the principal) for workers within 10 years of retirement. A worker could have only one mandatory individual account. Despite official estimates that 800,000 contributors would choose Fund 2, only 625 actually signed up (Homedes 2002).

Table 1.
Evolution of pension funds portfolio, by selected types of investments (as a percentage of total investment)

	Government bonds	Bonds of financial institutions	Mortgage bonds	Corporate stocks	Corporate bonds	International securities
1981	28.1	61.9	9.4	0	0.6	0
1982	26.0	26.6	46.8	0	0.6	0
1983	44.5	2.7	50.7	0	2.2	0
1984	42.1	12.2	42.9	0	1.8	0
1985	42.4	20.4	35.2	0	1.1	0
1986	46.6	22.9	25.5	3.8	0.8	0
1987	41.4	27.4	21.3	6.2	2.6	0
1988	35.4	28.5	20.6	8.1	6.4	0
1989	41.6	20.8	17.7	10.1	9.1	0
1990	44.1	16.3	16.1	11.3	11.1	0
1991	38.3	11.7	13.4	23.8	11.1	0
1992	40.9	9.4	14.2	24.0	9.6	0
1993	39.3	6.1	13.1	31.8	7.3	0.6
1994	39.7	4.8	13.7	32.1	6.3	0.9
1995	39.4	5.3	15.8	29.4	5.3	0.2
1996	42.1	4.2	17.9	25.1	4.7	0.5
1997	39.6	10.7	17.0	22.6	3.3	1.2
1998	42.4	1.6	16.4	14.0	3.0	5.3
1999	36.2	1.6	15.5	12.1	3.5	13.5
2000	36.4	2.0	14.5	12.3	4.0	11.3
2001	36.5	1.9	13.1	10.2	5.4	12.9
2002	33.1	1.9	12.4	8.8	6.5	15.2

SOURCE: Data for 1981–1997 are as of December (SAFP 1998b). Data for 1998–2001 are as of September (Salomon Smith Barney 2002). Data for 2002 are as of July (SAFP 2002b).

NOTE: Since these are selected types of investments, the percentages do not add up to 100 percent.

Multifunds

A law implemented in August 2002 requires each AFP to offer four different types of funds—called simply Funds B, C, D, and E—with varying degrees of risk. AFPs may also offer a Fund A. The Chileans call these *multifondos* or multiple funds. Under the new law, account holders can allocate their contributions between two different funds within one AFP, in whatever proportion they choose. A voluntary savings account can be in a different AFP than the mandatory account (Rioseco 2002).

The funds differ in the amount or maximum percentage that they may invest in variable-rate instruments (such as equities) and fixed income (such as bank deposits, mortgages, or government paper that offer a low level of risk or variability) (see

Table 2). The limit on foreign investment, which applies to all of the funds in a particular AFP, is calculated as the average of the foreign investment for all of the funds in that AFP. The funds' minimum and maximum rates of return vary and are calculated separately for each type of fund (Ferreiro 2003).

Most affiliates—workers who have enrolled with an AFP and have an individual account—can select any of the five funds throughout their working lives.[3] Pensioners who choose the programmed withdrawal or deferred annuity options may choose Fund C, D, or E. Affiliates who do not choose a fund are automatically placed in a fund according to their age. Those who have not been actively contributing to their accounts and who reach the next age bracket without choosing a fund are automatically enrolled in the fund corresponding to their age bracket. Their assets are transferred gradually—20 percent per year—from one fund to the next (AGAFP 2002a).

Current administrative fees, averaging about 13 percent of the workers' contributions, will not be raised at this time.[4] However, a previously mandated reduction in fees has been delayed. Fees are also charged for switching from one fund to another within the same AFP. Two transfers per year are free; an AFP may charge an exit fee for any subsequent transfer (SAFP 2002d; Rioseco 2002; *El Mercurio* 2002).

The multifund system gives affiliates the opportunity to take greater risks in pursuing higher returns. Between August 1 and October 1, 2002, affiliates were given their first opportunity to choose a fund. As of November 2002, only about one-third of all active contributors had yet made a choice. Of those contributors, 6.7 percent chose Fund A; 18.8 percent, Fund B; 56.0 percent, Fund C; 8.5 percent, Fund D; and 10.0 percent, Fund E. The affiliates in the higher-risk Fund A were mainly higher earners, 75 percent of whom were men. A breakdown by age is not readily available (Ferreiro 2003).

Table 2.
Characteristics of multifunds

Fund	Limits on investment in equities (percent) [a]		Default age designation (years)[b]	
	Minimum	Maximum	Men	Women
A	40	80		
B	25	60	Up to 35	Up to 35
C [c]	15	40	36 to 55	36 to 50
D	5	20	56 or older	51 or older
E [d]	[e]	[e]		

SOURCES: SAFP (2002e); AGAFP (2002a).

a. Applies to mandatory accounts only.

b. For members who do not choose a fund or do not actively contribute to their mandatory retirement account.

c. Was formerly Fund 1.

d. Was formerly Fund 2.

e. Mainly fixed instruments.

Voluntary Contributions

Various options for voluntary contributions give workers additional means of supplementing their pensions (SAFP 2002i):

- Additional contributions above the mandatory 10 percent of earnings, up to a ceiling of 60 UF (currently about US$1,300) to an individual account;
- A separate savings account;
- Employers' fixed deposits to employees' individual accounts; and
- A separate unemployment or severance account.

Voluntary savings accounts were permitted beginning in August 1987. Workers may make either regular or periodic deposits to their account but are limited to four withdrawals per year. Fixed deposits are agreements between employees and employers that allow employers to deposit either a lump sum or a periodic payment to mandatory accounts. These additional payments are not considered income and are not subject to income tax (SAFP 1998a).

Unemployment or severance accounts (*cuentas de ahorro de indemnización,* or CAI), which were created in November 1990, are voluntary for workers subject to the labor code (most workers) and mandatory for domestic workers who have worked for the same employer for at least 6 years. A worker's CAI must be in the same AFP as the mandatory individual account. Employees may set up this type of severance account with an AFP. Employers contribute 4.11 percent of monthly earnings up to a ceiling of 90 UF for labor code workers (60 UF for domestic workers) for a period of 11 years or when the employee is terminated, whichever comes first. Workers may begin to withdraw the funds from this account when they become unemployed (SAFP 1998a). Although AFPs are permitted to charge an administrative fee for these accounts, they have not done so to date. As of June 2002, there were about 450,000 CAIs, compared with about 6.7 million mandatory individual retirement accounts (SAFP 2002f).

Until March 2002, a portion of the additional voluntary contributions, as well as withdrawals from the voluntary savings account, were subject to income tax, whereas the mandatory contributions were tax-deferred. A new law now provides tax exemptions on up to 50 UF (about US$1,100) of retirement savings per month (EIU 2002) and for the first time allows the self-employed and

affiliates of the old public social security system to participate in the voluntary program (*El Mercurio* 2002).

The new law also encourages competition by allowing other types of institutions—including banks, brokerage houses, insurance companies, and mutual funds—to provide voluntary savings accounts. As a result, AFPs charge lower administrative fees for the voluntary savings accounts than they do for the mandatory accounts. Information about the fees charged by the other types of institutions is not readily available (EIU 2002; SAFP 2002a).

All of the above voluntary contributions and accounts may be combined with the mandatory individual account at retirement. At that point, workers may choose any of the above-mentioned types of retirement benefits.

New Mandatory Unemployment and Termination Indemnity Accounts

A new law implemented on October 1, 2002, established new mandatory individual accounts for unemployment benefits and termination indemnities (*cesantía*). Workers who began working on or after October 1 or who signed a new work agreement on that date are required to set up an account; those who were already working may participate voluntarily. Domestic workers, workers under the age of 18, apprentices, pensioners (unless partially disabled), the self-employed, and members of the armed forces are excluded from the program. This plan is separate from the voluntary program described earlier (CAI) and is mandatory for some domestic workers (AGAFP 2002; AFC 2002b).

This individual account (*cuenta individual de cesantía,* or CIC), is financed by 6 percent of an employee's earnings and 1.6 percent of an employer's payroll. If an employee has more than one employment contract, each employer must contribute to the individual account. A solidarity fund, which helps lower-income employees, is financed by 0.8 percent of the employer's payroll and the government's annual contribution of about US$9 million (adjusted annually depending on coverage). The ceiling on contributions is 90 UF as compared with 60 UF for the individual retirement account. Contributions are made monthly for up to 11 years for each job and are tax-exempt (AGAFP 2002b; AFC 2002; *La Tercera* 2002).

The AFC (*administradora de fondos de cesantía)*, a consortium of the existing AFPs overseen by the Superintendent of AFPs (SAFP), won the bid to manage the individual accounts for 10 years (AFC competed with

Table 3.
Contributions to individual accounts and related fees (as a percentage of earnings)

Type of contribution or fee	Employee	Employer	Government
		Monthly mandatory contributions	
Retirement	10	None	None[a]
Survivors and disability insurance	Average, 0.76	None	None
Retirement, survivors, and disability administrative fee	Average,1.6[b]	None	None
Mandatory unemployment (CIC)			
Account	6	1.60	None
Administrative fee	0.60	None	None
Solidarity fund	None	0.80	Annual contribution[c]
		Voluntary contributions	
Retirement	Over 10, up to 60 UF	Fixed deposits[d]	None
Savings			
Account	Unlimited	None	None
Administrative fee	Average 0.5 (annually)		
Voluntary unemployment (CAI)	None	4.11	None

SOURCES: SAFP (2002c, 2002d, 2002g, 2002h, 2002i).

a. The government guarantees a minimum pension to persons with 20 years of contributions whose accounts will not yield the minimum level benefit at retirement.

b. Does not include monthly flat fees.

c. In the first year, the government's contribution will be about US$9 million. The amount will be adjusted annually depending on coverage.

d. Either lump-sum or periodic payments.

two foreign bidders). The AFC collects contributions, maintains individual accounts, invests the funds, and pays benefits. AFC capital is subject to the same rules that apply to the AFPs. Allowable investments are the same as for Fund E, in fixed-rate securities. Annual administrative fees are set at 0.6 percent of the balance in the individual account (AGAFP 2002b; Callund 2003).[5]

Workers receive an average of 40 percent of their income for up to 5 months for each period of unemployment (Rohter 2002). Benefits vary depending on the type of labor contract (indefinite or short-term), the number of contributions made, and the balance in the individual account.[6] If a worker dies before retirement, funds in the account are transferred to a designated heir (AGAFP 2002b; AFC 2002; SAFP 2002h).

Benefits are payable from the solidarity fund if a worker has 12 consecutive months of contributions immediately prior to unemployment, has been dismissed for reasons beyond his or her control, and has a balance insufficient to pay a benefit. The worker must be unemployed when the request for benefits is made. Benefits are equal to a percentage of average earnings in the last 12 months (AFC 2002).

The head of the country's largest labor union federation has voiced concern about the viability of the new unemployment program. Since the pension system has not been able to raise its compliance rate, he questions how employees and employers will be convinced that they need to participate in the unemployment program (Rohter 2002).

Employees finance their mandatory individual accounts (retirement and unemployment) with 16 percent of earnings plus administrative fees (see Table 3, which summarizes the contributions to individual accounts and related fees). Employers contribute a total of 2.4 percent of earnings for the mandatory unemployment account and the solidarity fund. Employers' voluntary contributions include 4.11 percent to the voluntary unemployment account and either lump-sum or periodic payments to the mandatory individual account. The government does not contribute directly to any of the accounts, but it does provide subsidies for the guaranteed minimum retirement benefit and makes an annual payment to the unemployment solidarity fund.

Notes

[1] The *Unidad de Fomento* or UF is a monetary unit adjusted monthly to reflect changes in the consumer price index. Pensions are also denominated in UFs.

[2] The period of time was 1 year until October 1999, when the time frame was increased by 1 month every month until it reached 3 years.

[3] Not all affiliates are contributors in any given year. The compliance rate—the proportion of affiliates who actively contribute to their accounts—has been at about 50 percent for several years.

[4] The general manager of AFP Summa-Bansander estimated that AFP expenses in 2002 would initially increase by 10 percent from 2001 for areas such as investment, training, and information dissemination (24horas 2002).

[5] This rate can change only when the simple nominal average rate of return each month does not equal the rate of return of Fund E. If the AFC's rate is higher, then the administrative fee may be increased by 10 percent; if it is lower, then the fee must be reduced by 10 percent (AFC 2002).

[6] The number of withdrawals permitted (up to a maximum of five) depends on the number of years of contributions. For example, a worker must have a minimum of 54 contributions in order to make five withdrawals. Each withdrawal is a decreasing portion of the balance of the account. A worker may withdraw all the monies from the unemployment individual account upon retirement (AGAFP 2002b; AFC 2002; SAFP 2002g).

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