

CHAPTER III

THE ORIGIN OF THE INDIVIDUAL CAPITALIZATION SYSTEM

A. Conditions Needed for Implementing an Individual Capitalization System

In Chile the change in the Social Security System initially involved a series of challenges which had to be faced in order to ensure the success of the reform. In the first place, as mentioned in Chapter II, there were any number of social security institutions with different regimes, offering different benefits. For this reason, implementing an alternative scheme meant introducing reforms to standardize and rationalize the systems then in force.

On the other hand, it was necessary to solve the problem of how to transfer workers into the new System. It would have been possible to do this by obliging workers to change over, but the alternative was to give them incentives to make the change and in the end it was this second option that was adopted. The first option presented a series of problems: in the first place it produced considerable pressure on government expenditure, because the Old System had insufficient income to finance the pensions that were being paid and the State also had to recognize the contributions made by workers prior to the transfer. In the second place, the movement of workers en masse into the new System might have caused operational problems.

Voluntary transfer, on the other hand, had the advantage of validating the new System, since becoming a member of the scheme was a matter for each individual. It also produced less pressure on the state budget and fewer operational problems. Nonetheless, it was important to create suitable incentives to encourage workers to change to the New System and these had to do mainly with recognizing contributions paid under the Old System and creating economic incentives for the transfer. It was also necessary to provide information about the characteristics and advantages of the New System.

Once a significant number of members had transferred, it became necessary to merge the social security institutions of the old system to make them function more efficiently, since they were disproportionately large for the number of workers still remaining in them.

On the other hand, it became necessary to lay foundations for implementing the new Pension System in a number of areas, such as its oversight and its relations with the capital and insurance markets.

1. State Participation in the Implementation of the System

Regarding the role of the State in the Individual Capitalization System, it should be borne in mind that, since this System obliges workers to contribute, there must be a commitment on the State's side to ensure the security of the resources accumulated in the Pension Funds. This commitment is reflected in the supervisory work which the State has to undertake within the System.

One of the important decisions in this area concerns the constitution of the body responsible for the oversight of the System. It is worth mentioning that, given the specialization and magnitude of the tasks to be undertaken by the supervisory institution, in Chile's case it was considered advisable to create a specialized, independent institution to perform this work. In this way it was possible to concentrate efforts on implementing supervision, optimizing the processes and adapting the original legislation of the System in a dynamic environment. The autonomy of the supervisory body has resulted in greater efficiency, because it means specialized supervision of the Pension Funds. At the same time, it avoids possible conflicts of interest which might arise if the supervision were delegated to an existing supervisory body, which oversees other industries. In addition to this increased efficiency, specialization also allows decisions to be taken on the basis of criteria which strengthen the Pension System, over and above other objectives.

A second aspect related with the role played by the Chilean State in the Individual Capitalization System refers to the state guarantees which form a part of it. Such guarantees involve the use of government funds at a future date, so it is important to check the functioning of the Pension Funds to ensure that guarantees are given only where necessary and not because of inefficiency or malfunctioning of the System or the institutions responsible for managing the Pension Funds.

In the case of Chile, the benefits guaranteed by the State are the minimum pension, the minimum yield and pensions in the event of the bankruptcy of a Pension Fund Administrator or Insurance Company.

2. Existence of a Capital Market

When establishing an Individual Capitalization System in which private institutions manage money belonging to contributing workers by investment in the capital market, it is vital to have enough alternatives to make it possible to invest the large quantities of money accumulated by the Pension Funds. In other words, it is desirable to have a capital market that is already sufficiently developed before the Individual

Capitalization System is implemented, even though the Funds themselves facilitate the development of the capital market by their participation in it.

In general terms, it is necessary to have the following elements: financial debt instruments issued by the State, the Central Bank, banks, and financial institutions, and debt and capital instruments issued by companies. It is also advisable for the Pension Funds to have the possibility of investing abroad. On the other hand it is essential to have Stock Exchanges and suitably regulated intermediaries for securities.

At the same time it is necessary to have the following safeguards to cover Pension Fund participation in the capital market:

- a. Qualified supervisory and regulatory bodies for corporations (plc), financial institutions, life insurance companies, risk-rating bodies, stock exchanges, securities custodians and other relevant agents.
- b. A well-developed risk-rating industry.
- c. Securities deposit companies (custody).

However, when the reform was launched in Chile, not all these elements were present. For example, in the absence of a risk-rating industry and companies to act as securities custodians, it was necessary initially to establish regulations for the System that were consistent with the real situation of the market. In the case of the risk-rating industry – a very important element in the smooth running and transparency of the capital market – this task was carried out provisionally by a Risk-Rating Commission and by the Superintendency of AFPs. Later, the private risk-rating industry began to develop, driven on by the Pension Funds. The same thing happened with securities custody, which was entrusted to the Central Bank of Chile when the System first started. Nowadays this custody is provided by private securities deposit firms.

An additional aspect to be borne in mind when introducing an Individual Capitalization System has to do with the specific safeguards which have to be established for Pension Fund investments. In particular, regulations were included in social security legislation in Chile to cover aspects such as the types of instruments that were eligible, the maximum investment limits for each of these instruments, the characteristics of the markets which were authorized for trading the securities and the risk-rating of these, the custody of the Fund's securities and the management of conflicts of interest between the Administrators and the Pension Funds.

3. Existence of an Insurance Industry

The interwoven relationship that exists between a Social Security System based on individual capitalization and the insurance industry makes it essential for this market to fulfil certain conditions so that the Pension System can develop as it should. In Chile the relationship is produced mainly because the Pension Fund Administrators have to take out disability and survivorship insurance with the life insurance companies to cover those risks for their members. Moreover, beneficiaries are allowed to choose the life annuity pension option arranged with a Life Insurance Company when they begin to receive a retirement, disability or survivorship pension.

This requires a well-developed life insurance industry or at least one which exists and is adequately regulated, so that the Pension Funds can contribute to its further development. In this sense, legal safeguards are needed to allow an appropriate interaction between the two markets. With regard to regulations, the main object is to prevent insolvency, without interfering with competition within the sector.

There was a life insurance industry in Chile before the implementation of the Individual Capitalization System, but it was very under-developed. The creation of the AFP System has contributed to the growing development of this industry. With this in mind various legal modifications became necessary in order to encourage competition, with the safeguards needed for appropriate interaction between the two industries. For example, prices were made more liberal, foreign participation in the industry was authorized, a minimum capital was fixed in "Unidades de Fomento" (UF)¹⁶, transparent financial regulations were laid down and it became obligatory for premiums and payments agreed in pensions contracts to be fixed in UF.

4. Other Conditions Necessary for the Running of the System

In order to complement the support functions that had to be assumed by the State in the Individual Capitalization System, it was necessary to have a legal framework made up of laws, regulations and circulars, and the System's supervisory body has to keep a constant check to ensure that these are complied with. The Pension Funds must be safeguarded on this basis, to ensure that worker members will receive the benefits established by the System in due time and manner, plus the relevant information.

Other key factors in enabling a Private Pension System based on individual capitalization to develop adequately have to do with basic operating

¹⁶ A monetary unit of constant purchasing power.

requirements. In fact, the functioning of the Pension System involves handling a large quantity of information and this means having suitable computer networks and information systems, plus mechanisms for identifying the workers. In this way it is possible to keep an appropriate check on the processes to be carried out by the Administrators, and also to avoid potential anomalies.

B. The Transition Stage

1. Main Characteristics

In view of the problems affecting the running of the Pay-as-you-go System, which were analysed in Chapter II, it was decided in 1980 to replace the Social Security System then in force, separating the services provided by the health area from the Pension System once and for all.

The Pension System was reformed by means of DL 3,500, which introduced a standard system based on individual capitalization, with fixed contributions, private management of the Funds, freedom for members to choose their Pension Fund Administrator, and state supervision. In addition, the system was mandatory for employees joining the workforce for the first time¹⁷ and voluntary for those who were already members of one of the institutions in existence at that point in time (the Old System), and for self-employed workers.

At present the two Pension Systems co-exist, so this could be considered as a transition stage, dating from the beginning of the Individual Capitalization System and lasting until the Old System dies out completely and benefits cease to be paid to members who opted to stay in it.

The Old System continues to operate, mainly through the Institute of Social Security Normalization (INP), the body which brought together the main ex-“Cajas” of that System and is responsible for managing the systems of benefits offered by those institutions.

2. Re-organization of the Old System

As already mentioned in Chapter II, the Old System had a number of faults, but when the new System was established, the old had to continue operating so that those members who were already retired when the reform came in could receive their pensions, and so that contributions

¹⁷ It became mandatory as from January 1983.

might be collected to pay the pensions of those who chose to remain in the Old System.

The INP was created in 1980 by DL 3,502 and was the institution which brought together the different “Cajas de Previsión”. This meant taking on a large number of highly diverse tasks. Among these were the continuation of the work of each of the former “Cajas” and the issuing of Recognition Bonds for those members who decided to change to the new System. This institution was also assigned various other tasks connected with Social Security, such as paying welfare pensions and family allowances. Essentially, each social security institution continued with its own contribution rates, its own formula for calculating pensions and its own types of benefits and requirements. However, the legal age requirements for receiving a retirement pension have gradually been standardized.

This last point was achieved by applying the terms of DL 2,448, which established a mechanism to standardize these requirements over a period of time until, in the current situation, men may retire only when they reach 65 years of age and women when they reach 60.

3. The Mechanism for Transferring Workers to the New System

As already mentioned, the transfer of worker members from the Pay-as-you-go System to the Individual Capitalization System was carried out voluntarily. Two fundamental measures were adopted in order to encourage this: the recognition of contributions paid under the Old System and the creation of economic incentives for the transfer. In this latter case specifically, workers who opted to change to the New System received an increase in their net income averaging 12.6%¹⁸, compared with the income obtained when contributing under the Old System.

As a result, the Capitalization System received a warm welcome from workers and they transferred from the Old System in flocks. During the first year of operation, over a million workers left their respective “Cajas de Previsión” and transferred to the New System.

¹⁸ The average contribution for pensions in the Old System was 22.44% of salary, while this contribution averaged 12.66% in the AFP System when it began. This latter figure was made up of 10% to be deposited in the Pension Fund and 2.66% on average under the heading of commissions deducted from the taxable income to finance the Administrators' work. As a result, when workers changed System, they received an increase in net salary of $12.6\% = (1 - 0.1266)(1 - 0.2244) \times 100$. It is worth pointing out that the AFPs charged their members other commissions which were deducted from the balance in the individual accounts. These are analysed in the social security cost section.

4. Costs for the State Arising from the Reform

Once the reform of the Pension System came into force, the Old System had to continue paying benefits to its pensioners, with the result that the level of expenditure on pension payments remained the same. At the same time, the transfer of workers to the Individual Capitalization System reduced its income, meaning that the deficit carried by the old system became even deeper and the State had to assume the cost of covering it. In the case of workers who changed System, the State is responsible for paying compensation for the contributions made under the "Cajas de Previsión" regime, and does this by means of a financial instrument called a Recognition Bond (RB).

The payment of pensions from the Old System and the payment of Recognition Bonds are government contributions specific to the transition period in which the Social Security System currently finds itself, and they are made through the INP. This has meant a considerable financial cost to the State, and it has had to make an effort to fulfil its social security obligations. During the years since the social security reform came in, the State has used resources to finance it which amount on average to around 3.25% of the Gross Domestic Product (GDP) per year. The government expenditure generated by the change of Social Security System is of great magnitude, with the result that everything in this sector which is not social security must produce a surplus in order to finance that expenditure.

4.1 Recognition of Contributions Paid under the Old System

As has already been mentioned, the recognition of the contributions made under the Old System for those workers who changed to the Individual Capitalization System was achieved by issuing the so-called Recognition Bonds. In order to be entitled to such a bond, members have to meet the following requirements:

- a. They must have at least twelve monthly contributions recorded in some social security institution of the Old System, corresponding to remunerations accrued within the five years prior to November 1980, which have not served as a basis for a pension already obtained.
- b. Those members who do not meet the above requirement must have contributions recorded for remunerations accrued in the period July 1979 to December 1982, which have not served as a basis for a pension already obtained.

Recognition Bonds are calculated as the capital needed to enable the member who transferred from the Old System to obtain a pension for life

which is equivalent to 80% of the taxable remunerations that he/she received between June 1978 and 30th June 1980, weighted by the quotient between the number of years of contributing under the Old System and 35.

The value of the Bond calculated in this way is readjusted according to the variation in the Consumer Price Index (CPI) between the last day of the month prior to the member's joining the new System and the last day of the month prior to the date of its actually being paid; accruing an interest of 4% per annum in real terms, which is capitalized each year.

The Recognition Bond, its readjustments and interest become payable and are deposited in the member's individual capitalization account in any of the following situations:

- i.* When the member reaches the legal age to retire on age grounds¹⁹.
- ii.* When the member has recourse to a definitive disability pension (following the second decision of the corresponding Medical Commission).
- iii.* When the member has recourse to a transitory disability pension which is not covered by the insurance.
- iv.* When the member dies, at any age.

It should be mentioned that if the member decides to take early retirement, the Recognition Bond becomes payable only as from the date when he/she reaches normal retiring age.

4.2 Quantification of the Social Security Deficit

The large-scale transfer of workers to the new System accentuated the deficit of the "Cajas de Previsión". In the following table it is possible to see the gradual movement of membership in the Old and New Systems during the first few years after the reform.

¹⁹ 65 years of age in the case of a man or 60 years in the case of a woman.

Table III.1
DEVELOPMENT OF CONTRIBUTORS AND MEMBERS

Years	New Pension System (1)		Institute of Social Security Normalization (INP) (Ex Cajas de Previsión) (2)
	Number of Members	Number of Contributors	
1979	-	-	2,291,184
1980	-	-	2,226,931
1981	1,400,000	n,d,	731,939
1982	1,440,000	1,060,000	488,856
1983	1,620,000	1,230,000	477,798
1984	1,930,353	1,360,000	459,480
1985	2,283,830	1,558,194	454,409

Notes: (1) As of December each year.

(2) Annual average.

Sources: Statistics from the Superintendency of Social Security and the Statistical Bulletin of the SAFF.

The counterpart of this transfer of members was the loss of income to the institutions of the previous regime. This made their financing problems even worse because the flows of income and expenditure became totally disassociated.

The "state social security deficit" is the name given to the sum of the direct state contribution plus the value of the Recognition Bonds paid each year. The direct state contribution consists of those items charged to the national budget which are sent by the State to the social security institutions, used mainly to finance the deficits incurred by the social security institutions of the Old System. This contribution does not include transfers to the Caja de Previsión de la Defensa Nacional (the Armed Forces Social Security Fund) or to the Social Security Department of the Chilean Police Force. This is due to the fact that the position of these institutions vis-à-vis the budget is completely unrelated with the change of System.

In 1999, the social security deficit amounted to 1.54 billion pesos, equivalent to 2,341 million dollars. Since the creation of the AFP System, this deficit had been growing at an average rate of 10.2% per annum in real terms, with Recognition Bonds constituting the most rapidly increasing item (40.2 percent per annum in real terms). Nonetheless, for the past five years (December 1994 to December 1999) the growth in expenditure in RB has been gradually falling, reaching 14.6% per annum in real terms. Something similar has happened with the government contribution to the Old System, which increased 8.4% per year on

average over the whole period, while in the past five years it has increased 6.3%. As a result of this, in the period December 1994 to December 1999 the total social security deficit shows a growth deceleration from 10.2% on average over the whole period of the analysis to 8.1% for the past five years.

Table III.2
STATE SOCIAL SECURITY DEFICIT AND ITS COMPONENTS
(In thousands of pesos as of March 2002)

Year	State Contribution Old Sistem	%	Recognition Bonds	%	Total
1981	264,604,812	99.66%	911,831	0.34%	265,516,644
1982	273,706,125	95.52%	12,833,834	4.48%	286,539,960
1983	355,163,337	93.43%	24,995,163	6.57%	380,158,500
1984	439,228,107	93.17%	32,193,026	6.83%	471,421,133
1985	520,592,659	93.13%	38,420,493	6.87%	559,013,152
1986	615,331,382	91.90%	54,270,789	8.10%	669,602,171
1987	663,429,316	87.98%	90,620,178	12.02%	754,049,494
1988	649,700,698	88.12%	87,597,328	11.88%	737,298,027
1989	505,949,222	84.77%	90,883,860	15.23%	596,833,081
1990	632,307,923	85.60%	106,386,715	14.40%	738,694,638
1991	704,139,993	87.20%	103,328,441	12.80%	807,468,433
1992	710,288,755	84.58%	129,464,803	15.42%	839,753,558
1993	800,889,091	82.46%	170,381,317	17.54%	971,270,408
1994	836,645,919	80.58%	201,683,358	19.42%	1,038,329,277
1995	875,450,699	78.98%	232,979,996	21.02%	1,108,430,695
1996	840,494,669	77.01%	250,855,473	22.99%	1,091,350,142
1997	970,230,420	76.42%	299,393,644	23.58%	1,269,624,064
1998	994,720,559	74.83%	334,610,411	25.17%	1,329,330,970
1999	1,137,184,625	74.06%	398,287,190	25.94%	1,535,471,815
Average Annual Increase 1981-1999	8.44%		40.18%		10.24%
Average Annual Increase 1994-1999	6.33%		14.58%		8.14%

Source: Prepared internally on the basis of "Social Security Statistics", various years, Superintendency of Social Security.

Throughout the whole period, the main component of the social security deficit has been the direct state contribution to finance the payment of the benefits of the "Cajas de Previsión" merged in the INP. However, with the increase in the number of pensioners belonging to the AFP System but coming from the old regime, the expenditure in RB has grown in importance and in 1999 it represented 25.9% of the total. This has meant that the government contribution to the Old System has fallen from almost 100% in 1981 to 74.1% in 1999. It is hoped that in the future this upward trend in the relative weight of the RB in the state social security deficit will be maintained.

Measured as a proportion of the GDP, the social security deficit grew rapidly until 1986 and then decreased until 1989. As from 1990 this proportion remained steady with a tendency to increase towards the end of the period, due to the deceleration of the growth of the economy after 1998.

Table N° III.3
STATE SOCIAL SECURITY DEFICIT IN RELATION TO THE SIZE OF THE ECONOMY
 (As % of the PIB)

Year	State Contribution Old System	Recognition Bond	Total
1981	1.45%	0.00%	1.45%
1982	1.96%	0.09%	2.06%
1983	2.50%	0.18%	2.67%
1984	3.12%	0.23%	3.35%
1985	3.44%	0.25%	3.69%
1986	3.70%	0.33%	4.03%
1987	3.01%	0.41%	3.42%
1988	3.09%	0.42%	3.51%
1989	2.35%	0.42%	2.77%
1990	2.98%	0.50%	3.48%
1991	3.00%	0.44%	3.45%
1992	2.72%	0.50%	3.22%
1993	2.91%	0.62%	3.53%
1994	2.78%	0.67%	3.45%
1995	2.60%	0.69%	3.30%
1996	2.44%	0.73%	3.17%
1997	2.68%	0.83%	3.50%
1998	2.69%	0.91%	3.60%
1999	3.08%	1.08%	4.16%
Average 1981-1999	2.76%	0.49%	3.25%
Average 1991-1999	2.77%	0.72%	3.49%

Sources: Statistics and the Statistical Bulletin of the Superintendency of Social Security, and the Statistical Bulletin of the Central Bank of Chile.

5. Projection of the State Social Security Deficit

According to estimates reached on the basis of projections published in 1993²⁰, government expenditure on Recognition Bonds in the year 2015 will be 1.1% of the GDP for that year, assuming a growth in the GDP of 5% per annum in real terms. As may be seen in the table below, it is expected that expenditure on RB will increase in the next few years, reaching a maximum value in the year 2009, when it will represent over 1.5% of the GDP. As from that year there will begin to be a reduction in expenditure on this item.

The state contribution to the Old System, on the other hand, shows a clear downward trend. At present about 74% of this contribution is made up of the direct contribution, representing 3.08% of the GDP, but it is hoped that by the year 2015 this figure will have reached 52% of the total contribution, representing 1.2% of the GDP.

Table N° III.4
PROJECTION OF SOCIAL SECURITY DEFICIT
 (As % of GDP)

Year	State Contribution to the Old System	Recognition Bonds	Total
2002	2.35%	1.14%	3.48%
2003	2.26%	1.21%	3.47%
2004	2.16%	1.32%	3.48%
2005	2.07%	1.41%	3.48%
2006	1.88%	1.44%	3.31%
2007	1.79%	1.50%	3.28%
2008	1.70%	1.54%	3.24%
2009	1.62%	1.55%	3.17%
2010	1.54%	1.52%	3.07%
2011	1.47%	1.48%	2.95%
2012	1.40%	1.44%	2.84%
2013	1.33%	1.36%	2.70%
2014	1.27%	1.23%	2.50%
2015	1.21%	1.11%	2.32%

Notes: (1) Prepared internally, based on Arenas, A. and Marcel, M. (1993) and Ortúzar, P., "El Déficit Previsional: Recuento y Proyecciones" in "Sistema Privado de Pensiones", CEP, 1988.
 (2) A growth rate of 5% is used for the GDP.

²⁰ Arenas A. and Marcel M. "Proyecciones del Gasto Previsional 1992-2038, Un Modelo de Simulación para los Bonos de Reconocimiento" Working Document, Ministry of Finance Budget Department, February 1993.