Macro Vision

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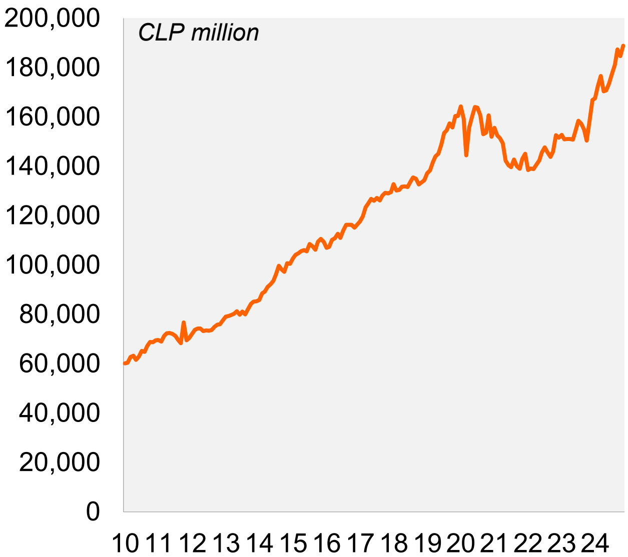
CHILE – Pension Reform: Is this time different?

- This note briefly describes Chile's pension system, provides context on reform efforts over the past decade and ongoing discussions in Congress. A pension reform approval with broad political support that raises pension payouts over time, increases domestic savings, safeguards formal employment, and ensures fiscal sustainability would be positive for Chilean risk assets. Still, the main fiscal risk over the short and medium-term consists in significantly raising publicly financed pensions in the absence of a stream of permanent revenues, all in the context of stressed fiscal accounts. However, persistent failure to achieve consensus on the pension reform in Congress over more than a decade reflects the challenges in Chile's fragmented and divided political system.

A primer …

A very brief overview of Chile's pension system. Chile's pension system is based on three pillars: a mandatory contributory pillar, a voluntary contributory pillar, and a solidarity pillar. The mandatory contributory pillar is based on individual savings accounts, sourced from 10% of monthly wages (capped at a threshold), managed and invested by pension funds (AFPs) across a set of five types of funds ("A" – high risk, mostly invested abroad; through "E" – low risk, mostly invested locally), that have gradually accumulated savings since 1980 (AUM at ~USD193 billion, roughly 63% of GDP, see chart below). The voluntary contributory pillar is also based on individual savings that have the objective of increasing pension savings by complementing the mandatory contributions, generally facilitated with tax incentives, and managed by AFPs and a broader set of financial institutions; the voluntary pillar has gradually accumulated savings since 2003 and as of June 2024 had AUM of roughly USD 12 billion (~3.9% of GDP). The solidarity pillar, financed entirely by the State, mainly focuses on the universal guaranteed pension (PGU in Spanish), which pays out pensions to those that are aged +65 years and not in the top 10% of the income distribution– at a sizable annual cost of 2.17% of GDP (2023).

Mandatory pension savings administered by AFPs



Source: Superintendencia de Pensiones

Table 1. Mandatory Savings Affiliates & Contributors

As of October 31, 2024

Total Affiliates	**11,860,138.0**
Growth (*% YoY*)	1.2
Total Active Contributors	**5,716,638.0**
Growth (*% YoY*)	-0.4
Average wage	CLP1.285.799
Average wage real growth (*% YoY*)	3.6

Source: Superintendencia de Pensiones.

Table 2. AUM in Mandatory Savings managed by AFPs

As of November 30, 2024

	Type of Fund					TOTAL
	A	B	C	D	E	
Total USD billion	31.9	39.5	65.2	33.3	23.3	193.2
Total CLP million	31,204,767	38,642,832	63,761,968	32,507,368	22,737,302	188,854,237
Real YoY change (%)	25.3	26.5	10.2	10.4	-1.30	13.9
% of GDP	10.4	12.9	21.3	10.9	7.6	63.1
Share of total	16.5	20.5	33.8	17.2	12.0	100.0

Source: Superintendencia de Pensiones.

Table 3. Asset Allocation

As of November 30, 2024

	AUM (USD bn)	YoY
Local equity	13.3	3.30%
Local fixed income	84	0.00%
Foreign equity	69.5	22.90%
Foreign fixed income	23.0	-7.90%
Other	3.1	

Source: Superintendencia de Pensiones.

A concise assessment of the pension system in stylized facts:

- Greater pensions have been at the top of the policy priority list for some time, as high expectations of replacement rates have underwhelmed, on average.
- Several factors have led to lower replacement rates in practice, including issues related to labor market participation (spells of unemployment, slowing wage growth, informality), demographics (unchanged retirement age, longer life expectancy), and capital markets (gradually lower returns);[1]
- Replacement rates are projected to be even lower considering the effects of sizable pension fund withdrawals between 2020-2021.
- Demographic trends in Chile suggest a shift back towards a PAYG system would simply be unsustainable. Raising the retirement age has not been formally discussed in several years.
- The accumulation of pension savings has contributed to the development of Chile's capital market.

[1] See "Estudio sobre Tasas de Reemplazo en el Sistema de Pensiones Chileno y sus Proyecciones bajo Distintos Escenarios. (2024)"

Several setbacks over the past decade. Even though changes to the pension system have been a policy priority for several years, the past two administrations have unsuccessfully attempted to reform the structure of Chile's pension system. The main stumbling blocks have been the distribution of any additional savings contribution, who will collect, invest, and pay out the pensions, and the interest of some of incorporating a pay-as-you-go component to the system. Having faced a deadlock on these issues in Congress in the past two administrations, the most recent reform to the solidarity pillar of the pension system was approved in February 2022, with the creation of the PGU that broadened the coverage and raised publicly financed pensions (with respect to the Pensión Básica Solidaria program, implemented originally in March 2008).

Black swans do occur… make that three, in a row! In the context of the pandemic, Congress approved a string of three withdrawals from individual savings accounts between 3Q2020 and 2Q2021 that totaled roughly USD50 billion (roughly 20% of GDP of 2020), generating severe imbalances in the economy, which were then compounded by fiscal cash transfers at a time in which Covid-related mobility restrictions were essentially withdrawn. While it is beyond the scope of this note to address the short-term macro-financial effects of these withdrawals in detail, in a nutshell: they boosted private consumption (especially of durable goods), contributed to a positive output gap that peaked at 5% of GDP, a current account deficit that edged up to 9.9% of GDP, lowered NPLs for consumptions loans, drove an unprecedented inflationary shock (peak of 14.1% YoY in August 2022), a period of unanchored inflation expectations, greater spreads in government bonds especially at the long end, higher risk premia on Chilean assets, exchange rate depreciation and volatility, among others. Since the approval of these withdrawals, Congressional proposals for new pension fund withdrawals have been rejected; the most recent effort was rejected by the Constitutional Committee of the Lower House in August 2024 and has yet to be voted on the Lower House Floor. Risks of new withdrawals over time continue to weigh on sentiment and the lower depth of the capital market. An unintended consequence of the withdrawals has been a greater sense of ownership of the savings in individual capitalization accounts, likely reflecting the hope of further withdrawals.

The Boric administration's original pension reform proposed a major structural overhaul of the pension system, even though they had a minority representation in Congress. The reform presented in November 2022 proposed the creation of a new "social security pillar" financed by new contributions of 6% of the workers' salary – to be nominally paid entirely by the employer – with contributions to increase gradually at a rate of 1% per year. Of this 6% increase, 1.8% (30%) would finance greater pensions for the most vulnerable, and the remaining 4.2% (70%) would be registered in an individual "notional account." As presented, the notional accounts differed from the individual capitalization account, in the sense that their returns would depend on the overall returns of the collective fund, whereas the individual capitalization account's return would be a function of the targeted date of the retirement fund. Contributions to the social security pillar would be administered by a new public entity, that would also, by default, receive the future flows of the mandatory 10% contributions to individual capitalization accounts. The bill also proposed replacing the AFPs with private investment managers that would only invest, leaving other roles currently performed by the AFPs such as the collection of contributions, pension payouts, and back-office functions to a new agency.

A slow burn. In the aftermath of the rejection of the administration's tax reform in March 2023, and the second constitutional process, pension reform discussions were essentially on hold throughout most of 2023. Facing difficulties in the reform discussions from a minority position in Congress and a united opposition, the administration gradually amended key elements of the reform.

Bittersweet progress in the Lower House… In January 2024, the government presented an amendment that ensured support from independent congressmen by changing the distribution of the additional 6% contribution to 2.1% to the individual capitalization account, 0.9% to an intragenerational savings account, and the remaining 3% to a social security fund. The amendment cleared the path for the reform's approval in the Lower House in January 2024, albeit with several key measures being rejected. In fact, the additional 6% contribution, arguably the most important measure of the bill, was rejected. Another key measure that was rejected was the creation of a state pension fund manager.

… Round 2, in the Senate. Following the reform's marred approval by the Lower House, discussions began in the Senate, where the opposition has half of the seats. In fact, the opposition has the presidencies of two commissions that are key for the pension reform– the Labor committee and the Finance committee. Changes eventually approved by the Senate floor must be taken back for approval by the Lower House floor, suggesting the reform is likely to end up in a Mixed Committee, towards the end of its legislative discussion.

Main changes approved in the Labor Committee of the Senate, so far:

- **Higher publicly financed pensions with greater coverage over time**: The PGU would gradually increase to CLP250,000 from CLP214,296 and would be adjusted once a year according to annual inflation. Importantly, additional financing of the measure has not yet been approved.
- **Greater contributions to individual capitalization accounts**: the wage threshold for 10% mandatory contributions to individual accounts would increase from 84.3UF (~USD2,400) to 126.6UF (USD3,600), matching the threshold of the UI system. This change would be favorable for the domestic capital market as it would increase the flow of savings.
- **Transition to a system of Targeted date funds**: the current structure of five types of funds stretching from riskiest to most conservative would be replaced with targeted date funds, reducing the financial risks associated with the massive fund switching in previous years, among other effects. The reform creates a new system of ten generational funds, in which savers will be grouped in five-year cohorts while the worker is saving.

The thorniest pending issues, which could eventually be postponed:

- **Distribution of the additional 6% contribution**: The main issue in this pension reform negotiation, as has been the case in the previous administrations, is the distribution of the additional 6% contribution. As mentioned earlier, the reform presented in November 2022 proposed the creation of a new "social security pillar" financed by new contributions of 6% of the workers' salary – to be nominally paid entirely by the employer – with contributions to increase gradually at a rate of 1% per year. Of this 6% increase, 1.8% (30%) would finance greater pensions for the most vulnerable, and the remaining 4.2% (70%) would be registered in an individual "notional account." This distribution was amended in the lower house to 2.1% to the individual capitalization account, 0.9% to an intragenerational savings account, and the remaining 3% to a social security fund; however, this formula was rejected by the Lower House. Polls show that a majority favor additional contributions to be paid out entirely to the individual capitalization account. The opposition is interested in the entire 6% being saved in individual capitalization accounts. Discussions in the Senate's Labor Committee had suggested 3% would go to individual accounts, 1% to a longevity insurance, and 2% to a loan, that would at least partially finance the increment of the PGU on a transitory basis.
- **Competitive auctions of affiliates**: to foster greater fee competition among AFPs, 10% of the outstanding stock of affiliates would be randomly bid on an annual basis. Savers would have to provide their consent if selected to shift to a manager with lower fees. The AFPs claim such a change would reduce pensions over time by limiting investments in high return / low liquidity assets. Several pension systems implement competitive bidding of affiliates, including Australia, Mexico, and Poland (See Harrison et al,2023), suggesting liquidity risks could be mitigated. Of note, our understanding is that lower fees would not raise pensions per se under the current fee structure based on flows (as lower fees would raise monthly income) but could change depending on the shift to a fee based on AUMs.
- **Separation of the Pension Fund Industry**: The bill approved by the Lower House created a new pension administrator responsible for the collection of contributions, pension payouts, and back-office functions; the AFPs currently perform these duties. In addition, Private Pension Investors were approved, replacing the current AFPs. In doing so, pension fund managers will have to adjust their fee structure, currently based on a percentage of the monthly wage, to a fee based on AUM.

The approval of a pension reform with broad political support that raises pension payouts over time, increases domestic savings, safeguards formal employment, and ensures fiscal sustainability would be positive for Chilean risk assets. Following the Lower House's approval of a watered-down version of the pension bill in January 2024, discussions in the Senate are likely to stretch through 1Q25. If approved by the Senate, the reform would probably end its legislative process in a Mixed Committee composed of 5 senators and 5 deputies: likely to be split evenly between the opposition and the governing coalition.

Even though legislative and presidential elections (November 23, 2025) may pose challenges to reach consensus on structural reforms such as the pension reform, as evidenced by recent statements from both sides of the political spectrum.

The main fiscal risk over the short and medium-term consists in significantly raising publicly financed pensions in the absence of a stream of permanent revenues, all in the context of stressed fiscal accounts. Using data from the Budget Office's financial report, we estimate that the increase of publicly financed pensions by 2027 would cost an additional 0.4% of GDP per year, on top of the current roughly 2.2% of GDP per year. Importantly, a consensus reached in the short term has the risk of not surviving the test of time, considering incentives faced by new administrations and low congressional quorums (simple majority). A "slippery slope" scenario in which publicly financed pensions are financed by a larger share of the additional workers' contribution– smaller amounts to individual accounts – would reduce household savings, lower benefits of formal employment, and reduce the flow of domestic savings, among other factors.

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