27th International Congress of Actuaries

ICA CANCUN 2002

Overview of Pension Plans in Latin America

with a focus on Brazil and Mexico

A New Millennium. A New Challenge for Actuaries

Pension Practice in Latin America

Three groups of countries are clearly identified

Group I

- Mainly depending on State Social Security (Pillar 1) and/or termination indemnity mandatory payments
  - Central America, Ecuador, Venezuela.
- Supplemental plans
  - Not common (except for State companies, Armed Forces, Oil industry, Executive arrangements)

Pension Practice in Latin America

<u>Group II</u>

- Influenced by "Chilean Model" implemented in 1981.
  - Social Security migrated to a mandatory DC system privately administered under government's supervision
  - "Old DB" system in transition.
- Some examples:
  - Argentina, Chile, Peru, Bolivia, Argentina, El Salvador, Colombia
- Supplemental plans
  - Not common (Oil, Mining, Highly paid executives, Armed Forces, Civil Service employees).

Pension Practice in Latin America

<u>Group III</u>

- State Social Security and Supplemental pension plans
- Includes the two largest countries in the region:
  - ***Mexico***, linked to mandatory termination indemnity with tax advantages for both employer and employees. Trend to change "short-term mentality" and cost sharing.
  - ***Brazil,*** most regulated supplemental pension market in the region. Also, largest prevalence of supplemental pension plans.

Mexico

Legal Environment

Taxation

Social Security

Market Practice

Mexico - Legal Environment

- Defined Within Tax, Social Security and Labor Laws
- No specific Pension Law
- Normally plans are set up under:
  - Trust Funds
  - Stock Broker investment contracts
  - Unfunded arrangements
- Legal Termination Indemnity has a significant influence on design.

Mexico - Legal Environment

- Old age is not justified cause to dismiss an employee
- Therefore, a termination indemnity must be paid to enforce retirement age. In practice, the employee remains in service until this benefit is paid
- The amount is 3 months of gross salary (all cash compensation), plus 20 days of salary for each year of service
- There is usually a defined benefit minimum (equal to the termination indemnity) even with a DC plan

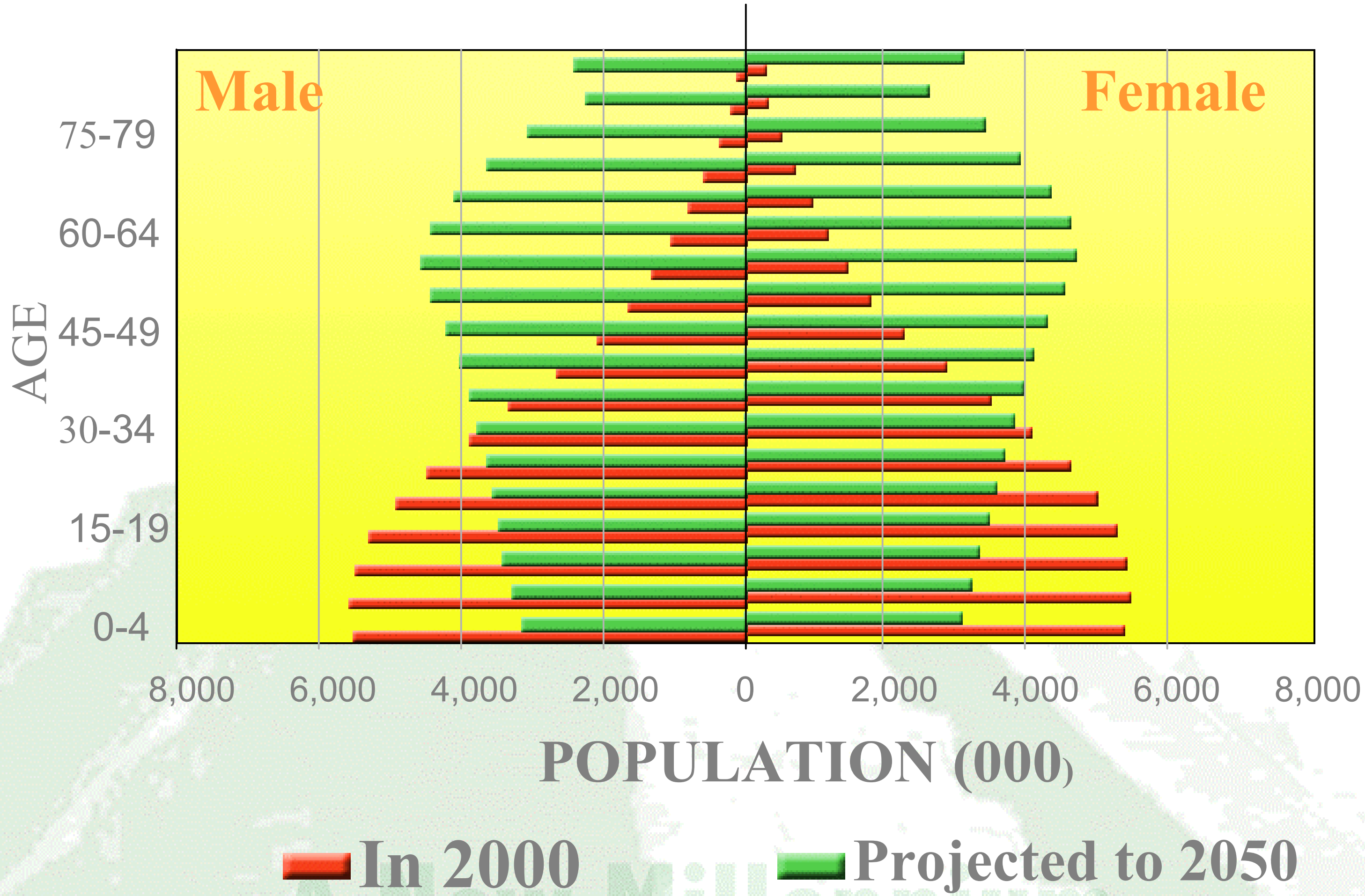
Mexico - Taxation

- Employer contributions are tax deductible
  - only restriction is for contributory DC plans: a minimum of 75% of eligible employees must participate for employer contributions to be tax deductible
- Employee Benefit income is tax free up to certain limit. (Lump sum payment around US$ 200,000)
- Return on Investment is tax exempt
- However, employee contributions are not tax deductible

Mexico - Social Security

- Mandatory Social Security Pension contributions are paid to AFORES (independent financial institutions typically run by banks).
  - New defined contribution system started in 1997
  - Those in the system in 1997 have a defined benefit guarantee of their pension in the old system
  - AFORE administration charges are very high, 20% - 25% of contributions
  - Contributions ceiling of 25 times minimum wage (US$ 38,300 annual)
  - Overall pension replacement ratio is very high at low salary levels and extremely low at higher salary levels

Mexican Population



Mexico - Market Practice

- About 70% of medium and large employers and most multinationals provide retirement benefits
- About 60% of plans only grant benefits equivalent in lump sum to termination indemnity
- Type of plan
  - Most existing plans are DB, but most new plans are DC
  - Most DC plans have employer matching contributions

Brazil

Legal Environment

Taxation

Social Security

Market Practice

Brazil - Legal Environment

- Defined Within Tax, Social Security, Labor Laws and Complementary Private Pension Law
- Normally Set Up under:
  - Closed Entity (Trust Fund), or
  - Open Entity
- Legal Termination Indemnity (FGTS) has little influence on design.

Brazil - Legal Environment
Private Pension Legislation

- At the end of May, 2001, a new legislation revoked Law 6,435 which was the basic legislation for the Private Pension System in Brazil
- The innovations are:
  - introduction of the portability concept;
  - minimum vesting conditions;
  - participants’ representatives in the Board of Directors of the plan

Brazil - Taxation

- Tax Relief on Employee Contributions up to 12% of annual earnings
- Tax Relief on Company Contributions up to 20% of monthly payroll of the Plan Participants
  - Plan must be non-discriminatory to avoid social charges
  - Minimum benefit is accepted to include low paid employees in the plan
- Benefit is taxable income to Employees when paid

Brazil - Taxation of Investments

- Controvertial Issue
- My vary depending on financing vehicle, origin of contribution, and existence of court action.
- Current status:
  - Return on Investments are taxed if the plan uses a traditional plan through an open or closed entity, but it is exempt of tax if a “PGBL” approach is used (no longer valid for plans implemented after 1/1/2002).
  - Some pension funds fought in court to guarantee the “imunidade tributária” or at least tax exemption

Brazil - Social Security

- Social Security is a defined benefit system
- Financed on a pay-as-you-go basis
- In November 1999 the Congress approved the "fator previdenciário" which is a table that reduces benefit in case of early retirement and increases benefit in case of postponed retirement.
- There is a transition period of 5 years in which this reduction will be phased-in.

Brazil - Social Security

- This change is clearly insufficient to balance Social Security's "assets" and liabilities
- Change has led to a complete need of separation between the benefits in private plans and the Social Security benefits
  - Led to an increase in DC plans, that can be more easily separated from the Social Security benefit
- Overall, Social Security pension is very good for very low salaries and very low for high earners
  - the maximum Social Security benefit is about US$ 660

Brazil - Market Practice

- Initially established by public-sector companies using a DB approach
- These plans used to provide 100% replacement ratio including Social Security benefit
- The benefits were adjusted not only with inflation but with salary increases for active employees
- For private-sector companies, the main reasons to implement a pension plan was the lack of retirement benefit provide by Social Security, especially for executives
- Until mid-80's, most plans used defined benefit approach

Brazil - Market Practice

- DC plans introduced in the mid-80s
- Since then, this type of plan is growing fast in popularity because of:
  - Social Security instability
  - Brazilian economy volatility - reduction of risk for employers
  - Changes in demographic and employment pattern
- About 70% of companies (medium and large) grant retirement benefits.
- Some of the existing DB plans have been converted into a DC or cash balance plan

Overall - Recent Regional Trends

- More agressive vesting
- Variable compensation being introduced as part of pensionable earnings
- Multi-investment choices becoming more common (mostly in Brazil)
- Global or regional guidelines also becoming common