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BofA SECURITIES

Chile Viewpoint

Pension Reform Approved! Macro Impact.

Congress approves pension reform by a wide margin

The pension reform was approved by a wide margin in Congress. It will become law if it passes the review of the Constitutional Tribunal. The reform completes the transition towards a mixed system of individual capitalization and social security (intergenerational transfers). The main goal is to raise pension benefits in Chile, which are considered relatively low, an important demand of 2019's mega protests.

What's in the Pension Reform?

The main point of the reform is a new employer contribution (7% of salaries, gradual increase over 9y). This will finance higher pensions today, through a social security fund, and higher future pensions, via individual capitalization. The reform increases the universal pension and provides a new retirement benefit depending on the number of years contributed. It also stimulates competition among pension fund managers.

Higher fiscal deficit vs large domestic savings

The negative side of the reform is the fiscal cost, of 1% of GDP in the medium term (increasing gradually). On the positive side, the reform should boost assets managed by AFP pension funds (partially offset by lower voluntary savings), improving the depth of the financial system. These may help finance the fiscal deficit. An agreement was reached after years of gridlock. Without the reform, pressure to increase pensions would remain.

Labor market, inflation and exchange rates

Higher contribution costs could generate more labor informality. However, the benefits based on years of contribution incentivize formal work. Impact on inflation is ambiguous. Overall, during the first years we expect risks of higher inflation due to higher social spending and fiscal deficit. The larger savings lead to a better current account balance and induced demand for foreign assets (from AFPs). Impact on the exchange rate should be non-linear: pressures for a stronger CLP in the first years, and weaker in the long-run.

EXD Strategy: Remain Marketweight.

We keep our MW recommendation on Chile's external debt (EXD). Chile trades slightly wide to its ratings, justified by fiscal risks. Gradual implementation of pension reform gives time to adjust. Domestic savings could reduce EXD issuance over time.

FX Strategy: Short PEN/CLP. Equities: uncertain allocation

We open a new trade: short PEN/CLP at a 266.91 spot level (240 target, 280 stop). The trade has negative carry of 0.3% per year and volatility of 13.5%. We estimate Chile's peso is ~10% undervalued. Amid more hawkish BCCH and pro-market regime potential.

Refer to important disclosures on page 12 to 14. Analyst Certification on page 10. Valuation & Risk on page 10.
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See Team Page for List of Analysts

For a list of our open and closed trade closed over the last twelve months, please refer to our GEMs Weekly report.

In the equity front, we expect an increase in AUM, but allocation to local equities is low.

Pension Reform: Macro Impact

The government and the center-right opposition reached a historical agreement regarding modifications of the pension reform, after 40 years of failed attempts. The new bill was approved by a wide margin in both the Senate and the Lower House. It will become law if it passes the review of the Constitutional Tribunal, which we expect to happen in the coming days.

The reform accelerates the transition towards a mixed system of individual capitalization and social security regime (intergenerational transfers). The ultimate goal is to raise pension benefits in Chile, which are considered relatively low. Higher pensions were one of the main demands of 2019's mega protests.

A Mixed Social Security System

The key measure of the reform is an increase in employer contributions to finance higher pensions today (through a social security fund) and to increase future pensions (individual capitalization).

7% new employer contribution

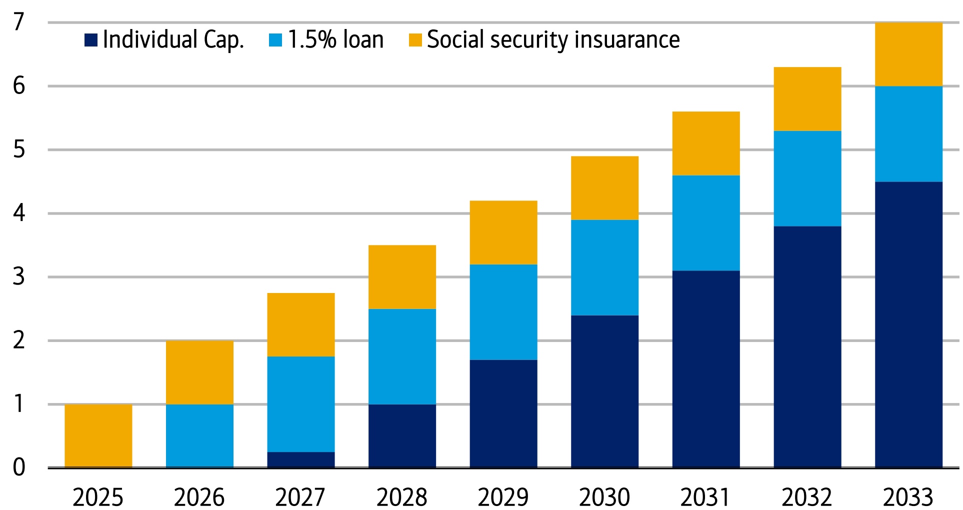
Employer contributions will rise by 7pp (of workers salary) gradually over nine years -see timing below- (reaching a total of 8.5%, adding to the existing 1.5% employer contribution).

Funds from the 7pp contributions will be split as follows1) 4.5% will go directly to individual capitalization accounts and 2) 2.5% will go to a new social security fund to finance current pensions and social insurance. Of this 2.5%, 1.5% will be considered a reimbursable loan to the social security fund that is payable to workers when they retire.

Creation of a Social Security Fund

Of the 7pp additional contributions, 2.5pp will fund a social security fund (SSF) (adding to the existing 1.5% employer contribution). The SSF will also be funded by government transfers (about 0.2% of GDP a year) and a $900mn loan from the pension sovereign wealth fund (repaid in 20 years).

Exhibit 1: New Employer Contributions % of salary (and use of funds)
Gradual increase in employer contributions (9 years)



Source: Dipres, Ministry of Finance.

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This Fund will be in charge of financing social insurance for current retirees, including a new compensation for women, due to longer life expectancy (on top of the existing disability insurance and survivorship rights). It will also support a new pension benefit that depends on a workers years of contributions (0.1 UF monthly per year of contribution, or ~$3). To qualify for the new pension benefit, women must contribute for at least 10 years and men must contribute for at least 20 years. Women's minimum years will eventually increase to 15 years (after 10 years). This benefit will reach current retirees and persons that retire in the next 30 years (the benefit will be reduced very gradually over time).

The "magic" loan: deferred contribution with protected returns

The social security fund will have to pay back the 1.5pp of the contributions to workers when they retire (reimbursed over 20 years or 240 monthly installments). This is considered a loan that will capitalize with market-determined returns, backed by a government guarantee (we understand returns will be tied to CPI-indexed government bonds).

Raising the Universal Guaranteed Pension (PGU)

The government will increase the PGU benefit from CLP 214kto 250k CLP or 17%, starting with beneficiaries aged 82+ six months after the law's is enacted, which will be extended gradually to the rest of retirees. Note that the Treasury pays for this benefit (not the SSF). PGU is adjusted by inflation once a year in February.

Stock Auctions to Enhance Competition

10% of pension fund affiliates will be auctioned every two years to encourage competition among pension fund managers, aimed at reducing fees. Limits include a 25% market share cap and a five-year price stability requirement for auction winners.

Also, note that pension funds offered will transition from current multi-funds scheme A-E (depending on the type of instruments) to age-dependent portfolios (generational funds).

Public fund manager? Not this time.

New pension fund managers can compete with existing private pension fund managers, to spur competition. But the potential creation of a public fund manager was left out of the agreement as there was no consensus (this is something the government could insist in Congress in the future, but we do not think it will pass).

Exhibit 2: Employer contributions % (timeline and uses)
Contributions reach 7% after 9 years

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
Employer contribution	1	2	2.75	3.5	4.2	4.9	5.6	6.3	7
Individual capitalization	0.1	0.1	0.25	1	1.7	2.4	3.1	3.8	4.5
Loan to Social Security Fund	0	0.9	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Insurance (women, disability, survivorship)	0.9	1	1	1	1	1	1	1	1

Source: Dipres, Ministry of Finance.

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Timing is crucial: contribution and uses

The implementation of the reform is gradual. The new employer contribution starts at 1% the first year and increases to 2%, 2.75% and 3.5% in years two, three and four respectively. Afterwards, it goes up by 0.7pp per year until it reaches 7% in year nine (see Exhibit 1 and Exhibit 2).

Uses: social security first, individual capitalization later

Regarding the uses of the contribution, during the first years, the bulk of the money is devoted to the social security fund, especially for women retirement, disability insurance and survivorship rights (0.9% from the first year) and the 1.5% loan to the fund (in full since year three).

In contrast, the funds destined for individual capitalization are very low the first three years (0.1% in year one and two, and 0.25% in year three). They gain steam only starting in the fourth year (1%), then increasing 0.7pp per year until reaching 4.5% in 2034 (remaining at 4.5% until 2044). The percentage starts increasing gradually again in 2045 until it reaches 6% in 2054 (simultaneously to the reduction of the "loan" to the social security fund, which disappears in 2054).

PGU increase and new pension benefit

The universal pension benefit increase (17%) is gradual, reaching beneficiaries aged 82+ six months after the law's is enacted, following with 75+ in 18 months and for the rest of retirees (65+) in 30 months. The fiscal cost is projected at 0.02%, 0.11%, 0.20% and 0.32% of GDP in years 1, 2, 3 and 4 respectively. The new pension benefit depending on years contributed will reach about 1 million persons the first year, gradually increasing to reach 1.5mn people by 2034.

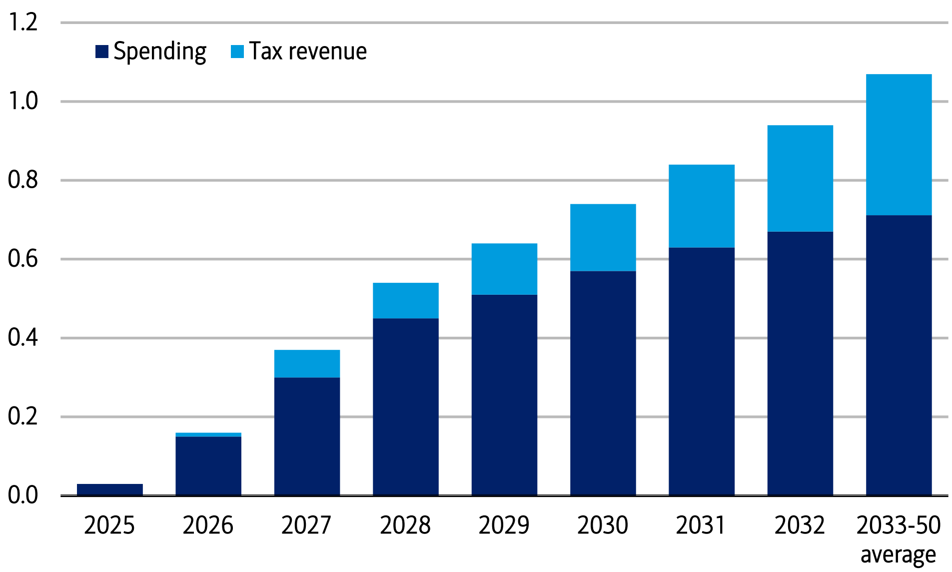
Macro Impact: Fiscal & Assets

Overall, the reform will have significant fiscal costs, but it will also increase the assets under management of pension funds.

Credit Impact: pros and cons

The negative side of the reform is the fiscal cost, of 1% of GDP in the medium term (see below), starting already from a high fiscal deficit. The social security spending is committed, but the resources to finance that deficit (from the evasion reduction law) are uncertain. True, the deficit increase is gradual, so Chile has time to make a fiscal adjustment if tax revenue underperforms.

Exhibit 3: Fiscal Cost per year (% of GDP)
More Social Spending, less revenue



Source: CFA, Dipress, BofA Global Research. Assuming the reform starts being implemented this year.

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On the positive side, the reform should generate substantial additional assets for the AFP pension fund managers (and some assets for the new social security fund), which can increase the size and depth of the domestic financial system. These may help financing part of the incremental fiscal deficit during the transition.

it's also positive that the main actors of the political system have finally come to an important agreement, after years of gridlock in congress. Without the reform, pressure to increase pensions would have continued (and without a strategy to finance it), leading to a higher deficit anyway. The total 8.5% employer contributions add to the existing 10% employee contribution, leading to a strong boost of pension benefits, solving one of the main demands of 2019's protests. The initiative benefits 2.8mn retirees, leading to between 14% and 34% increase in pension benefits, according to the government.

Overall, Chilean government bond prices have not reacted much to the progress of the reform, so they likely see that positive factors mostly offset the negative ones.

Fiscal Cost: 1% of GDP medium term

The reform will have significant fiscal costs, reaching a peak of 1% of GDP annual average in 2033-50. Of this, 2/3 is explained by more social security spending (0.3 of GDP increase in universal pensions, 0.2% treasury transfers to the social security fund and 0.2% public workers contributions), while 1/3 is due to less tax revenue (0.4%). See Exhibit 3 and Exhibit 4.

The government hints it will finance the reform deficit with the additional tax revenue arising for the lower evasion law (it expects 0.7% of GDP in 2025, 1.1% in 2026 and 1.5% of GDP a year from 2027 onwards). The 1.5% of GDP looks quite uncertain to us and note that the government counted on it to converge to previous fiscal targets, of 0% of GDP by 2028 (coming from a 3.5% deficit of GDP last November).

Exhibit 4: Fiscal Cost of the Pension Reform (% of GDP per year)
Higher spending, lower revenue

	Fiscal Cost	**More Spending**			**Less Revenue**
	Total	Universal Pension	Public workers contribution	Transfers to Social Sec. Fund	Taxes
2025	**0.0**	0.0	0.0	0.0	0.0
2026	**0.2**	0.1	0.0	0.0	0.0
2027	**0.4**	0.2	0.1	0.0	0.1
2028	**0.6**	0.3	0.1	0.0	0.1
2029	**0.7**	0.3	0.1	0.1	0.1
2030	**0.8**	0.3	0.1	0.1	0.2
2031	**0.9**	0.3	0.2	0.2	0.2
2032	**1.0**	0.3	0.2	0.2	0.3
2033-50 average	**1.1**	0.3	0.2	0.2	0.4

Source: CFA, Dipres, BofA Global Research.

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Assets: pension funds vs aggregate savings

The increase in employer contributions should be a strong boost to assets managed by local pensions funds (AFPs) in the medium term. But this effect will gain steam only after the fourth year (as mentioned above the first three years there won't be much individual capitalization).

We estimate that the reform should increase AFPs' assets under management by around 40% of GDP in 30 years (about 20% of GDP in 20 years and 7% in 10 years), This adds to the current AFPs assets (about 60% of GDP).

We expect around 50% of these new assets to remain in the domestic financial system, given current composition of AFPs' assets (of the domestic assets about 85% are invested in fixed income and 15% in equities). This should also lead to an increase in average duration of Chilean invested assets as AFPs have a long horizon.

However, note that aggregate savings of the private sector will increase significantly less that the assets of AFPs, due to a reduction in voluntary savings as:

1) Employers can translate part of the additional contributions to lower wages, reducing employees' income (affecting workers savings capacity).

2) Workers will reduce voluntary savings as a response to higher expected income at retirement ("wealth" effect), amid higher forced savings.

Companies also can reduce savings because of smaller profits.

But overall, we would expect a significant net increase in aggregate savings of the economy in the medium term and thus a smaller current account deficit and largest net external position.

In the medium term, a higher current account balance and demand for external assets from AFPs would be consistent with a weaker real exchange rate (vs the scenario without reform). In the short-term, we see other positive developments for the CLP, including a hawkish turn from BCCh (the reform should be a hawkish shock at start) and potential transition to a market friendly government (plus improving copper production). See FX strategy section below.

Labor market costs and informality

The higher employer contributions may lead to an increase in informality at the margin, adding to growing labor market frictions (higher minimum wage, shorter hours per work-week law). In contrast, note that the new pensions linked to years contributed is an incentive to work formally, that can partially offset the higher costs.

Inflation and Consumption

On the inflation front, the impact of the reform is ambiguous. We believe that in the first years of the reform the risks are tilted for higher inflation give the focus on more social spending, as new benefits kick in (higher pensions, women insurance), especially after 18 months when the universal pension is extended to 75+. The recipients of these transfers should have a relatively high propensity to consume. Also, companies that cannot fully translate the new contributions to lower wages will see lower profits, reducing supply.

On the other hand, lower household income (companies reducing wages), should lead to less consumption, partially offsetting the effect above.

Overall, we think the inflation risks of the reform are a factor for BCCh to stop cutting rates (see BCCh on hold. A longer pause. 29 January 2025).

Fiscal council advice and Government response

The fiscal council presented a series of recommendations to the government. In particular, it suggested to delay the implementation of the reform if the tax revenue targets are not reached. The government took the advice and proposed a more gradual implementation of the contributions of 11 years in that case.

The council also warn of additional fiscal needs that can arise from the reform (we think of assistance to small companies that cannot afford the additional contributions).

The Fiscal Council also suggested to incorporate the new social security fund liabilities (not considered government debt) into the fiscal rules/debt framework (the SSF is autonomous). Note that the insurance provided by the government to back the loans received by the SSF will be reported yearly by the Treasury.

The ministry of finance estimated that the social security fund could manage assets for 10% of GDP by 2050 and of 15% of GDP by 2080. We estimate that the debt of the Fund with workers (the "1.5% contribution" loan) could create a liability of over 7% of GDP by 2050, below the estimate of assets. The fiscal council suggested to monitor the potential contingent liabilities of the Fund.

Note that the social security fund will assess its sustainability from time to time and a committee may suggest adjustments to benefits and contributions for that sake (with the assistance of the fiscal council and a pension advisory council).

External Debt Strategy

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Maintain Marketweight recommendation

Small discount to ratings justified by lingering fiscal risks

We keep our Marketweight recommendation on Chile's external debt (EXD). Chile trades slightly wide to its average credit rating (A2 stable/A stable/A- stable), though that discount has narrowed significantly from the levels observed in 2021-2023, when there were risks of substantial changes to Chile's constitution. We think valuations are generally fair given lingering fiscal risks that if unaddressed could lead to credit rating downgrades in the medium-term.

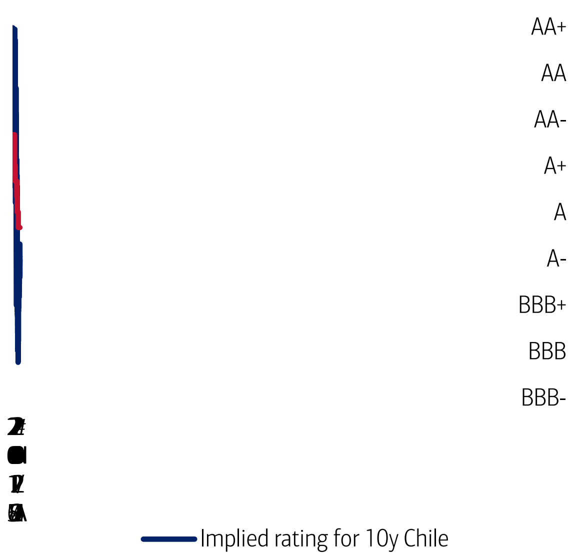
Pension reform is a relatively market-friendly solution to societal demands

Overall, we see the pension reform as a relatively market-friendly solution to society's demands for additional pension benefits and more solidarity. The main risk we see from the external debt perspective is that the fiscal costs are not fully covered by anti-evasion measures. However, because the pension reform will be implemented gradually, we think the government will have time to address those potential shortfalls.

Additional domestic savings could reduce EXD issuance

Additional domestic savings should be supportive of reduced reliance on external debt to finance the government. External debt issuance has fallen from the high levels observed during the pandemic ($9bn/year during 2020-2022), but it remains higher than its pre-pandemic trend ($2.2bn/year during 2015-2019).

Exhibit 5: Chile trades at about 1 notch discount to its A average rating
Comparison of 10y bond spreads to Chile's average credit rating



Source: BofA Global Research, Bloomberg.

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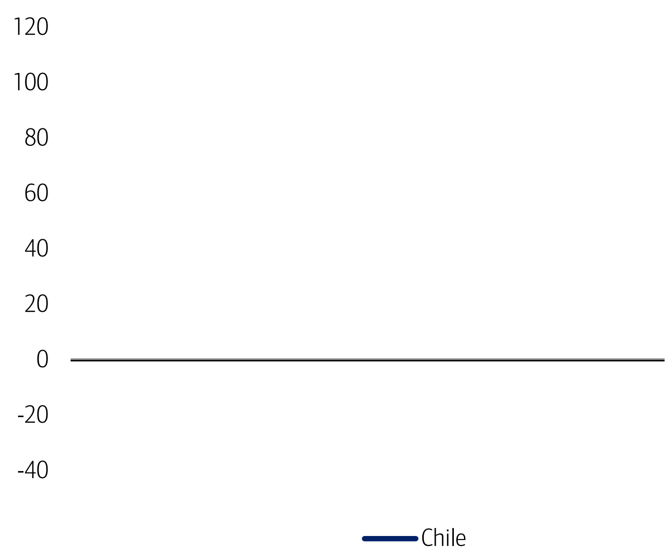
Exhibit 6: Chile trades about 20bp wide to its rating
Difference in bps between actual rating and implied rating



Source: BofA Global Research, Bloomberg.

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Local Markets Strategy

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We open a new trade: short PEN/CLP at a 266.91 spot level with a 240 target and a 280 stop (see Exhibit 7). The trade has negative carry of 0.3% per year and annualized volatility of 13.5%. We estimate Chile's peso is around 10% undervalued to fundamentals. There will be no additional interest rate reductions. And this year's general election is likely to result in a more pro-market government winning. Risks are lower copper prices and U.S. tariffs.

Short PEN/CLP given reform's fiscal impulse and this year's election.
We turn bullish the Chilean peso. The real exchange rate is more than 10% cheap to its long-run average (see Exhibit 8). Chile's external balance has significantly improved thanks to an undervalued peso, shifting to a 2.3% current account deficit in 2024 from 8.7% deficit two years earlier. We forecast a 2.5% deficit in 2025, a normal level for Chile's economy.

We no longer expect interest rate cuts. The pension reform should provide a positive fiscal impulse in the first years as money is transferred to retirees and low-income people with higher propensities to consume. This will add modest but positive pressures to inflation. Lately, Chile's lower interest rates relative to its regional peers drove investors to sell Chile's peso and use it as a funding currency for carry trades. Foreigners positioning is considerably undersold now. But with no further rate cuts, we expect CLP to outperform PEN where we expect at least one additional rate cut.

Lastly, Chile will hold general elections later this year. The incumbent left-wing government faces an uphill battle as it struggles with historically low approval ratings. Public dissatisfaction has been driven by weak economic growth, high crime rates, and policy missteps. Should the center-right or right-wing party win, the peso is likely to benefit from significant capital inflows after several years of weak private investment; total investment is down to 23% of GDP in 2024 from a high of 29% in 2012.

Exhibit 7: We open a short PEN/CLP
Spot PEN/CLP rate.

Source: Bloomberg

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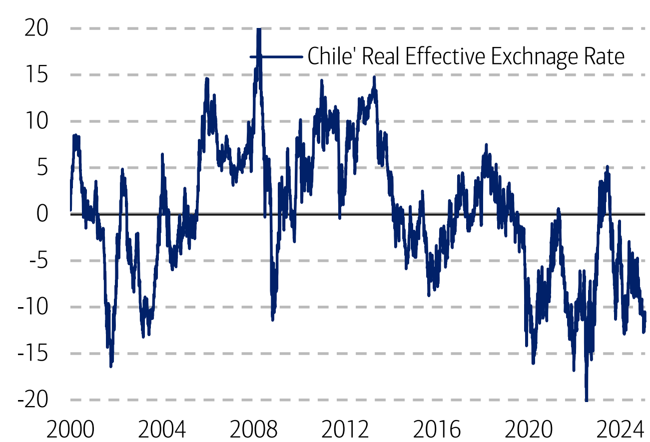
Exhibit 8: Chile's real exchange rate cheap to history
Chile's real effective exchange rate, percent deviation from long-run mean.



Source: Haver Analytics

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Equities: More AUM, uncertain allocation

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Allocation to local equities is low

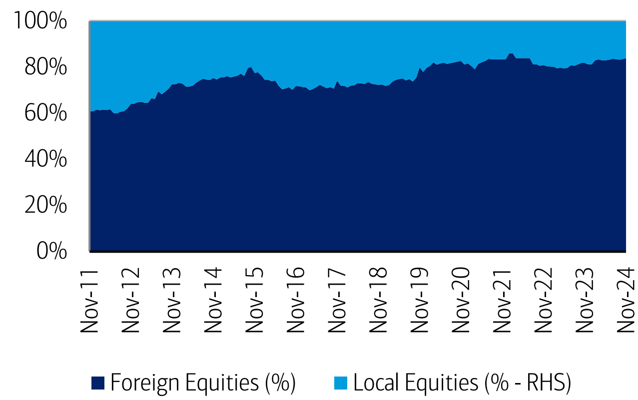
As individual capitalization starts to increase after the 4th year, we expect to see an increase in assets under management (AUM) of AFPs. However, it is uncertain if the increase in AUM will translate into inflows to local equities. Chilean pension funds allocate around half of their AUM into foreign assets (Exhibit 5). Less than 15% of their equity allocation is allocated in local equities (totaling around US$6bn – Exhibit 6)

Competition and age-dependent fund types could drive asset allocation

The reform states that fund managers will transition from current pension funds A-E to age-dependent portfolios. This could eventually translate to more AUM being allocated into more defensive asset classes. The government wants to foster competition to lower fees, which could eventually favor asset classes that require less active management.

Exhibit 1: Chile pension funds: local vs foreign equity allocation Nov-19 to Nov-24

Allocation to foreign equities (~84%) is higher than allocation to local equities



Source: SAFP Chile

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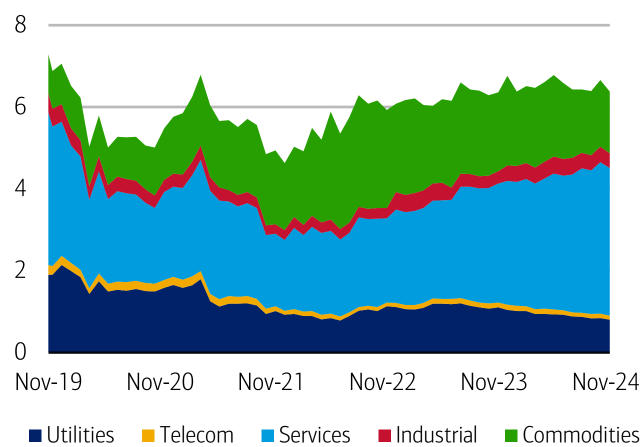
Exhibit 2: Allocation to local equities per sector (US$bn), Nov-19 to Nov-24

Allocation to Services is the largest (US$3.6bn; ~57%)



Source: SAFP Chile

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Valuation & risk

Chile (CHILE)

We are Marketweight Chile external debt. Chile trades cheap to its ratings, but we think this is justified by fiscal risks.

Upside risks: We expect Chile bonds to outperform if growth is stronger, debt rises less than expected, and copper prices rally.

Downside risks: We expect Chile bonds to underperform if the deficit and debt rise faster than expected, growth stagnates, protests resume and political risks increase.

Analyst Certification

We, Sebastian Rondeau, David Beker, Lucas Martin, CFA and Paula Andrea Soto, CFA, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers.

We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

Some of the securities discussed herein should only be considered for inclusion in accounts qualified for high risk investment.

Disclosures

Important Disclosures

Credit opinion history

Chile / CHILE

Sovereign	Date[R1]	Action	Recommendation
Chile / CHILE	31-Dec-2021		Underweight
	31-Aug-2022	Upgrade	Marketweight
	03-Nov-2023	Restricted	NA
	03-Jan-2024	Coverage Resumed	Marketweight

Table reflects credit opinion history as of previous business day's close. ^First date of recommendation within last 36 months. The investment opinion system is contained at the end of the report under the heading "BofA Global Research Credit Opinion Key."[R1]

BofA Global Research Credit Opinion Key

BofA Global Research provides recommendations on an issuer's bonds (including corporate and sovereign external debt securities), loans, capital securities, equity preferreds and CDS as described below. Convertible securities are not rated. An issuer level recommendation may also be provided for an issuer as explained below. BofA Global Research credit recommendations are assigned using a three-month time horizon.
Issuer Recommendations: If an issuer credit recommendation is provided, it is applicable to bonds and capital securities of the issuer except bonds and capital securities specifically referenced in the report with a different credit recommendation. Where there is no issuer credit recommendation, only individual bonds and capital securities with specific recommendations are covered. Loans, CDS and equity preferreds are rated separately and issuer recommendations do not apply to them.

BofA Global Research credit recommendations are assigned using a three-month time horizon:
Overweight: Spreads and /or excess returns are likely to outperform the relevant and comparable market over the next three months.
Marketweight: Spreads and/or excess returns are likely to perform in-line with the relevant and comparable market over the next three months.
Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

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Buy Protection: Buy CDS, therefore going short credit risk.
Neutral: No purchase or sale of CDS is recommended.
Sell Protection: Sell CDS, therefore going long credit risk.

Sovereign Investment Rating Distribution: Global Group (as of 31 Dec 2024)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R2]	Count	Percent
Buy	14	25.45%	Buy	7	50.00%
Hold	34	61.82%	Hold	14	41.18%
Sell	7	12.73%	Sell	2	28.57%

[R2] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only Sovereign issuer recommendations. A Sovereign issuer rated Overweight is included as a Buy, a Sovereign issuer rated Marketweight is included as a Hold, and a Sovereign issuer rated Underweight is included as a Sell.

Credit Opinion History Tables for the securities referenced in this research report are available on the Price Charts and Credit Opinion History Tables website, or call 1-800-MERRILL to have them mailed.
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