



**BANCO CENTRAL DO BRASIL**

# **Banco Central do Brasil Technical Notes**

**Number 5**

**November 2001**

**Supplementary Social Security in Brazil**  
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ISSN 1677-4205  
CGC 00.038.166/0001-05

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| Banco Central do Brasil<br>Technical Notes | Brasília | no. 5 | Nov | 2001 | P. 1 - 27 |
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# Banco Central do Brasil Technical Notes

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## Foreword

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The institutionalization of the Banco Central do Brasil Technical Notes, conducted by the Economic Department, promotes the dissemination of works featuring economic content, attracting both theoretical and methodological interest, giving a view of the short-term developments of the economy and reflecting the work of the Bank's employees in all areas of action. Besides, other works, though external to the Banco Central, may be included in this series provided the Bank has afforded institutional support to their preparation.

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# Supplementary Social Security in Brazil

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## 1. Introduction

Private or supplementary social security is optional in Brazil and is designed to supplement the benefits provided by the country's public social security systems. It has become progressively more important in Brazil and in the world at large as official systems' capacity to operate satisfactorily has declined. The public social security system is in a state of crisis that will be hard to overcome. This can partly be explained by demographic and economic factors. The aging of the population and recent trends in the expansion of the level of employment have impaired the solvency of the system, which depends on contributions from active workers to pay out benefits to those who have retired.

Supplementary social security has increasingly served to plug the widening gaps left by the basic social security system in modern societies. Besides softening the drop in the level of income when workers come to the end of their working lives, private social security institutions usually perform another vital economic function: they serve as an important mechanism for encouraging domestic savings.

The prime purpose of this paper is to describe the main features of supplementary social security in Brazil, pride of place being given to closed supplementary social security institutions, also known as pension funds, on account of their relative importance in the economy. Initially, a number of key concepts for examining social security regimes are presented. This is followed by a brief description of the public social security system in Brazil and an analysis of the current crisis in the welfare system stemming, among other factors, from changes in demographic patterns. In addition, a parallel is drawn between the evolution of such patterns in Brazil and the rest of the world. The main points of the recent, unfinished welfare reform are examined with considerations as to the impact on the Government's fiscal results. The last section of the paper deals with supplementary social security in Brazil and begins with a brief description of the open private social security sub-system. Closed private social security institutions (pension funds) are then analyzed in greater detail, special attention being paid to legislation on the investments they make owing to the weight of pension-fund assets in various markets in Brazil.

## 2. General concepts

There are two main types of welfare systems. In social security systems those participating pay to be eligible for the benefits, whereas in social assistance programs the benefits are provided without any requirement for contributions on the part of the beneficiaries. Social assistance programs can be offered to people from any income bracket

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or focus exclusively on less well-off segments of the population. Since retirement pay and pensions are basically designed to reimburse income earned at an earlier date, the social security system is exclusively for those who have been part of the workforce, whereas social assistance encompasses the entire population. However, as they too redistribute income and provide protection for retired workers, social security systems also act as social assistance programs for those no longer apt for work due to age or invalidity.

With regard to methods for financing the benefits, social security systems can operate either on a pay-as-you-go basis or on capitalization. In pay-as-you-go schemes, retired workers' benefits are paid from contributions levied from active workers, i.e., the sum total of contributions, administrative costs deducted, is shared out among the pensioners according to pre-defined criteria. In this case, there is a net transference of funds from active to retired workers. This system is based on the hypothesis that there will always be sufficient contributions from active workers to bear the cost of benefits granted to retired workers. In other words, it depends on continual expansion of the working population and of employment. Under capitalization schemes, each participant pays contributions into a fund managing resources that will later be withdrawn to pay the beneficiaries. A key aspect of this system is the existence of a direct relation between the contributions paid in and the benefits each participant receives. The original sums paid by each member will be pooled in a fund that will in the future finance their retirement pay. The public systems tend to use the pay-as-you-go method while supplementary social security institutions tend to adopt the capitalization method.

Social security plans can operate on the basis of fixed benefits or fixed contributions. In the former case, future benefits are pre-determined when the beneficiary joins the plan and are calculated on the basis of the last set of contributions or some other contractual parameter. The risk in fixed-benefit plans befalls the sponsor primarily since the value of the benefits bears no relation to the level of capitalization of the institution's assets. This may require the institution to review the percentages of contributions or to raise additional funds. In the second case, contributions are set in advance in the form of a contract, and future benefits depend on the level of capitalization. It should be remarked that the risk inherent in investments in this sort of plan lies ultimately with the participants, who may find the level of their benefits compromised should the resources invested fail to be suitably managed.

### **3. The public social security system**

The Brazilian welfare system consists of "... an integrated set of actions promoted by the authorities and society designed to ensure rights relating to health, social security and social assistance" (1988 Federal Constitution, Art. 194). It is comprised by basic social security, which is public, and by supplementary social security, which is private.

Subscription to public social security is compulsory and universal, i.e., it covers all formally registered workers in Brazil. It operates according to pay-as-you-go method. In theory, this means that disbursements are paid from the contributions levied within the same period. The National Social Security Institute (INSS) administers the system, which operates under two distinct regimes: the General Social Security Regime (RGPS) for private sector workers; and the Unified Civil Service Regime (RJU) for civil servants. Under RGPS,

benefits are based on the contributions made as from 1994 and are limited to a ceiling of R\$1,328.25 (*reais*)<sup>3</sup>. Workers who have contributed to the system for at least 35 years, in the case of men, and 30 years, in the case of women, are entitled to draw benefits. Under RJU, benefits are not subject to an upper limit and they correspond to the last salary civil servants receive before going into retirement.

As is the case in many other countries, the Brazilian social security system is in financial difficulties, mostly resulting from the demographic changes taking place in the second half of the 20<sup>th</sup> century. Advances in medicine, improvements in hygiene and broader coverage in the health services have reduced mortality rates and raised life expectancy. As can be seen from Table 1, life expectancy among Organization for Economic Cooperation & Development (OECD) countries is approaching 80 years of age and only remains below 70 in some underdeveloped regions of the world.

**Table 1 – Life expectancy at birth – 1970 to 2020 by region (in years).**

| Region                           | 1970 | 1980 | 1990 | 1995 | 2000 | 2010 | 2020 |
|----------------------------------|------|------|------|------|------|------|------|
| OECD                             | 70.9 | 73.8 | 76.0 | 77.5 | 78.4 | 79.8 | 80.7 |
| Latin America & the Caribbean    | 60.6 | 64.8 | 68.1 | 70.9 | 72.0 | 74.2 | 75.6 |
| Eastern Europe & ex-Soviet Union | 65.0 | 67.8 | 69.3 | 69.4 | 70.3 | 72.3 | 74.4 |
| Middle East & North Africa       | 52.8 | 58.5 | 64.5 | 67.6 | 68.8 | 70.4 | 72.7 |
| Asia                             | 48.8 | 53.8 | 59.2 | 59.5 | 60.7 | 63.8 | 66.9 |
| Sub-Saharan Africa               | 44.2 | 47.6 | 50.7 | 51.8 | 50.6 | 55.2 | 59.3 |

Source: World Bank (2001)

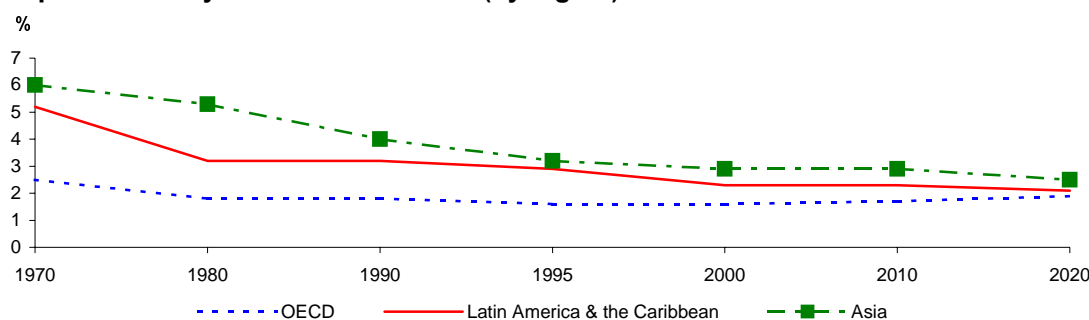
At the same time, changes in behavior and the dissemination of contraceptive methods have led to a steady decline in fertility rates. In developed countries and in Eastern Europe this reduction was already visible before 1970, but persisted in the following decades. In poorer regions of the world, fertility rates have fallen more than 50% over the last thirty years.

**Table 2 – Fertility rates – 1970 to 2020 (by region).**

| Region                           | 1970 | 1980 | 1990 | 1995 | 2000 | 2010 | 2020 |
|----------------------------------|------|------|------|------|------|------|------|
| OECD                             | 2.5  | 1.8  | 1.8  | 1.6  | 1.6  | 1.7  | 1.9  |
| Latin America & the Caribbean    | 5.2  | 4.1  | 3.2  | 2.9  | 2.3  | 2.2  | 2.1  |
| Eastern Europe & ex-Soviet Union | 2.6  | 2.5  | 2.3  | 1.6  | 1.6  | 1.7  | 2.0  |
| Middle East & North Africa       | 6.8  | 6.1  | 4.9  | 4.0  | 3.2  | 2.6  | 2.3  |
| Asia                             | 6.0  | 5.3  | 4.0  | 3.2  | 2.9  | 2.7  | 2.5  |
| Sub-Saharan Africa               | 6.6  | 6.6  | 6.0  | 5.5  | 5.1  | 4.1  | 3.2  |

Source: World Bank (2001)

**Graph 1 – Fertility rates – 1970 to 2020 (by region).**



Source: World Bank

3/ Sum extant in July 2001.



The combination of an increase in life expectancy and a decline in fertility rates has produced an aging of the population, which has in turn put increasing pressure on public social security systems around the world. In the year 2000, people over the age of 60 already accounted for more than 20% of the population in some developed countries and this figure may reach as high as 30% in the next few decades (Table 3).

**Table 3 – Proportion of the population over 60 years of age in selected countries – 1995 to 2020 (%).**

| Country        | 1995 | 2000 | 2010 | 2020 |
|----------------|------|------|------|------|
| Germany        | 20.6 | 22.7 | 25.1 | 29.6 |
| France         | 20.2 | 20.4 | 22.5 | 26.5 |
| Japan          | 20.5 | 23.1 | 29.8 | 32.9 |
| United Kingdom | 20.7 | 20.8 | 23.3 | 26.4 |
| Sweden         | 21.9 | 22.1 | 25.9 | 29.0 |
| United States  | 16.4 | 16.3 | 18.8 | 24.1 |
| Argentina      | 13.2 | 13.3 | 14.1 | 16.0 |
| Brazil         | 7.1  | 7.6  | 9.0  | 12.1 |

Source: World Bank (2001)

The World Bank data displayed in Table 4 below shows the decline in the relation between working-age population (20 to 59 years old) and the population over 60 years of age. According to Singer (1996: 53), in 1996 each old-aged pensioner in the United States was supported by 4.5 workers paying in social security contributions. This ratio will fall to 2.1 following the projection for 2020.

**Table 4 – Ratio between working population (20 to 59-year-olds) and population over 60 years of age in selected countries – 1995 to 2020.**

| Country        | 1995 | 2000 | 2010 | 2020 |
|----------------|------|------|------|------|
| Germany        | 2.8  | 2.5  | 2.3  | 1.8  |
| France         | 2.7  | 2.7  | 2.4  | 1.9  |
| Japan          | 2.8  | 2.4  | 1.7  | 1.5  |
| United Kingdom | 2.6  | 2.6  | 2.3  | 2.0  |
| Sweden         | 2.4  | 2.4  | 2.0  | 1.7  |
| United States  | 3.4  | 3.4  | 2.9  | 2.1  |
| Argentina      | 3.7  | 3.8  | 3.8  | 3.4  |
| Brazil         | 7.1  | 7.0  | 6.3  | 4.7  |

Source: World Bank (2001)

The crisis in the Brazilian social security system has specific causes. The broadening of the system's coverage, especially during the military regime (1964 to 1985) institutionalized a complete dissociation of contributions and benefits. Workers became eligible for benefits after a certain number of years in employment, whether or not they had paid social security contributions throughout their working lives. In the public sector, the RJU, which became effective in 1991, granted civil servants previously subject to the ceiling for INSS benefits the same rights as all other civil servants.

Until the mid-nineties, the Brazilian Social Security system ran a surplus. Nevertheless, the credit balance shrank from 1.7% of GDP in 1990 to 0.3% of GDP in

1992. Worse still, as from 1995, the contributions levied failed to cover outlay. The public social security system became a fiscal burden for the government, with deficits climbing to 1% of GDP in 1999.

**Table 5 – Net revenue, outlay on benefits and INSS balance for RGPS: 1990 to 2000.**

| Period | Net revenue   |       | Outlay on benefits |       | Balance for RGPS |       |
|--------|---------------|-------|--------------------|-------|------------------|-------|
|        | R\$ millions* | GDP % | R\$ millions*      | GDP % | R\$ millions*    | GDP % |
| 1990   | 35 956        | 5.1   | 22 280             | 3.4   | 13 676           | 1.7   |
| 1991   | 32 322        | 4.5   | 23 362             | 3.5   | 8 960            | 1.0   |
| 1992   | 31 886        | 4.6   | 25 429             | 4.3   | 6 457            | 0.3   |
| 1993   | 36 234        | 5.4   | 34 212             | 5.0   | 2 023            | 0.4   |
| 1994   | 38 668        | 5.0   | 37 745             | 4.9   | 924              | 0.1   |
| 1995   | 46 450        | 5.0   | 46 820             | 5.0   | - 371            | -0.1  |
| 1996   | 50 636        | 5.2   | 50 959             | 5.2   | - 323            | 0.0   |
| 1997   | 52 377        | 5.1   | 56 017             | 5.5   | -3 640           | -0.4  |
| 1998   | 53 349        | 5.2   | 61 472             | 6.0   | -8 123           | -0.8  |
| 1999   | 53 474        | 5.1   | 63 691             | 6.1   | -10 128          | -1.0  |
| 2000   | 57 128        | 5.2   | 67 412             | 6.1   | -10 283          | -0.9  |

Source: Social Security Secretariat/Ministry of Welfare & Social Security (MPAS)

\* At constant values for December 2000.

The civil service social security regime has been notching up even greater deficits. In 2000, for instance, expenditures on this segment were 7.5 times net revenues whereas among private sector workers the ratio was less than 1.2 (Ministry of Welfare & Social Security).

**Table 6 – Net revenues, outlays on benefits and balance for civil service social security system in 2000.**

| Item                    | R\$ billions (Reals) | % of GDP |
|-------------------------|----------------------|----------|
| Net revenue             | 6.9                  | 0.6      |
| Outlay on benefits      | 52.0                 | 4.8      |
| Social security balance | -45.2                | -4.1     |

Source: Social Security Secretariat/Ministry of Welfare & Social Security (MPAS)

The failure to balance the accounts in the public sector social security system becomes more evident when the ratio between the number of beneficiaries and the volume of expenditure is compared with that prevalent in the General Social Security Regime. Though they represent just 11% of the beneficiaries of the entire public social security system, civil servants are the recipients of 41% of the outlays on benefits.

**Table 7 – Beneficiaries of the public social security system in 2000.**

| Item          | Number of beneficiaries | %     |
|---------------|-------------------------|-------|
| RGPS          | 19 573                  | 88.7  |
| Civil service | 2 501                   | 11.3  |
| Total         | 22 074                  | 100.0 |

Source: Social Security Secretariat/Ministry of Welfare & Social Security (MPAS)

In view of this state of affairs, as has been the case in other countries in recent decades, a decision was taken to reform the social security system so as to guarantee its accounts would be sound and make the system sustainable without needing to rely on bail-outs from the Government. An integral part of the strategy proposed at the time was to encourage private social security institutions that would serve to supplement public social security and generate domestic savings.

A review of the social security system was implemented by Constitutional Amendment 20 (December 15, 1998). The most important change was the replacement of the concept of years of employment by years of contribution as the prime requirement for retirement. Under the RGPS regime, the minimum length of contribution was raised to 35 years for men and 30 years for women, providing they had reached the ages of 65 and 60, respectively. Retirement on proportional pay was abolished for workers entering the system subsequent to the reform. For those already contributing to the system prior to the change in the law, transition rules were established, setting a minimum retirement age of 53 for men and 48 for women.

Another significant modification was the introduction of a social security factor in 1999. The measure was designed to restrict the system's outlay on the payment of benefits and, at the same time, to establish incentives for workers to postpone their retirement and thus extend the period in which they made contributions. This explains why the reference wage used for calculating benefits – previously equivalent to the average wage for the last three years before retirement – was made to correspond to an 80% average of the highest contribution wage as from 1994. This reference wage is multiplied by a coefficient (the social security factor) calculated on the basis of the length of time during which social security contributions have been made and of the worker's age. This factor is less than one among early-retiring workers and over one for workers continuing to work beyond the minimum age and length of contribution. It should be stressed that the social security factor will be one or over for workers joining the system after the reform since they have forfeited the option of retirement on proportional pay. So, under the current rules, the social security factor will only be employed to determine an increase in retirement benefit for workers extending their working lives. Another important feature to observe is that the beginning of the period in which the reference wage will be calculated was set in 1994. As time passes, this period will be extended to cover workers' entire working lives.

A threshold for civil service retirement was set at 60 years of age for men and 55 for women, in addition to the requirement of 35 years of contribution (30 for women) with the provision that at least ten years refer to employment in the civil service. Workers already employed under the old system will be subject to transition rules analogous to those adopted for private sectors workers, a minimum retirement age of 53 for men and 48 for women being established. Retirement benefits can no longer be in excess of civil servants' pay for the post from which they have retired, and those entering the civil service are not entitled to accumulate two civil service pensions or a civil service pension and another public sector job.

The specific social security regimes for civil servants and military personnel employed by federal, state or municipal institutions must now comply with the provisions of the General Public Social Security Law (Law 9,717 of November 27, 1998), which determines that these regimes must be organized in such a way that financial and actuarial balance be secured. Directly levied revenues for public social security systems must be

greater than revenue derived from constitutional transfers from the Union and the States. The difference between outlays on benefits and revenues from social security contributions may not exceed 12% of current net revenue<sup>4</sup> in each financial year. Moreover, the federal and state administrations are not authorized to make contributions more than twice the contribution withheld at source from employees.

Other less far-reaching measures have been introduced and have enabled the system to obtain short-term gains. Provisional Act 1,586 (September 11, 1997), for instance, determines that companies hiring workers by outsourcing must withhold at source (subrogate) 11% of the sum total for the services contracted. This means that the contracting company levies the social security contributions that would otherwise fall to the firm supplying the service. The result is the prevention tax evasion on the part of sub-contracted firms, often facilitated by the fact that they hire workers without a formal labor contract. Law 9,703 (November 1998) establishes that labor tribunals are “...legally empowered to levy social contributions resulting from the sentences they proffer or the agreements they confirm” (Ministério da Previdência e Assistência Social, 2000c). The aim of this measure is to prevent the evasion that previously occurred in agreements confirmed by Labor Tribunals. Workers hired without formal labor contracts filed suits in the Labor Tribunals upon dismissal and often entered into an agreement with their employers, who paid the labor dues, but failed to make the appropriate social security contributions. Another precautionary measure introduced to avoid abuse was the requirement for corporate entities filing suits against the social security system to deposit under custody of the court 30% of the value of the suit.

As a result of these alterations, revenues from social security contributions in 2000 were up 6.8% in real terms on 1999 figures and 7.1% in comparison with revenues in 1998. Deposits in court, sums withheld at source (subrogation), the regularization of municipal debts and the levying of contributions by the Labor Tribunals were the source of R\$2.9 billions in additional revenue in 2000. Meanwhile, changes in the eligibility conditions for retirement on proportional pay increased the average retirement age from 48.9 years in 1998 to 54.5 years in the year 2000 (Ministério da Previdência e Assistência Social, 2000c). This meant a substantial reduction in the granting of retirement pensions based on length of employment, as displayed in Table 8. It should, nonetheless, be stressed that the progress made was insufficient to prevent the social security system from continuing to run a deficit, the debt balance of its accounts in 2000 standing at R\$10.3 billions.

**Table 8 – Retirement pensions based on length of employment granted by the social security system: 1995 to 2001.**

| Year                    | Retirement pensions based on length of employment<br>(monthly average) |
|-------------------------|--|
| 1995                    | 27 429   |
| 1996                    | 26 687   |
| 1997                    | 34 785   |
| 1998                    | 24 821   |
| 1999                    | 12 012   |
| 2000                    | 9 557  |
| 2001 (1st two quarters) | 10 366   |

Source: Social Security Secretariat/Ministry of Welfare & Social Security (MPAS)

4/ The sum of revenue from taxation, property, industrial, agricultural and service contributions, current transfers and other current revenues (Ministério da Previdência e Assistência Social, 2000b).

## 4. Supplementary private social security

Supplementary social security comprises two schemes provided by open supplementary social security institutions (EAPCs) and closed supplementary social security institutions (EFPCs). In Brazil, the latter are considerably more important, both in terms of the number of associates and in terms of the volume of their assets. The relatively small scale of the open segment is due to Brazil's scant tradition in private social security as a voluntary savings option. Meanwhile, closed institutions, especially those run by state-owned or joint stock corporations, have always attracted great interest. Among other factors, this is due to the hefty contributions paid in by the sponsoring corporation, to the possibility of access to mortgage loans, and to the firm guarantee of supplementary income upon retirement.

### 4.1 – Open supplementary social security institutions

Open supplementary social security institutions operate as administrators of personal savings accounts, private individuals being eligible to join such schemes on a voluntary basis, in contrast with pension funds, which are restricted to the employees of the sponsoring corporation. The system of fixed contributions prevails in open schemes and the institutions running such schemes are entitled to obtain profits from their operations, the one restriction being that "... they may not distribute profits or any other corresponding funds to surplus asset reserves if such distribution may impair compulsory investments in capital and reserve, pursuant to the criteria established in this Law" (Law 6,435/1997, Art. 18). The participants in the scheme are entitled to a residual share of total profits, remunerated at actuarial interest rates and incorporated into the fund.

Open supplementary social security institutions are established by profit or non-profit, non-trading corporations and insurance companies. The latter have the lion's share of the market: 81.5% in 2000, as shown in Table 9. The institutions establishing these funds may operate them themselves or delegate management to financial institutions accredited to the Brazilian Central Bank.

**Table 9 – Market share of different types of supplementary social security institutions in December 2000.**

| Institutions                    | % Share |
|---------------------------------|---------|
| Profit-making open institutions | 11.9    |
| Non-profit open institutions    | 6.6     |
| Insurance companies             | 81.5    |

Source: Susep (Internet)

According to the National Private Social Security Association (ANAPP), the most common type of scheme at the moment is what is called the General Unrestricted Benefits Plan (PGBL) regulated by CNSP Resolution 006 of November 1997. Under this scheme, investors can decide on the make-up of investments in the fund established to finance their individual benefits and opt to pay monthly, two-monthly, half-yearly or annual contributions. The benefits can take the form of life-long or temporary income, it also being possible to withdraw the entire balance of the capital accumulated on a given date. The benefit to be received is calculated at the end of the contribution period. This is based on

the balance of the mathematical reserve of benefits to grant<sup>5</sup> the participant has accumulated (item 24 of the Regulation attached to CNSP Resolution 25/1994 and Art. 16, § 1, and Art. 1 of the Regulation attached to CNSP Resolution 6/1997).

In 2000, the total sum of the assets invested in open institutions stood at R\$17 billions, equivalent to 12.2% of the assets managed by pension funds. The substantial growth observed in recent years is the result of monetary stabilization in the wake of the *Real Plan* and also to the fact that, since 1996, the full amount of contributions paid into private social security schemes – limited to 12% of an individual's gross income declared to the Federal Revenue Service – is tax deductible (ANAPP, internet).

The Private Insurance Superintendence Department (Susep) is responsible for regulating and inspecting the institutions operating open supplementary social security schemes in Brazil. The investment funds instituted by the schemes they operate and the financial institutions managing them are overseen by the Brazilian Central Bank.

Assets securing the reserves are held in custody and cannot be disposed of or encumbered without prior authorization from the authorities. Alterations to the schemes' tables and provisions can only be made with the consent of the regulatory bodies, commercial or financial transactions with the managers, their families or firms being expressly forbidden.

Investments made by open supplementary social security institutions are regulated by National Monetary Council (CMN), Resolution 2,286 of June 1996, subsequently altered by Resolution 2,639 of August 1999. These rulings decree that the funds guaranteeing the uncommitted technical reserves<sup>6</sup> of these institutions can be invested as follows:

- up to 100% in securities issued by the National Treasury or the Brazilian Central Bank;
- up to 80% in fixed income instruments: state or municipal public bonds, time deposits, savings accounts, investment funds, gold, foreign investment funds, public issue debentures, bills of exchange, mortgage bills and privatization certificates, among others;

**Table 10 – Income and investment portfolios of open private social security institutions in Brazil: 1994 to 2000.**

| R\$ millions |        |               |                       |               |
|--------------|--------|---------------|-----------------------|---------------|
| Year         | Income | Variation (%) | Investment portfolios | Variation (%) |
| 1994         | 546    | 93.6          | 2 084                 | 34.4          |
| 1995         | 1 050  | 92.3          | 3 539                 | 69.8          |
| 1996         | 1 397  | 33.1          | 4 637                 | 31.0          |
| 1997         | 2 163  | 54.8          | 6 254                 | 34.9          |
| 1998         | 3 185  | 47.2          | 8 376                 | 33.9          |
| 1999         | 3 803  | 19.4          | 12 726                | 51.9          |
| 2000         | 5 326  | 40.3          | 17 142                | 34.7          |

Source: ANAPP

5/ "Current value of the institution's commitment to the active participants in the scheme, minus the current value of the contributions due to the institution from these participants" (Ministério da Previdência e Assistência Social, 2001a: 16).

6/ Reserves associated with scheduled disbursements falling due in over 360 days (CMN Resolution 460, February 1978).

- up to 50% in variable income investments: stocks or quotas in mutual share investment funds<sup>7</sup>;
- up to 30% in urban properties or in real estate investment fund quotas;
- up to 10% in loans granted to participants.

The committed portion<sup>8</sup> of the funds guaranteeing the scheme's reserves can be invested in compliance with the following limits:

- up to 100% in securities issued by the National Treasury or the Brazilian Central Bank;
- up to 60% in fixed income instruments: time deposits, savings accounts, bills of exchange, mortgage bills, investment funds, gold and foreign investment funds;
- up to 50% in variable income investments.

Investments in derivatives are permitted under the terms specified by Susep<sup>9</sup>. There are restrictions on investment in securities, stocks and shares, debentures or investment funds offered by a single financial institution, corporation or state administration. Investments are prohibited in associate companies or companies in which the managers or their relatives up to twice removed have more than a 10% share. Open supplementary social security institutions may not operate as financial institutions granting natural persons or corporate bodies loans or advances, save in the exceptional circumstances provided for in the regulation. Funds may not be invested abroad except through foreign investment funds.

## 4.2 – Closed supplementary social security institutions

Closed supplementary social security institutions, also known as pension funds, are non-profit organizations in which only the employees of a corporation or group of companies, referred to as the sponsors, can participate. Thus, there is a legal requirement for a bond of employment and the payment of contributions by the sponsoring company, under the terms established in the contract for each pension fund. These organizations receive contributions from both the company and its employees, investing them so as to guarantee participants payment of benefits that supplement those provided by the public social security system. In this segment, the fixed benefit system predominates, though there is a trend now to switch to fixed contribution schemes, especially among pension funds sponsored by private-sector corporations. Closed social security organizations are regulated and inspected by the Ministry of Welfare & Social Security's Supplementary Social Security Secretariat (SPC/MPAS).

7/ In the case of variable contribution schemes, investment in fixed income bills is limited to 49% of the fund's total investments (Resolution 2,460/1997, Art. 4, subsection 1).

8/ Reserves associated with scheduled disbursements falling due in less than 360 days (CMN Resolution 460, February 1978).

9/ "... operations can be contracted exclusively by means of public auctions, or electronic systems providing the same competitive conditions as public auctions, in markets administered by stock exchanges or commodities and futures exchanges; the contracting of over-the-counter operations, even when in systems administered by stock exchanges or commodities and futures exchanges, must comply with regulations to be instituted by joint decision of the Brazilian Central Bank, Susep and the Securities & Exchange Commission (CVM); such operations must be associated with authenticated contracts in assets that can be incorporated into the exclusive financial investment fund and with indices representative of such assets and the respective rates of remuneration; the sum of the values corresponding to the guarantee margins plus the sum total of premiums on purchase option transactions may not exceed 5% of the exclusive financial investment fund's net assets, the sums corresponding to margins in transactions relating to future sales of purchase options and the sale of sales options being limited to 1%; the contracting of fund-raising operations being prohibited" (CMN Resolution 2,460/1997, Art. 4, subsection II).

Pension funds comprise an endogenous domestic savings system administering long-term savings. Development of this sector may help expand the rate of domestic savings in the country, a crucial factor for promoting sustained economic growth. As it is the case with institutional investors in other countries, pension funds have become increasingly important in the Brazilian economy, largely as a result of the substantial increase in the assets they manage. Their resources grew rapidly as a proportion of GDP in the nineties, attaining the impressive sum of R\$151.5 billions in April 2001, equivalent to 13.9% of GDP<sup>10</sup> (Ministry of Welfare & Social Security, internet). In April 2001, there were 361 closed supplementary social security organizations (EFPC) in Brazil serving 2.3 millions associates, 1.7 million of whom were in active service and 539 thousand in retirement.

**Table 11 – Pension fund assets: 1990 to 2000.**

| Year         | Pension fund assets<br>(R\$ billions) | Assets/GDP<br>(%) |
|--------------|---------------------------------------|-------------------|
| 1990         | 26.3                                  | 3.3               |
| 1991         | 36.8                                  | 4.6               |
| 1992         | 43.3                                  | 5.5               |
| 1993         | 60.0                                  | 7.2               |
| 1994         | 72.7                                  | 8.3               |
| 1995         | 74.8                                  | 8.2               |
| 1996         | 86.6                                  | 9.2               |
| 1997         | 101.0                                 | 10.3              |
| 1998         | 101.1                                 | 10.3              |
| 1999         | 126.0                                 | 12.5              |
| 2000         | 144.0                                 | 13.2              |
| 2001 (April) | 151.5                                 | 13,9*             |

Source: Brazilian Association of Closed Private Social Security Organizations (ABRAPP)

\* Based on GDP figures for December 2000.

The major funds for state-owned corporations have traditionally been run by their own staff, but in recent years there has been a trend to outsource fund management services. This may take the shape of direct transference of the resources to be managed, investment in exclusive funds or joint management. This set-up was begun by the pension

**Table 12 – Quantity of closed supplementary social security organizations (EFPC) and type of management in April 2001.**

| Sector    | Quantity |          | Type of management |           |       |         |
|-----------|----------|----------|--------------------|-----------|-------|---------|
|           | EFPCs    | Sponsors | Outsourced         | Own staff | Joint | No data |
| Total     | 361      | 2 356    | 178                | 97        | 83    | 3       |
| Public    | 87       | 293      | 4                  | 52        | 31    | 0       |
| Federal   | 42       | 134      | 2                  | 29        | 11    | 0       |
| State     | 43       | 153      | 2                  | 23        | 18    | 0       |
| Municipal | 2        | 6        | 0                  | 0         | 2     | 0       |
| Private   | 274      | 2 063    | 174                | 45        | 52    | 3       |
| Brazilian | 169      | 1 480    | 83                 | 40        | 44    | 2       |
| Foreign   | 105      | 583      | 91                 | 5         | 8     | 1       |

Source: SPC/MPAS

10/ Using GDP figures for December 2000.



funds sponsored by multinational corporations, based on the model adopted in the country where the companies' headquarters are located. Many smaller companies that are hard pressed to bear the costs of employing their own management team have followed suit. In April 2001, approximately 50% of the pension funds in Brazil were outsourcing their management services while 23% operated joint management schemes.

As pension funds are long-term investors managing third-party assets, the rule of thumb governing their investment policies is the minimization of risk. Table 13 displays the distribution of these investments and the way they have evolved since 1994. A substantial increase in the share of fixed income investments can be noted in addition to a relative decline in the importance of investments in real estate and property development. These changes reflect the development of the economic and financial scenario in Brazil and also the legislation governing such investments.

**Table 13 – Distribution of assets invested by closed supplementary social security organizations: 1994 to 2001 (%).**

| Investments                | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001* |
|----------------------------|------|------|------|------|------|------|------|-------|
| Stocks & shares            | 39.1 | 29.5 | 30.9 | 28.5 | 19.2 | 26.3 | 23.6 | 23.4  |
| Real estate                | 14.4 | 14.9 | 12.9 | 10.4 | 10.7 | 8.8  | 8.0  | 7.6   |
| Time deposits              | 11.5 | 14.6 | 9.6  | 7.6  | 9.7  | 4.6  | 3.2  | 3.0   |
| Funds – fixed income       | 12.4 | 11.9 | 16.8 | 19.3 | 22.8 | 31.6 | 36.7 | 37.1  |
| Funds – variable income    | n.d. | n.d. | 2.6  | 10.7 | 10.2 | 12.2 | 11.4 | 12.4  |
| Loans to participants      | 1.9  | 1.9  | 2.2  | 1.9  | 1.9  | 1.6  | 1.8  | 1.8   |
| Property development       | 4.6  | 5.8  | 5.1  | 4.5  | 4.4  | 3.4  | 2.9  | 2.8   |
| Debentures                 | 1.9  | 5.2  | 4.8  | 3.9  | 3.6  | 2.5  | 2.0  | 1.9   |
| Government securities      | 3.8  | 4.4  | 5.7  | 3.7  | 6.5  | 6.3  | 6.6  | 6.7   |
| Others                     | 2.6  | 2.5  | 2.4  | 2.2  | 2.6  | 2.6  | 3.6  | 3.1   |
| Transactions with sponsors | 7.8  | 9.4  | 6.9  | 7.4  | 8.4  | 0.1  | 0.2  | 0.1   |

Source: ABRAPP

\* Figures for April

n.d.: no data available

Pension funds were initially subject to requirements for minimum investment limits in particular types of assets, which effectively made these investments compulsory. Resolution 460 (1978), subsequently consolidated in CMN Resolution 1,362 (1987), set minimum percentage allocations for different types of investment, the majority of which pension funds had rarely invested in until then. As a result, the funds were obliged to diversify their portfolios. Concern regarding excessive concentration of pension fund portfolios is, indeed, perceptible in this legislation.

In addition, Resolution 460 set limits for transactions with the sponsoring corporations to prevent them subordinating the pension funds to their own interests. The regulation likewise forbid supplementary social security organizations to acquire a controlling share of any company, besides restricting pension funds' operations to Brazilian territory and determining that at least 75% of their portfolios be comprised by bonds issued by Brazilian businesses.

The process of diversifying pension fund portfolios was assisted by the timely development of the Brazilian and international financial markets. The supplementary social security organizations were thus faced with new financial instruments, some of which were

capable of exposing them to high levels of risk. To offset such risks the authorities issued CMN Resolution 2,109 in 1994, capping rather than setting minimum limits for investments and introducing restrictions on the investment of funds in the derivatives market.

CMN Resolution 2,206 (1995) introduced further restrictions on leveraging investments by means of derivatives. This new norm put a cap on the proportion of total assets in a fund that could be invested without capital cover in such markets, the aim being to encourage pension funds to operate in the derivatives markets as hedgers and not as speculators. For pension funds to qualify to participate in the National Privatization Program (PND) they were required to make stock market investments exclusively in companies with publicly-held capital stock. This mechanism secured intense participation of the more strongly capitalized pension funds in PND.

Pension fund investments overseas were authorized by Resolution 2,109 (1994), which allowed them to make investments in the economies of other Mercosul member-states. Investments in foreign investment funds were also permitted by Resolution 2,114 also issued in 1994.

CMN Resolution 2,324 (1996) made alterations to the limits for pension fund investments. These included:

- a reduction in the cap on personal loans to participants from 7% to 3% of total assets;
- a reduction in the cap on property development loans to participants from 10% to 7% of total assets;
- a reduction in the cap on investments in real estate from 20% to 15% of total assets;
- a reduction in the cap on the purchase of land from 5% to 2% of total assets;
- a reduction in the cap on investments in shares of a single company from 25% to 20% of the company's share capital;
- a reduction in the cap on investments in shares of mutual funds for investment in fledgling businesses from 50% to 5%, total investments in such funds being limited to 20% of the investment fund's net assets;
- a reduction in the cap on investments in property development funds from 50% to 10%, the total sum being limited to 20% of the investment fund's net assets;
- a reduction in the cap on loans to the sponsoring companies from 30% to 10% of total assets;
- investments in stocks and bonuses for the subscription of shares in a single company limited to 5% of the fund's resources and no more than 20% of that company's voting capital or total stock;
- investments in shares of a single property development fund or mutual fund for investment in fledgling businesses limited to 20% of the fund's net assets.

Resolution 2,720 (April 24, 2000) made yet further restrictions on real estate transactions and transactions between the funds and their sponsoring companies besides upholding the demand for yield on investments. Precautions regarding exposure to risk remained high on the agenda, visible both in the specification of prudent caps on the holding of assets and in the express contemplation of derivatives being used to hedge against risk in other investments. One innovation was the introduction of the special segment comprising

investments in energy and sanitation infrastructure projects and in shares or debentures of companies with publicly held stock being restructured.

Resolution 2,720 was suspended by Resolutions 2,791 of November 2000 and 2,810 of December the same year “... until studies for the review of the provisions in the said Resolution be concluded...” (Resolution 2,791/2000, Art. 1), at which point Resolution 2,324 (1996) would once again become effective.

New regulations for pension fund investments were established by Resolution 2,829<sup>11</sup>, issued in March 2001, which classified these investments in four different segments: fixed income, variable income, real estate, and funding and loans. Each was to be administered independently as if it were a distinct investment fund. The guidelines set forth here confirm the trends set in previous resolutions, including: the stipulation of prudential limits for the different investment segments; restrictions on transactions with the sponsoring company and with real estate, including a gradual reduction in property investments and elimination, by the year 2005, of investments in land; the requirement of minimum yields in the real estate and funding & loans segments. The most remarkable novelty was the encouragement of investment in the stock of corporations complying with the requirements of corporate governance, reflected in the setting of a higher ceiling for investments in such companies. It was likewise required that closed supplementary social security organizations hire independent auditing services and a custodian agent entrusted with the task of controlling and transacting bonds and securities, settling financial transactions and handling the documentation and information relating to fixed and variable income investments. The administrators of pension funds were to be held responsible “... for act or omission, for damage and loss caused to the closed private social security organization, including that ensuing from non-observance of the policy established for investing funds or from the use of inconsistent risk assessment criteria” (Resolution 2,829, Art. 54, §1).

Decree 3,721 of January 2001 altered the minimum age for granting payment of pension fund retirement benefits. The minimum age of 55 is to be extended by 6 months every year until it attains 60 years of age in 2010. In the case of other schemes, the minimum age is to be raised at the same pace until it attains the age of 65 in the year 2020. According to the Supplementary Social Security Secretariat, in January 2001 no less than 51.7% of closed supplementary social security institutions already adopted a minimum retirement age equivalent to or over 60. Of these, 86.4% were plans operated by foreign sponsoring firms while 52.4% were plans with Brazilian private sector sponsoring firms and a mere 5.1% belonged to federal public enterprises (Ministério da Previdência e Assistência Social, 2000a, pp.5-6).

On May 30, 2001, Laws 108 and 109 on supplementary social security institutions in Brazil were sanctioned.

Law 108 regulates relations between public-sector pension funds and their sponsoring companies, establishing parity in the payment of contributions by the sponsoring companies and the participants, the aim being to prevent sponsors from controlling the funds. It also sets a quarantine period for administrators when they relinquish their posts in the fund.

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11/ See Annex 1 (p. 24) of the current Technical Note.

Law 109, meanwhile, sets out general norms for the operation of closed supplementary social security organizations. One of the prime novelties here is the establishment of norms on differential proportional benefits (vesting) and portability. Differential proportional benefits refer to the vested rights of participants whose labor bond with the sponsoring company is severed before they have acquired the right to the full benefits afforded by the scheme to enjoy a retirement benefit proportional to the length of their contributions to the plan (Law 109, Art. 13). Portability, on the other hand, refers to the possibility of participants transferring the reserves constituted in their name by the participants themselves and by their employers in the sponsoring company to another open or closed<sup>12</sup> supplementary social security organization.

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12/ In transferring funds to an open private social security organization, the participant is obliged to contract a life-long monthly income or a fixed-period plan, which must extend for at least 15 years and for as long as the period during which the reserve in the original fund was constituted (Law 109, Art. 15, § 1, subsection b IV).

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- ANAPP [National Private Social Security Association] ([www.anapp.com.br](http://www.anapp.com.br))
- World Bank ([www.worldbank.org](http://www.worldbank.org))
- Brazilian Ministry of Welfare & Social Security ([www.mpas.gov.br](http://www.mpas.gov.br))
- Susep [Private Insurance Superintendency Department] ([www.susep.gov.br](http://www.susep.gov.br))

## Annex 1

### **Regulation of pension fund investments pursuant to the terms of Resolution 2,829 of March 2001**

This Resolution establishes four segments for investments by closed supplementary social security organizations:

- fixed income;
- variable income;
- real estate;
- funding and loans.

The fixed income segment is divided into two separate portfolios, one with low-risk credit and the other with medium and high-risk credit. The former comprises investments in:

- federal, state or municipal securities, providing they are classified as low risk<sup>13</sup> or have been refinanced by the Treasury; can comprise up to 100% of fixed income investments;
- fixed income bills or securities issued by or with co-liability of financial institutions deemed to be low risk, limited to 80% of fixed income investments;
- savings account deposits held by low risk financial institutions, up to 80% of fixed income investments;
- debentures and other fixed income securities issued by low risk business corporations, limited to 80% of fixed income investments;
- quotas in overseas investment funds, limited to 10% of fixed income investments.

The medium and high-risk fixed income portfolio is comprised by investments in other corporations or institutions not classified as low risk. The cap on investments in the medium and high-risk credit segment is 30% for fixed contribution schemes and 20% for other schemes. Not including federal securities and credits securitized by the Treasury, these investments are limited to 20% of all the bonds and securities issued by a single institution. Should this be a financial institution, the cap is 25% of net assets in the low-risk segment or 15% of net assets in the medium and high-risk segment.

Investments in the variable income segment are limited to 60% of total investments in the case of fixed contribution schemes and 45% for other schemes. Four capping levels have been set for investments in stocks and shares depending on the extent to which corporations adhere to standards of good business governance. The highest caps apply to shares negotiated in the special segment, along the lines of the Bovespa New Market. The two intermediate levels apply to shares of companies ranking, respectively, at Bovespa Level 2 and Level 1. The lowest cap applies to shares for all other business

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13/ On the basis of classification by risk classification agencies operating in Brazil. The ceiling for investment in such bills is 80% of funds invested in the fixed income segment.

corporations<sup>14</sup>. For quotas in investment funds there is a requirement that the portfolio shares be issued by companies ranking in one of the three levels of good business governance mentioned above. Investments in shares of a single company cannot exceed 20% of the company's voting or total stock.

Variable income investments are divided into the following portfolios:

- market shares traded on the stock exchange or on the over-the-counter market organized and accredited by the Securities & Exchange Commission (CVM) or purchased by subscription. The cap on such investments ranges from 30% to 60% depending on the good business governance ranking of the company issuing the shares and on the type of plan;
- quota shares in investment funds, limited to 20% in the case of fixed contribution schemes and to 10% in the remainder. The quota may not exceed 25% of the fund's net assets<sup>15</sup>;
- other variable-income assets. These include Brazilian Depository Receipts (BDRs), shares in companies based in the Southern Cone Common Market (Mercosul), gold bullion certificates and debentures with profit sharing that are not primarily derived from financial investments. Investment in this category is limited to 3% of total variable income investments.

Transactions with fixed and variable income derivatives traded on the stock exchange are countenanced in the “guaranteed” category. Sales transactions for purchase options with no cover, on the other hand, are expressly forbidden.

Investments in the real estate segment must comply with the following decreasing caps: 16% in 2001 and 2002 to 8% as from 2009. Net yield from the letting of properties may not be less than 70% of the average rate of return on EFPC investments in this segment. Pension funds will not be authorized to hold investments in land as from 2005, their investments in this segment being capped at 2% of total assets in 2001 and 2002. Properties purchased or sold must be conveyanced in advance and at least every three years, in compliance with the criteria specified by the Supplementary Social Security Secretariat. Investment in real estate is divided into the following portfolios:

- development. Investment in property development for future sale, limited to 25% of the development;
- rent and income. Decreasing caps: 70% of investments in the segment in 2001 and 2002 and 50% as from 2005;
- real estate funds. Investment must not exceed 25% of each fund's net assets;
- other property investments, comprising investments in property for own use received as payment or settlement of debts, land and other property not classified under the previous headings. Investment in a single property may not exceed 4% of the pension fund's resources.

In the funding and loans segment investments may not yield less than the variation of the National Consumer Price Index (INPC) in the case of fixed contribution schemes or the minimum yield established in the respective actuary plans in the case of other schemes.

<sup>14/</sup> The required standards of good business governance are described in detail in Annexes I and II of Resolution 2,829.

<sup>15/</sup> Or 40% in the case of joint investments with the company sponsoring the pension fund.

Investments may not be in excess of 10% of the bonds or securities issued by the sponsoring company, its controlling company, subsidiary, affiliate or associate companies.

Pension funds are obliged to hire a custodian agent, a corporate body accredited to the Securities & Exchange Commission and entrusted with the task of controlling and transacting bonds and securities, settling financial transactions and handling the documentation and information relating to fixed and variable income investments. The hiring of such an agent is a *sine qua non* requirement if investments in these segments are administered by a financial institution.



## Annex 2

### Evolution of basic legislation regulating pension funds

| Legal instruments     | Date       | Contents   |
|-----------------------|------------|--|
| Law 6,435             | 7.15.1977  | Regulates private social security institutions.  |
| Law 6,462             | 11.9.1977  | Alters provisions in Law 6,435/1977.   |
| CMN Resolution 460    | 2.23.1978  | Sets out guidelines for investments.   |
| MPAS/CPC Resolution 1 | 10.9.1978  | Establishes norms for the operation of EFPCs.  |
| CMN Resolution 1,362  | 7.30.1987  | Consolidates provisions in Central Bank Resolution 1,362.  |
| Law 8,020             | 4.12.1990  | Regulates relations between closed private social security organizations and their sponsoring companies within the framework of federal public administration.     |
| Decree 607            | 7.20.1992  | Regulates the Supplementary Social Security Administrative Council (CGPC).   |
| CMN Resolution 2,109  | 9.20.1994  | Alters and consolidates norms regulating investment of EFPC funds.   |
| CMN Resolution 2,114  | 10.19.1994 | Regulates investments made by private social security organizations, insurance companies and capitalization corporations with quotas in Overseas Investment Funds. |
| CMN Resolution 2,143  | 2.22.1995  | Regulates investments made by financial institutions, other institutions authorized to operate by the Central Bank of Brazil and EFPCs.                            |
| SPC Norm 6            | 6.16.1995  | Establishes procedural norms for the State, regulations and subscription covenants.  |
| CMN Resolution 2,206  | 10.25.1995 | Regulates investment of EFPC funds.  |
| CMN Resolution 2,324  | 10.30.1996 | Alters and consolidates norms regulating investment of EFPC funds.   |
| CMN Resolution 2,720  | 4.24.2000  | Alters and consolidates norms regulating investment of EFPC funds.   |
| CMN Resolution 2,791  | 11.30.2000 | Suspends Resolution 2,720.   |
| CMN Resolution 2,810  | 12.28.2000 | Alters Resolution 2,791.   |
| Decree 3,721          | 1.2.2001   | Alters retirement age for participants in EFPCs.   |
| CMN Resolution 2,829  | 3.29.2001  | Alters and consolidates norms regulating investment of EFPC funds.   |
| Law 108               | 5.30.2001  | Regulates relations between public agencies and their respective pension funds.  |
| Law 109               | 5.30.2001  | Regulates operational norms for pension funds.   |

Source: ABRAPP (Internet)