Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

March 2005

Europe

Denmark

Since January, workers have been able to choose how their mandatory Special Pension (SP) savings are invested. A law passed in June 2003 and implemented at the beginning of this year created the *Folkebørsen*, or People's Stock Exchange, which now offers almost 200 funds.

The SP was implemented in 1999 as a mandatory pay-as-you-go supplement to the public pension system and is financed by a contribution of 1 percent of a worker's gross income. In 2002, the SP was converted to a system of individual accounts with pooled investments managed by the SP administrator. (The SP contributions for 2004 and 2005 have been suspended, however, in an effort to stimulate the economy by increasing workers' disposable income.) Currently, some 3.3 million workers have SP accounts with a total of DKr43 billion (US$7.5 billion) in assets.

The new system, modeled on the Swedish Premium Pension Agency, provides workers with a number of alternatives for the first time:

- Workers may choose the lifecycle approach, under which the SP administrator continues to make decisions according to the worker's age. As a worker nears retirement, investments are switched from equities to bonds and cash.
- Workers may choose the assisted option, under which they may select the investments themselves with advice from the SP administrator.
- Workers may also make their own investment choices from among the funds in the People's Stock Exchange. The government offers online investment tools, including a fund rating system that provides information on administrative fees and rates of return for each fund.
- Workers may also transfer their account out of the People's Stock Exchange to a fund managed by an asset manager, who is approved by the SP administrator. To date, fewer than 12 funds outside of the system have been certified.

Denmark's social security system comprises three pillars. The first is formed by the mandatory programs: a flat-rate, universal pension funded by the government; the labor market supplementary pension (ATP) financed by fixed-sum employer and employee contributions; and the SP. Second-pillar supplementary occupational pensions are set up by collective agreements and are fully funded by employer and employee contributions. The third pillar consists of voluntary, private pensions.

Sources: Financial News, January 4, 2004; *Investment & Pensions Europe*, January 17, May 17, and September 13, 2004; Social Security Administration, *Social Security Programs Throughout the World: Europe, 2004* (Washington, DC: SSA, September 2004); Watson Wyatt Worldwide, Global News Briefs, January 2005; Funds International, January 18, 2005; International Benefits Information Service (IBIS), February 2005.

Norway

The government announced in December that it plans to significantly change the pension system and proposed the introduction of compulsory occupational pensions. The reform plan is based on the January 2004 recommendations of the Pension Commission. (See also the February 2004 issue of *International Update*.)

Norway's retirement system consists of a pay-as-you-go National Insurance Scheme (NIS) for those with at least 3 years of contributions and an earnings-related supplement. It is funded by employer and employee contributions, and the government meets any deficit. The normal retirement age is 67, but several occupations have lower retirement ages. All public-sector employees as well as 43 percent of private-sector employees have an opportunity to retire as early as at age 62 through the state-subsidized early retirement program (AFP), which is underwritten by employers.

Although the government plans to maintain the existing NIS structure, it has proposed the following reforms:

- Allowing flexible retirement beginning at 62 with a reduced benefit. After the age of 62, a person receiving a pension could continue to work without the income counting against the benefit. The government also proposed that those who remain in the

labor force beyond the age of 70 be allowed to continue to accumulate pension entitlements. Today, the cutoff age is 70.

- Reviewing government support for the early retirement program (AFP), with a possible phase out beginning in 2007.
- Introducing mandatory occupational pensions. Two general options have been discussed: one would impose minimum requirements on existing (largely defined benefit) supplemental pension programs, while the other would mandate defined contribution plans similar to Sweden's Premium Pension program. (See also the September 2004 issue of *International Update*.)
- Establishing a contingency reserve fund to protect against future pension shortfalls by combining resources of the Government Petroleum Fund (GPF) and the National Insurance Fund; because of rising surplus oil revenues, current reserves in the GPF now top $165 billion.
- Introducing a life-expectancy "stabilizing factor" to ensure that annual pension payments are reduced in proportion to future increases in average life expectancy; this mechanism would be similar to those recently adopted in Finland and Sweden and would be applied equally to women and men. (See also the September and November 2004 issues of *International Update*.)
- Appointing a commission to study how best to integrate civil service pension plans with mandatory occupational pension plans in the revised pension system.

Today, Norway has about 2.5 working taxpayers for each retiree, but that proportion will fall to 1.6 workers for every pensioner by 2050. According to the Organisation for Economic Co-operation and Development, Norway's current public pension expenditures represent a relatively low 5 percent of gross domestic product (GDP), but without reform that figure will reach 13 percent by 2050.

The Pension Commission set a tentative target date of 2010 for introducing the reforms and proposed that they be introduced gradually over a period of 15 years. Those born before 1950 would not be affected, while the new rules would apply fully to those born after 1965.

Sources: IBIS, February 2004; European Industrial Relations Observatory On-Line (http://www.eiro.eurofound.eu.int), February and April 2004 and January 2005; Organisation for Economic Co-operation and Development (OECD), *Norway: Ageing and Employment Policies* and *Economic Survey—Norway 2004* (Paris: OECD, March and June 2004); *European Pensions & Investments News*, September 27, 2004; Dow Jones International News, December 9, 2004; Government of Norway, *Pension Reform—Safeguarding Our Pensions*, White Paper (Oslo: Ministry of Finance and Ministry of Labor and Social Affairs, December 10, 2004); *New York Times*, January 1, 2005; http://www.IPE.com (Web extension of *Investment & Pensions Europe*), February 18, 2005.

The Americas

Peru

The Superintendent of Banking and Insurance has announced that by the end of the year, Peru's asset management companies (AFPs) may offer three types of pension funds with varying degrees of risk. All AFPs are required to register the new funds and the details of their investments by May 2. Up until now, each AFP has been allowed to offer only a single fund, with the allocation of assets limited by law.

A law passed in December 2003 but not yet implemented expands the number and types of funds that AFPs can offer. Each AFP must provide two types of pension funds: Type 1, a preservation of capital fund with up to 10 percent in equities and up to 100 percent in fixed income, and Type 2, a mixed fund with up to 45 percent in equities and 75 percent in fixed income. AFPs may also offer a third pension fund: Type 3, which is a growth fund with up to 80 percent in equities and 70 percent in fixed income.

An account holder must choose one type of fund for the mandatory contribution of 8 percent of earnings and may set up a second account with another AFP for additional voluntary contributions.

In a related development, the rules for transferring from one AFP to another were eased. Previously, a worker opting to switch funds had to make at least six monthly contributions to one AFP, pay an exit fee, and wait 10 months for the process to be completed. Under the new law, the worker need only be enrolled in an AFP, the fee is eliminated, and the process should take 2 to 3 months.

As of June 2004, about 3.3 million workers, or 28.6 percent of the labor force, had individual accounts with total assets of US$6.6 billion, or 11.2 percent of GDP. The investment portfolios of the four AFPs have earned a 7 percent real rate of return since 1993. The investments included 21.2 percent in government debt, 36.9 percent in stocks, and 9.5 percent in foreign investments. A fifth AFP is expected to begin operation by mid-year.

Sources: *El Peruano*, "Normas Legales," 4 de junio de 2003; Asociación Internacional de Organismos de Supervisión de Fondos de Pensiones, *Boletín Estadístico AIOS*, Número 11, Junio de 2004; Superintendencia de Banca y Seguros, "Nota de Prensa," 15 de diciembre de 2003 and 20 de septiembre de 2004, http://www.sbs.gob.pe; Business News Americas, February 17, 2005.

Africa

South Africa

The Parliament's finance committee is considering the merits of establishing a funded pension system for low-income workers and those with irregular work histories. The National Treasury recently released a discussion paper that suggested establishing a National Savings Fund (NSF), under which workers would be allowed to make intermittent contributions to a personal account. The defined contribution accounts would be managed by the private sector but overseen by the government. Assets would be primarily invested in South Africa. The discussion paper did not include specifics, such as contribution rates and administrative fees.

Unlike other countries where growing demographic pressures are driving pension reforms, South Africa is pursuing reform out of a desire for economic fairness. According to the discussion paper, "the South African retirement fund industry has been heavily influenced by a racially divided past and the parallel existence of developed and emerging components of our economy." Currently, occupational pensions cover less than 25 percent of the population. However, the government provides a means-tested monthly benefit with an upper limit of R780 (US$132) for retirees with low incomes. The goal of the National Savings Fund is to enable all workers to prefund their retirement.

Sources: National Treasury, *Retirement Fund Reform: A Discussion Paper*, December 2004 (Pretoria, Republic of South Africa); *Financial Times*, February 17, 2005; Business Report, February 21, 2005; *Financial Times*, February 21, 2005; Mail & Guardian Online, March 3, 2005, http://www.mg.co.za.

Asia and the Pacific

South Korea

The National Assembly has approved the establishment of a new system of employer-sponsored retirement plans. On December 29, the Employee Retirement Income Security Act was enacted to encourage prefunded retirement benefits in the form of annuities, instead of the lump-sum severance payments characteristic of the existing Retirement Allowance System (RAS). Implementation is set for December 1, 2005, for employers with five or more employees; smaller firms will have to comply by 2010.

Under the RAS system, all employers with five or more employees must provide any employee leaving service with a severance payment equal to at least 30 days' average wages for each year employed. These lump-sum payments often do not contribute toward retirement savings because they are cashed out and spent by the worker. Moreover, most companies do not set aside financial assets to prefund these severance liabilities.

The new rules will be mandatory for new firms and will require current employers operating under an RAS arrangement to give their employees the choice of remaining in the old RAS system or joining a funded retirement plan under the new Retirement Plan System (RPS). Employers can move all employees to a new RPS plan if a majority of the staff approves. A funded RPS plan will take one of the following forms:

- A defined benefit (DB) plan with a retirement benefit equal in value to at least one month's final salary for every year of service with the company.
- A defined contribution (DC) plan funded by employer contributions equal to at least 1/12 of a worker's annual salary. Employees would be permitted to make voluntary contributions to the plan and to choose their own investment options.
- A hybrid DB–DC plan combining the design features outlined above: the DB portion would provide retirement benefits up to a basic income level, while the DC portion would allow for individual flexibility above that minimum guarantee.
- An individual retirement account (IRA) for employers with less than 10 employees, as an alternative to a funded RPS plan. The IRA is a new retail retirement product primarily intended for employees who choose to invest their severance payments in a retirement plan. In addition, benefits accumulated under an RPS plan must be transferred to an IRA for those leaving employment before retirement.

Employers will be able to either cash out or transfer an employee's RAS service accruals into the employee's new funded plan. Employer contributions under the new RPS will be 100 percent tax deductible, while the tax advantages for the RAS will be phased out after 5 years. RPS plans will be funded, and insurers and other financial institutions may provide administrative and investment services.

The new law sets out broad principles and obligations covering reporting standards, employee education, and solvency requirements for DB plans. The government is expected to issue further clarification as early as the end of March on investment restrictions, employee education, and employee access to savings prior to retirement. The Ministry of Labor has been designated as the principal regulator and will establish a committee to propose future amendments to the law.

According to the National Statistical Office, the country is expected to become the most aged society in the world by 2050 with a median age of 53.9 years. By that time, the worker-to-retiree support ratio will be 1.4 workers compared with 8.6 workers per retiree today. Official projections indicate that the national pension fund may become insolvent as early as 2042. The government has proposed pension reforms that could include higher contribution rates and lower benefits in an effort to ensure the system's long-term solvency.

Funded pensions under the new RPS system are expected to create a sizable pool of investment capital. Some industry analysts estimate that the corporate pension market will grow from KRW49 trillion (US$48.8 billion) in 2006 to about KRW75 trillion (US$74.5 billion) in 2010 and to perhaps as high as KRW190 trillion (US$170 billion) by 2015.

Sources: Mercer Human Resource Consulting (http://www.mercerHR.com), September 9, 2004, and January 27, 2005; Ron van Oijen, "Pension Opportunities: Lessons Learned from the World," ING Life, presented at the Hankyung Conference in Seoul, Korea, December 14, 2004, available online at http://partner.hankyung.com/download/Ron.pdf; Watson Wyatt Worldwide, Global News Briefs and *Bulletin*, January 2005; *Korea Times*, February 17, 27, and 28, and March 16, 2005; *Korea Herald*, February 14 and 16, 2005; and *Financial Times*, February 27 and 28, 2005.

Other News

SSA has released Social Security Programs Throughout the World: Asia and the Pacific, 2004

Social Security Programs Throughout the World, a four-volume series, highlights the principal features of social security programs in over 170 countries. Each volume focuses on a different region: Africa, The Americas, Asia and the Pacific, and Europe. The most recent volume—Asia and the Pacific—was released in March 2005. The next volume, Africa, will be released in September 2005. The series is available at http://www.socialsecurity.gov/policy/docs/progdesc/ssptw.

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