Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

January 2006

Europe

United Kingdom

On December 16, the Pension Protection Fund (PPF) announced that companies with defined benefit pension plans will be required to pay approximately twice as much in premiums as originally estimated. The new premiums, which will go into effect on April 1, address increasing life expectancy and the underfunding of defined benefit pension plans. Among the 100 largest publicly traded U.K. companies, unfunded defined benefit pension liabilities have grown over the last year from £65 billion (US$115 billion) to £75 billion (US$133 billion).

In addition to higher premiums, new funding regulations went into effect on December 30 that grant pension fund trustees greater authority and require underfunded pension plans to develop clear recovery strategies. (See also the November 2005 issue of *International Update*.)

The PPF (modeled after the U.S. Pension Benefit Guaranty Corporation) was established in November 2004 to insure workers' defined benefit pensions against company default or bankruptcy. (See also the April 2005 issue of *International Update*.) However, according to a senior partner at the actuarial firm of Lane, Clark, & Peacock, the new premium amount of £575 million (US$1.0 billion), though nearly double the original estimate of £300 million (US$531 million), will cover only half of the shortfall in the nation's 8,500 defined benefit pension plans.

Sources: IPE.com, December 9, 2005; Citywire, December 16, 2005; Pensions & Investments Online, December 16, 2005; *Birmingham Post*, December 23, 2005; *Herald* (Glasgow), December 28, 2005; MoneyMarketing.com, January 5, 2006.

Denmark

A government commission has recommended that the normal retirement age be increased to 66 and that the early retirement age be raised from 60 to 61. The commission proposed that beginning in 2013 the normal retirement age be increased by 1 month per year until it reaches age 66 in 2025. However, the commission stopped short of establishing age 66 as the ultimate limit on the retirement age. It further recommended that beginning in 2009 the early retirement age should increase by 4 months per year until it is phased out by 2028.

The recommendations, released on December 7, come less than 2 years after Denmark lowered the retirement age from 67 to 65 to help reduce public spending on the more generous voluntary early retirement program. (See also the February 2004 issue of *International Update*.) Today, Danes can retire as early as at age 60, with a reduced public pension of about US$1,920—one-third of Danish workers retire before age 61. In 2000, about 20 percent of the population was older than 60 years, and the life expectancy at birth for both sexes was 76.5 years. By 2050, about 28 percent of the population is expected to be older than 60, and the average life expectancy at birth for both sexes is estimated to be 82 years.

The nine-member Welfare Commission, composed of economists and business leaders, was appointed in 2003 to determine how best to sustain Denmark's extensive welfare system as the working population shrinks and the retiree population grows during the next three decades—without sacrificing economic growth or increasing public expenditures. To improve the labor supply and increase the number of workers participating in a pension plan, the commission further recommended

- awarding resident visas to immigrants who are highly skilled and educated (asylum seekers will not have to meet those requirements);
- providing a financial incentive to students who get a college or university degree within a set time frame; and
- creating a special pension plan for low-wage workers, the self-employed, and workers not covered by an employer pension plan.

In 2001, Denmark devoted about 13 percent of its gross domestic product to pension expenditures, compared with 12.5 percent for the European Union and 11.8 percent in the United Kingdom.

Sources: *Financial News*, October 8, 2005; Eurostat, November 2005; US Fed News, November 23, 2005; AFX News, December 7, 2005; Associated Press Newswire, December 7, 2005; *Financial Times*, December 9, 2005; nordicreviews.com, January 2006; U.S. Census Bureau, International Data Base, January 2006; *World Population Prospects: The 2004 Revision*.

Norway

On December 20, Norway's parliament voted to mandate minimum occupational pensions for the 25 percent of the workforce that is not currently covered by employer-sponsored pension plans. Companies that currently provide their employees with a pension plan will not be affected. Most of the workers who will benefit from the new pension plans are young and employed in the service and retail sectors, which experience high staff turnover.

Effective July 1, companies having at least two employees must enroll their workers in either a defined benefit (DB) or a defined contribution (DC) pension plan. Employers will be required to contribute a minimum of 2 percent of the employee's annual earnings of between NKr60,699 (US$9,155) and NKr728,388 (US$109,815) into an account with a private asset manager as well as cover the administrative costs. Employees will have the option of matching their employer's contributions to a DC plan. Employers who establish a DB plan will be required to provide approximately the same minimal benefit that would be received by employees in a DC plan.

The new plans are expected to generate annual contributions of between NKr3 billion to NKr4 billion (US$442 million to US$590 million). Industry analysts expect that within 15 years these new funds will exceed the NKr240 billion (US$36 billion) in corporate fund assets currently under management.

In December 2004, the government announced a plan to reform the nation's retirement system on the basis of earlier recommendations from a national Pension Commission. Those recommendations included mandating occupational pension plans for all companies. (See also the February 2004 and the March 2005 issues of *International Update*.)

Sources: *Hewitt Global Report*, November 2005; Dow Jones International News, December 16, 2005; *Wall Street Journal Europe*, December 19, 2005; *Financial Times*, December 20 and 21, 2005; Global Insight Daily Analysis, December 21, 2005; IPE.com, December 21, 2005; Datamonitor News and Comment, December 23, 2005.

The Americas

Argentina

Recent changes to Argentina's social security system will generate additional revenue and provide benefits to more workers. In late 2005, the wage limit for employers' social security contributions was eliminated. In addition, workers who reach retirement age without sufficient contributions to qualify for a pension will be allowed to make the back payments and receive a benefit.

The ceiling on employer contributions began to be gradually raised from 4,800 pesos (US$1,584) per month in October 2004 until it was removed entirely in October 2005. Workers continue to pay either 7 percent of earnings to an individual account or 11 percent to the public pay-as-you-go system, up to 4,800 pesos per month. Employers do not contribute to a worker's individual account and depending on the type of company pay either 10.17 percent or 12.71 percent of the worker's earnings to the public pay-as-you-go system. (See also the July 2005 issue of *International Update*.)

Women who were aged 60 and men who were aged 65 by the end of 2004, but who lack as many as 60 monthly contributions (out of the required 30 years) to qualify for a pension, will be allowed to pay back contributions and receive the minimum benefit of 390 pesos (US$130) per month. These workers have until January 2007 to pay the outstanding contributions plus 0.5 percent interest for periods of work since September 1993.

This new ruling will provide access to a retirement benefit to many individuals who are either unemployed or who work in the informal sector and have irregular contribution histories. Surviving spouses of workers who did not contribute sufficiently to the retirement system may also participate in this new program. Separate provisions are expected for domestic workers who have never paid into the system.

Source: *Global RFM Update*, November 2005; *Clarín* (Buenos Aires), November 21, 2005; *La Nación* (Buenos Aires), December 17, 2005; Inter Press Service, December 27, 2005; *Social Security Programs Throughout the World: The Americas, 2005*, forthcoming.

Panama

President Torrijos approved a new social security law that will introduce voluntary individual accounts as a supplement to the pay-as-you-go system in 2008. The legislation, Law 51, also raises the contribution rates and gradually increases the required number of contributions while maintaining the current retirement ages.

After 5 months of discussions with business, labor, and civic groups, the National Assembly in December passed Law 51. It replaces Law 17, which made unpopular changes to the pay-as-you go system last June. President Torrijos quickly suspended Law 17 following a month of nationwide protests, mainly over the gradual increase in the retirement ages for men from 62 to 65 and for women from 57 to 60. (See also the June 2005 issue of *International Update*.) Law 51 contains about 250 articles that affect programs run by the Social Insurance Fund, including old age, survivors, and disability; sickness and maternity; work injury; and family allowances.

Beginning in 2008, new entrants to the labor force and all workers under the age of 35, including the self-employed, will be covered by the new reformed system. Workers who are older than 35 may opt to join the new two-pillar system or remain covered by the old pay-as-you-go system. Those earning less than $500 a month will contribute only to the pay-as-you-go first pillar, and workers earning more than $500 must contribute to the first pillar and may also choose to contribute to an individual account, supervised by the Social Insurance Fund.

The main provisions of Law 51 are the following:

- The retirement age for men will remain at 62 and for women at age 57; workers will be allowed to retire up to 2 years earlier with a reduced pension.
- The number of monthly contributions required to become eligible for a pension will increase gradually from 180 to 240 between 2007 and 2013.
- The contribution rates for old-age, survivors, and disability programs will rise gradually between 2008 and 2013 from 6.75 percent to 9.25 percent of earnings for employees and from 2.75 percent to 4.25 percent of payroll for employers.
- Workers who choose to have an individual account will have their contributions split between the two pillars: contributions on earnings up to $500 per month will go to the first pillar, and those on earnings over $500 will go to the worker's individual account.
- Individual account benefits will be paid as programmed withdrawals calculated to guarantee income according to the worker's expected lifespan. Workers with low account balances will receive a lump-sum distribution.

Between 2007 and 2060, the government will contribute $7.2 billion to help reduce the system's deficit, currently running at $100 million per year.

Sources: Agencia Mexicana de Noticias, November 21, 2005; Proyecto de Ley, "Que Reforma La Ley Orgánica de la Caja de Seguro Social y Dicta Otras Disposiciones," 5 de diciembre de 2005; Reuters, December 21, 2005; AP Spanish Worldstream, December 27, 2005; prensa.com, December 27 and 29, 2005; *Social Security Programs Throughout the World: The Americas, 2005*, forthcoming.

Peru

Peru's workers are now able to contribute more to their individual accounts and have greater choice in investing their funds. Beginning in January, a worker is allowed to contribute 10 percent of earnings to an individual account. Even though a 10 percent contribution rate is mandated in the law, it has been "temporarily" reduced to 8 percent since 1995 to encourage greater participation in the system. Because Congress did not vote in 2005 to extend the rate reduction, the rate automatically rose to 10 percent of earnings for 2006.

Until last December, each pension management company could offer only a single fund with limited investments. (See also the March 2005 issue of *International Update*.) Now workers with individual accounts are permitted to choose a fund from among three different types with varying degrees of risk:

- Type 1 is a *preservation of capital fund* with up to 10 percent in equities and up to 100 percent in fixed income,
- Type 2 is a *mixed or balanced fund* with up to 45 percent in equities (the original fund when only one was permitted), and
- Type 3 is a *growth fund*, with up to 80 percent in equities and up to 70 percent in fixed income.

Type 2 funds currently account for about 93 percent of the system's assets under management, as workers who do not make a choice are assigned to that fund. By the time the new multiple-fund system began operation on December 12, only 11,600 of the 3 million account holders had made an active choice, and half of them had chosen a Type 2 fund. Account holders over the age of 60 are automatically assigned to a Type 1 fund to reduce their portfolio risk. Currently, only about 3 percent of account holders are older than 60.

Some groups, including the Association of Pension Fund Management Companies, advocate increasing the current limit on foreign investments from 10.5 percent of assets to 20 percent to achieve greater differentiation among the funds. However, a recent technical report by the Central Bank cautions that such a move could pose a risk to the country's macroeconomic stability.

Sources: *Boletín FIAP*, September 2005; The Fund Pro Latin America, October 18, 2005; *El Comercio* (Lima), October 20, December 13, and December 30, 2005.

Asia and the Pacific

China

On December 15, the State Council acted to protect the integrity of workers' individual retirement accounts by lowering the contribution rate from 11 percent to 8 percent of salary and separating the management of these accounts from the pay-as-you-go pillar. Each of China's 30 provinces manages its own two-pillar public pension system—a pay-as-you-go pillar with contributions split between employers and employees and an individual account pillar with contributions from employees only. Until this recent action, contributions and benefits from both pillars were managed by the provincial governments with no effective barrier between them.

Today, many provinces do not collect sufficient pay-as-you-go contributions to fund current benefits for retirees from the state-owned enterprises, and to make up for the shortfall, they divert contributions from workers' individual accounts. In addition to the tapping of individual accounts, the size of the employee's contribution to this account (11 percent) has contributed to widespread payment evasion and underreporting of earnings. To address these problems, the State Council mandated that each province manage the two pillars separately and that the individual account contribution rate be reduced from 11 percent to 8 percent. The 13 percent pay-as-you-go contribution rate will remain unchanged.

The State Council expects that the reduction in contribution rates and the securing of individual retirement accounts will create a sufficient incentive to increase coverage under the public pension system by 10 million workers per year. Today, less than one-quarter of China's working-age adults, approximately 168.7 million people, are fully covered under the public pension system.

Sources: *China Daily*, November 17 and December 16, 2005; Reuters, December 15, 2005.

South Korea

Since December 1, the Employee Retirement Security Act (ERSA) has mandated that all newly formed companies with five or more employees establish a funded retirement plan. ERSA, which used the U.S. 401(k) plan as a model, was enacted at the end of 2004. (See the March 2005 issue of *International Update*.) It provides an additional pillar of retirement income for South Korea's rapidly aging population and offers an alternative to the Retirement Allowance System (RAS)—a severance plan that provides a lump-sum payment equal to at least 30 days of average wages for each year of employment.

A majority of a company's employees will determine whether an existing employer continues to participate in an RAS or establishes an ERSA retirement plan. An ERSA plan may take the form of a defined benefit, a defined contribution, or a hybrid defined benefit–defined contribution model.

Under ERSA defined benefit plans, the pension benefit must total at least 1 month of an employee's final salary for every year of employment. For ERSA defined contribution plans, employers must contribute at least 1/12 of employees' annual salaries and provide their workers with investment options. Hybrid plans must provide a basic level of retirement income under the defined benefit portion while allowing for additional retirement income and employee investment options under the defined contribution portion. Employee contributions under ERSA are voluntary.

South Korea has had limited experience with private pension plans, whose assets currently represent only 3 percent of gross domestic product compared with 15 percent in Japan and 55 percent in the United States.

Sources: *Hewitt*, March 2005; *Mercer*, October 21, 2005; Emerging-Markets-Online.com, December 5, 2005; Joins.com, January 2, 2006.

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