Social Security
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International Update:

Recent Developments in Foreign Public and Private Pensions

January 2010

Europe

Czech Republic

On January 1, changes to the Czech Republic's social insurance system went into effect that raise the retirement age, increase the years of service required to obtain an old-age pension, increase the annual earnings contribution ceiling, and expand the definition of disability. According to the government, the changes are meant to stabilize the country's state-run, pay-as-you-go system.

Specifically, the changes—

- Raise gradually the retirement age to 65 by 2028 for men and for women without children. Women with children will be able to retire from ages 62 to 65, according to the number of children. Currently, the retirement age is 62 and 2 months for men and from 57 through 61 for women, according to the number of children. (Under a previous law, the retirement age was increasing gradually to 63 for men and for women without children and from 59 through 62 for women with children, depending on the number of children.)
- Increase gradually the number of years of covered employment required for an old-age pension from 25 to 35 years by 2019. In addition, starting in 2011, individuals who are 5 years older than the normal retirement age will be able to retire with 17 years of contributions (increasing by 1 year each year thereafter until reaching 20 years by 2014). Currently, men and women aged 65 or older can retire with at least 15 years of covered employment.
- Increase the maximum annual earnings for contribution calculation purposes for employees and employers from 48 to 72 times the national average monthly wage. For 2010, this ceiling is set at CZK1,707,048 (US$93,342), based on a national average monthly wage of CZK23,709 (US$1,296).
- Replace the old disability classification, which consisted of partial (33–65 percent loss of earning capacity) and total disability (66 percent or higher) categories, with one based on three levels of disability: 1st degree (35–49 percent), 2nd degree (50–69 percent), and 3rd degree (70 percent or higher). To qualify for disability benefits under the new law, individuals aged 38 or older must have been in covered employment for 10 of the last 20 years before the onset of disability; fewer years are required for individuals younger than age 38. (Previously, 5 years of covered employment was required for individuals aged 29 or older, with fewer years required if younger than age 29).

The Czech Republic's social insurance system covers all employed and self-employed persons and is financed by employee contributions of 6.5 percent of monthly covered earnings (28 percent for the self-employed) and employer contributions of 21.5 percent of monthly payroll.

Sources: *Social Security Programs Throughout the World: Europe: 2008*; "Convergence Programme of the Czech Republic," Ministry of Finance of the Czech Republic, November 2008; *IBIS Compliance Alert, Czech Republic*, November 30, 2009; "Zmeny v Duchodovem Pojisteni," Ceska Sprava Socialniho Zabezpeceni, December 2009; "Co Se Zmeni Duchodovem Pojisteni od 1.1.2010," Ceska Sprava Socialniho Zabezpeceni, December 11, 2009.

Sweden

In a report made public on November 30, an independent committee within the Ministry of Finance recommended the merger of Sweden's pension buffer funds in order to take advantage of economies of scale and to improve returns. According to the report, these funds, with combined assets of 745 billion Swedish kronor (US$104 billion), could save an estimated 330 million kronor (US$46 million) and potentially boost returns by 700 million kronor (US$98 million) annually by consolidating their operations. A seven-member task force, led by Sweden's minister of social security, needs to agree to a review of fund administrative costs and fund performance before addressing the report's recommendations.

Buffer funds in Sweden are intended to even out temporary fluctuations during periods when social insurance pension contributions are insufficient to cover pension disbursements. Under the current system of social insurance, four identical buffer funds were created to diversify risk management, increase competition to the system, ensure funds are not so large as to interfere with the operation of domestic financial markets, and reduce the risk from possible political influence on the governance of Swedish enterprises (whose shares would be held by buffer funds).

According to the report, most of these arguments for operating several buffer investment funds rather than one large fund no longer exist. Specifically, the report notes that—

- Financial markets have developed in many ways during the past 10 years, with new financial instruments and the introduction of new investment strategies, so there is minimal risk that a merger of the funds would disturb the functioning of financial markets.
- Competition among buffer funds appears to have resulted in very similar portfolios, reflecting a herd mentality, which increases (not diversifies) the total risk in the system.
- Fund management performance does not appear to have improved as a result of competition; although there has been pressure to reduce costs in the system, the net results from active fund management (2001–2008) have been poor in all funds.

The report also suggests replacing current investment restrictions, including limits on private equity investments and a prohibition on commodity investing, with a more "prudent-person" approach (restricting portfolio investments to those a prudent person seeking reasonable income and preservation of capital might buy) to create conditions for more efficient fund management. In its review of issues affecting governance, the report recommends forming a parliamentary panel to oversee buffer funds similar to the way the central bank is run, allowing this new panel to select all board members and improving board member qualifications.

Sources: "Swedes Debate Merging Buffer Funds," citywire.co.uk, December 1, 2009; "Report Recommends Merging 4 Swedish Pension Funds," *Pensions & Investments*, December 7, 2009; "Sweden's AP Funds Should Be Merged—Report," ipe.com, December 7, 2009; "ESO Report on the Swedish Pension Fund System," *Investor Services Journal*, December 8, 2009; "Swedish Government Mulls Merger of AP Funds," *Pensions & Investments*, December 11, 2009; "Swedish Fund Merger Talks Heat Up," *Pensions & Investments*, December 14, 2009.

Asia and the Pacific

Australia

On December 14, the government-appointed Super System Review panel issued a preliminary report on governance of superannuation funds entitled *Clearer Super Choices: Matching Governance Solutions*. The panel was formed in May 2009 to examine the country's nearly 20-year-old superannuation system; it will release a preliminary report on operation and efficiency around March–April 2010 and another report on structure around April–May 2010. The final report on all three topics is due on June 30, 2010.

The preliminary report on governance finds that the current "one-size-fits-all" regulatory infrastructure of the superannuation industry does not protect the interests of all members and may be too complex and too costly for certain groups. (A member is anyone with a superannuation account.) The panel suggests a shift away from this single model of fund governance to one that takes into account the different types of members, which include the following groups.

- *Disconnected members*: those who joined an employer-sponsored plan more than 2 years ago whose account has been inactive for the past 5 years. As of June 2008, the government reported 6.4 million of these so-called "lost accounts," representing about one in five of all superannuation accounts. The report suggests placing these disconnected members in a low-cost fund with a conservative investment strategy and the highest level of protection against loss.
- *Universal members*: those who do not choose the type of investment fund for their superannuation account. Currently, some 90 percent of members do not make a choice. The report suggests that these individuals be in a fund with a single diversified investment strategy (such as life cycle) where the member is not required to make any choices. Fees would also be relatively low.
- *Choice members*: those who actively choose their funds and type of investments. The report suggests that an appropriate fund for individuals in this group would offer a potentially unlimited menu of options for investment. Choice members would pay proportionately higher fees and assume substantial responsibility for their investment and fund choices.

Superannuation assets under management as of June 2009 equaled A$1.1 trillion (US$976 billion), with an average fund size of A$1.5 billion (US$1.3 billion). Most of the 447 superannuation funds in Australia are defined contribution plans with an average account balance of A$70,000 (US$62,153). The report projects that by 2025 the number of funds will decrease to 119; total assets under management will double; the average fund size will increase to A$11.7 billion (US$10.3 billion); and the average account balance will rise to A$105,000 (US$93,229).

The full report is available online at http://www.supersystemreview.gov.au/content/downloads/clearer_super_choices/Clearer_super_choices.pdf.

Sources: "Superannuation Clearing House and the Lost Members Framework," Australian Treasury, 2008; "Australia," *International Update*, U.S. Social Security Administration, May 2009; "Clearer Super Choices: Matching Governance Solutions," Australian Government, December 14, 2009; "Superannuation Review Proposed Simpler System for Default Super Funds," Smartcompany.com.au, December 15, 2009.

Reports and Studies

World Bank

The World Bank recently released *Pensions in Crisis: Europe and Central Asia Regional Policy Note*, which analyzes the impact of the global financial crisis on pension systems in Europe and Central Asia (ECA), reviews the policy responses implemented by individual governments, and provides recommendations for strengthening pension systems. According to the report, the financial crisis has had a significant impact on first-pillar, pay-as-you-go (PAYG) pension programs through a decrease in contribution revenues and an increase in expenditures and on second- and third-pillar individual account programs through a decrease in asset values. However, the report warns that the financial crisis will have far less impact in the long run than rapid population aging over the next 60 years, which is projected to lead to pension system deficits three times as high as those currently experienced in the worst-hit ECA countries.

The report notes that a number of governments across the region implemented policies in response to the crisis that may have unintended long-run consequences. Estonia, Latvia, Lithuania, and Romania, for example, have all reduced contribution rates to their second-pillar individual account programs, while increasing the rates to their state-run PAYG programs. Although such a reduction increases state revenues in the short run, the report argues that in the long run it could lead to higher expenditures on state-run PAYG programs to compensate for lower second-pillar pensions.

To improve the long-run sustainability of pension systems in the ECA, the report recommends that these countries—

- Index public pensions to inflation, rather than wage growth. Inflation indexation not only helps pensioners in the short run by maintaining the purchasing power of their pensions, but also improves the long-run fiscal sustainability of these programs.
- Increase retirement ages of men and women to age 65 or older. Currently, workers in most ECA countries can retire younger than age 65.
- Promote public awareness of pension issues. Financial literacy and information awareness campaigns are important to increase public support for pension reform and to encourage individuals to save more for retirement.

The report is available online at http://siteresources.worldbank.org/ECAEXT/Resources/258598-1256842123621/6525333-1260213816371/PensionCrisisPolicyNotefinal.pdf.

Sources: "Pensions in Crisis: Europe and Central Asia Regional Policy Note", World Bank, November 12, 2009.

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