Social Security

# International Update:

## Recent Developments in Foreign Public and Private Pensions

December 2005

## Europe

### Italy

**On November 28, Italy's parliament took an important step in developing a funded second-pillar pension system by voting to allow workers to redirect contributions from employee severance accounts (*Trattamento di fine rapporto,* or TFR) into private and occupational pension funds.** Following several years of discussion, the new law will take effect on January 1, 2008, 2 years later than originally planned, to allow companies more time to adapt to the new rules. (See also the June 2005 issue of *International Update*.) Employees will have 6 months from that date to decide whether to leave their accumulated severance payments with their employer or to transfer them to an occupational or private pension fund.

Under the current severance arrangement, employers contribute about 7 percent of payroll each year to an employee's TFR account. The employer holds the funds as a book reserve and annually must pay 1.5 percent interest on the account balance plus 75 percent of the inflation rate. When employees terminate employment for any reason, including retirement, they are entitled to a lump-sum payment of their account balance.

TFR reserves total about €125 billion (US$147.4 billion), or 10 percent of gross domestic product (GDP). Until employees withdraw their TFR funds, employers often use the accumulations as a medium-term loan at below-market rates. Since the new law could eliminate employers' access to those funds, and as a means to persuade employer groups to support the legislation, the government and the banking association reached an agreement in October to provide reduced-rate financing for those affected employers.

The new law is expected to give a sizable boost to Italy's private pension industry by shifting as much as €13 billion (US$15.2 billion) per year, or 1 percent of GDP, into supplementary private and occupational pension plans. Today, only about 12 percent of Italy's workforce, or 2.8 million people, contribute to either an occupational or a private pension plan. Those plans hold about €41 billion (US$48 billion) in assets.

**Sources:** "The Pension System in Italy," presentation at the International Pension Funds Conference (Madrid, Spain), April 2000; BNP Paribas, January 24, 2005; Agence France-Presse, November 24, 2005; Reuters.com, November 24, 2005; Dow Jones International News, November 24 and 25, 2005; *Pensions & Benefits Daily*, November 30, 2005; AGI online, December 5, 2005.

### Sweden

**The Premium Pension Committee's evaluation of the premium pension system (PPM) found that the mandatory system of individual accounts works well and is reasonably cost-effective but that there is room for further simplification and cost reduction.** The report, *Difficult Waters? Premium Pension Savings on Course*, was submitted to the government in October.

The committee was established in September 2004, because of concerns about the pension system's cost structure and the ability of participants to understand it. (See also the September 2004 issue of *International Update*.) The premium pension forms a relatively small component of the two-pillar social security system launched in 1998. Employers and employees contribute a total of 2.5 percent of payroll into the funded individual account component and another 16 percent of payroll to the pay-as-you-go notional defined contribution system.

The report offers the following general recommendations:

- *Assist PPM participants to compose a well-diversified fund portfolio with low administrative costs.* The report proposes that pension savers be given in-depth support services to aid their daily management, evaluation, and review of accounts, as well as information about the design of the public old-age pension system.
- *Reduce administrative costs charged by mutual funds.* Although charges paid by PPM participants were found to be low by international standards, the committee concluded they could be reduced further. Mutual fund managers charge PPM participants and private investors the same fee, but because PPM accounts are administered by a government-run clearinghouse, the actual cost to manage them is lower. Therefore, fund managers are required to pay

a rebate to the government, which is then passed along to participant accounts. The committee proposed that the amount of the rebate be increased to benefit plan participants.

- *Reduce the number of mutual funds offered to participants.* The PPM system provides a choice of over 700 mutual funds—up from 470 in 1998. Since nearly 90 percent of the system's capital is invested in about 150 funds, the committee concluded that the fund menu could be reduced to between 100 and 200 funds without damaging participants' investment prospects. In addition, the committee suggested that funds be required to achieve a given market share within a certain time limit or be eliminated.
- *Transform the government's default fund into a generation (life-cycle) fund.* The default fund is for individuals who do not actively choose a fund or who simply prefer to have the government invest for them. Converting the default fund to a *generation fund*, in which asset allocation automatically adjusts to become more conservative as the expected retirement date approaches, would reduce portfolio risk as participants get older. The government also offers another investment fund that can be chosen actively by PPM savers, but the committee recommended that it be phased out, which would leave only one government-managed fund.
- *Consolidate pension administration.* There are currently two agencies responsible for old-age pensions: one for the unfunded pay-as-you-go portion of social security and the other for the funded PPM system. The report recommends the establishment of a separate, independent pension authority with administrative responsibility for both systems.

**Sources:** "How Do Individual Accounts Work in the Swedish Pension System?" Center for Retirement Research, August 2004; "Design and Implementation Issues in Swedish Individual Accounts," Center for Retirement Research, April 2005; "Investment Choice in the Swedish Premium Pension Plan," Center for Retirement Research, April 2005; Swedish Ministry of Finance, press release, October 27, 2005; *Difficult Waters? Premium Pension Savings on Course*, Extended Summary, Premium Pension Committee, October 27, 2005; IPE.com, October 31, 2005; "Individual Accounts—Lessons from Sweden," presentation at the Association for Public Policy and Management Research Conference, November 3, 2005; *European Pensions & Investment News*, November 7, 2005.

## *United Kingdom*

**The Pensions Commission has proposed restructuring aspects of the United Kingdom's public pension systems to provide a more generous, non-means-tested benefit; establishing a system of voluntary, individually owned pension accounts—the National Pension Savings Scheme (NPSS); and increasing the retirement age.** The long-awaited report, issued on November 30, is a follow-up to the commission's first report released in October 2004 that outlined the problems with the nation's pension systems and private savings, *Pensions: Challenges and Choices*. (See also the November 2004 issue of *International Update*.)

The commission's report declared that the state's role "should in the long-term be concentrated on securing as generous and as non-means-tested flat-rate state pension provision as possible, with the state withdrawing gradually from its role in PAYG earnings-related pension provision as the NPSS provides a proven alternative earnings-related system." To that end, the commission called for reforming the Basic State Pension (BSP) and the State Second Pension and eliminating the means-tested Pension Credit.

The BSP currently provides a maximum flat-rate benefit of 328 (US$569) per month to individuals who have worked at least 39 years. Those with fewer years of employment receive an incrementally smaller benefit. The report concluded that the BSP is currently less fair to women than to men, as women's work lives are more frequently interrupted to raise children and be caregivers. The commission therefore proposed changing the basis for receiving BSP benefits from the number of years of active employment to one of residency. The commission further proposed increasing the BSP benefit by indexing it to the average growth in earnings beginning in 2010 or 2011, rather than indexing it to the average growth of prices, as is currently done. The commission also recommended that by 2030, the State Second Pension be gradually changed from an earnings-related benefit to a flat-rate benefit by freezing the upper-earnings limit for accruals in nominal terms. It further recommended eliminating the means-tested Pension Credit, which it determined is a disincentive to personal savings.

To help reduce the state's role in pension provision, the commission proposed developing a system of individually owned defined contribution accounts, the National Pensions Savings Scheme, modeled in part on the Swedish PPM system. All employees not already covered by an occupational pension plan would be automatically enrolled in the NPSS, while retaining the right to opt out. The NPSS would be financed by an 8 percent contribution rate, with a contribution from workers of 4 percent of wages, an employers' contribution of 3 percent of wages, and a 1 percent tax relief or tax credit. The self-employed would be allowed to participate in the NPSS on a voluntary basis. Contributions would be invested at the individuals' instructions in a limited range of funds, with a default fund for workers not making a selection. The administrative fees of the investment fund would be kept low, with the annual fee for account management targeted at 0.3 percent of fund assets or less.

The commission projects that the combined effect of the changes to the state systems and the NPSS would result in a median earner achieving a replacement rate of 45 percent of preretirement income. It further recommends that additional voluntary contributions be allowed so as to enhance the level of income replacement.

The commission estimated that its recommendations would increase public expenditures for pensions from today's 6.2 percent of GDP to between 7.5 percent and 8.0 percent by 2045. However, to keep the costs within limits that are fair between generations and sustainable over the long term, it proposed increasing gradually the retirement age from 65 to 68 by 2050.

The government has welcomed the framework of the Pensions Commission's proposals as providing a "good basis of debate to come." On December 5, Pensions Minister Stephen Timms urged the pension industry to develop alternative models to the NPSS and to submit their proposals to the government by early February 2006. He anticipates the release of a government white paper on pension reform in the spring.

**Sources:** "A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission," Pensions Commission, November 30, 2005; Watson Wyatt Worldwide, December 2, 2005; IPE.com, December 5, 2005; *Independent*, December 6, 2005.

## Africa

### *Ghana*

**The Presidential Commission on Pensions has recommended replacing Ghana's two major pension systems with a three-pillar model.** The proposed framework seeks to increase coverage and improve retirement income security, although certain measures could reduce benefits in the long run. The commission submitted an interim report to the president in June that was made available for public comment in October.

Ghana has two major pension systems: the Social Security and National Insurance Trust (SSNIT) for workers in the private sector and some civil servants and the CAP 30 system for public-sector employees.

The mandatory pay-as-you-go SSNIT provides old-age, disability, and survivor benefits. It is financed by a contribution rate of 17.5 percent of the employee's salary (5 percent from the employee and 12.5 percent from the employer). Workers become eligible for full benefits after contributing for 20 years, and the pension benefit is based on the average of the workers' 3 highest earning years. The normal retirement age is 60, but workers in hazardous jobs may retire with a full benefit at age 55. Early retirement is available with reduced benefits from the age of 55. At the end of 2004, the SSNIT had nearly 1.1 million contributors and paid out benefits to nearly 67,000 pensioners.

The commission predicted that the SSNIT will face a funding shortfall by 2036 because of a recent government directive that diverts a portion of contributions to finance health care. The commission also identified other weaknesses of the SSNIT, including low rates of coverage for the self-employed and workers in the informal sector, high rates of attrition, poor returns on reserve investment, high administrative expenses, no coverage for sickness or unemployment, and political interference in management.

Ghana's other major pension system, the CAP 30 Pension Scheme, is an unfunded defined benefit system for civil servants. Although its contribution rates are the same as those of the SSNIT, the CAP 30 provides a monthly pension to eligible employees with 10 years of service, with benefits that are based on final salary. Although the compulsory retirement age is 60, employees may retire as early as at the age of 45. Not all civil servants contribute to the CAP 30 system. Police and other security agency workers as well as members of the judicial and legal services are exempt.

The commission highlighted several problems with the CAP 30 system, most notably that benefits lack any actuarial basis, an inequity exists between contributing and noncontributing workers, and the collection of contributions and payment of benefits is substantially in arrears, because of inadequate budgeting and delays in processing. At the end of March, the CAP 30 system covered more than 31,000 public workers and paid benefits to 97,000 pensioners. Despite its limited coverage, CAP 30 expenditures accounted for 1.3 percent of GDP in 2004, and since 2000, the annual cost of the system has risen by more than 300 percent. Also, the share of noncontributing CAP 30 pensioners, already in the majority, is projected to increase during the next few years.

The commission proposed a framework comprising three pillars to improve retirement security. The mandatory first pillar would become a restructured pay-as-you-go SSNIT system offering a monthly pension. Contributions would be 13.5 percent of payroll. Higher investment returns would be sought through professional management of fund reserves.

A mandatory second pillar would be provided through a privately managed defined contribution occupational plan. The minimum contribution rate would be 4 percent of employee earnings plus another 1 percent of earnings contributed by the employer, the employee, or both; additional contributions would be permitted. Benefits would be paid in a lump sum.

A third pillar would be provided through a voluntary personal pension system supported by tax incentives and a regulatory framework already captured by provisions in the Long-Term Savings Act of 2004.

**Sources:** *Ghanaian Chronicle* (Accra), March 4 and June 23, 2004, and September 29, 2005; "Interim Report," Presidential Commission on Pensions, June 7, 2005; allAfrica.com, July 5, 2004 and October 25, 2005; Ghanaweb.com, August 4 and September 21 and 28, 2005; News in Ghana, October 14, 2005.

# The Americas

## *Mexico*

**CONSAR, the Mexican pensions regulator, has authorized two new asset management companies to increase competition and expand pension coverage to low-income workers.** Beginning in January, millions of low-income workers not covered by social security will be able to set up an individual retirement account with one of these new companies, or *afores*. In Mexico, about 42 percent of the labor force is unemployed, employed only part-time, or employed in the informal economy with irregular income and no benefits and no access to commercial banking. The self-employed have been allowed to contribute to an individual account since June 2005. (See also the May 2005 issue of *International Update*.)

One of the new *afores* will be available through the Coppel Department Store, which has 470 stores throughout the country that sell to some 5 million mainly low-income customers. Bansefi, a government bank, will launch the other new *afore* for its 3.6 million customers who are primarily low income.

Mexico currently has 16 *afores*, whose shareholders include international banks and investment companies. They are permitted to charge account holders a variety of fees including a percentage of earnings, a percentage of real rates of return, a percentage of the account balance, and a "loyalty discount." Since not all companies charge the same type of fees, CONSAR created a method for comparing the different fees by equating them to a fee on the year-end account balance.

Competition has increased and fees have decreased since the introduction of the newest *afore* in October. Today, the average fee for all 16 companies is 2.80 percent on the year-end account balance, with the highest at 4.00 percent and the lowest at 1.55 percent. After five companies lowered their fees earlier this year, Banamex, with 5.7 million of the system's 34 million workers, reduced its charges by 9 percent. When the two new asset management companies begin operation in 2006, Bansefi's rate will be 2.17 percent of the account balance and Coppel's at 2.21 percent.

**Sources:** CONSAR, "Boletín de Prensa," 26 y 30 de octubre de 2005; "Comisiones Equivalentes Sobre Saldo," CONSAR, octubre de 2005; Reuters-Noticias Latinoamericanas, November 15, 2005.

# Reports and Studies

**The World Bank and the United Nations Development Programme issued "Ageing and Poverty in Africa and the Role of Social Pensions," which examined the feasibility of providing noncontributory pensions to the elderly in 15 low-income sub-Saharan African countries.** The study, released by the United Nations in October, concluded that the cost of such an effort, estimated at between 2 percent and 3 percent of each country's GDP, would be prohibitive. It instead recommended targeting noncontributory pensions to a smaller segment of the elderly population, namely, the poor elderly, those over the age of 65 who are living in households that are below the national poverty level. The report further recommended that the pension benefit be limited to about one-third of the poverty level.

Africa's elderly population has had an increasing burden placed on it to head households and care for children, because of the deaths of children's parents from HIV/AIDS, regional conflicts, and a weakening of the extended family support system. Given the diversity of the elderly across the 15 countries studied, the report recommended more country-specific assessments of what is most feasible and cost-effective.

**Source:** "Ageing and Poverty in Africa and the Role of Social Pensions," World Bank and UN Development Programme, August 2005.

***International Update*** is a monthly publication of the Social Security Administration's Office of Policy.

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SSA Publication No. 13-11712