Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

November 2005

Europe

United Kingdom

The government and Britain's public-sector unions have reached a compromise on raising the retirement age for civil servants. Separately, the Pensions Regulator has announced how it intends to oversee private-sector final-salary pension plans.

Secretary for Trade and Industry Alan Johnson announced on October 18 that all current public-sector workers will be allowed to continue to retire at age 60 with a full benefit, but beginning in April 2007, new public hires will have to work until 65 to receive a full pension. Earlier this year, the government sought to extend the retirement age from age 60 to 65 for all civil servants beginning in 2013. (See also the January 2005 issue of *International Update*.) However, strike threats by the 3 million union members caused the government to modify its position. Today, Britain's public pension liability is estimated at £380 billion (US$674 billion). The compromise measure is expected to save £13 billion (US$23 billion) over the next 50 years.

Britain's largest general union, the GMB, is critical of the policy change for new hires, claiming it will create "two-tiered pensions in public services." The compromise has also come under fire from the nation's business community for aggravating the already significant disparity between public and private pensions. According to the Pensions Policy Institute, civil servants in the United Kingdom (UK) generally enjoy between 5 percent and 20 percent more of their final salary from defined benefit pensions than do their counterparts in the private sector. Public-sector pensions are also more secure than private ones. Recent years have seen a majority of private-sector defined benefit plans closed to new members because of underfunding.

In a separate development, on October 31, the Pensions Regulator issued proposed regulations on how it will define at-risk, private-sector pension plans as part of the wider reforms set out in the Pensions Act 2004. A 12-week consultation period is expected to be followed by a formal statement on the regulatory approach early next year.

Under the proposed regulations, company plans will be deemed to be at risk once they hit certain trigger points. Plans will be evaluated on a case by case basis with investigative emphasis on pension funds that are less than 70 percent to 80 percent funded and those whose recovery plans are scheduled to take longer than 10 years to implement. Actuarial consultant Watson Wyatt estimates that more than 2,000 UK companies will have difficulty meeting the new pension deficit guidelines.

Sources: "Occupational Pension Provision in the Public Sector," Pensions Policy Institute, March 2005; *Financial Times*, October 18, 2005; GMB press release, October 18, 2005; *Guardian* (Manchester), October 19, 2005; *Times* (London), October 19, 2005; *Sunday Times* (London), October 23, 2005; FT.com, October 31, 2005; IPE.com, October 31, 2005; CBI press release, October 31, 2005; *Independent* (London), November 1, 2005.

Serbia

At the end of September, the parliament approved reforms to the first-pillar pay-as-you-go system and introduced supplementary voluntary individual accounts. Earlier reforms, in 2001 and 2003, proved insufficient in ensuring the public system's long-term sustainability. Serbia's public pension system has one of the highest dependency ratios in the region, with some 2 million workers supporting 1.4 million pensioners. It is currently running a deficit equal to 7 percent of gross domestic product.

The new first-pillar law requires

- setting a target for a minimum average replacement rate that is equal to 60 percent of the average wage for the previous 3 years; currently, there is no minimum target;
- adjusting benefits twice a year instead of quarterly: benefits will continue to be adjusted to reflect a combination of 50 percent of the rate of inflation and 50 percent of the nominal wage growth;
- beginning in 2008, gradually increasing the normal retirement age by 6 months each year from 63 to 65 for men and from 58 to 60 for women (the earlier reforms increased the retirement age from 60 to 63 for men and 55 to 58 for women);

Another new law establishes the framework for a supplementary system of voluntary individual accounts. It sets March 31, 2006, as the deadline for adopting the implementing regulations. Under the new system, workers and employers will be permitted to contribute to more than one individual account, and each pension fund company will be allowed to manage multiple pension funds. Administrative charges to the worker may include up to 3 percent of the worker's monthly contribution, up to 2 percent of the annual value of assets in the worker's account, and a transfer fee for switching from one management company to another. Workers will be allowed to withdraw their individual account funds at the age of 53 as a lump sum, through programmed withdrawals, by purchasing an annuity, or through a combination of any of these options.

The law lists the categories of allowable investments including government bonds, mortgage bonds, domestic real estate, securities issued by international financial institutions, foreign A-rated debt, and stocks listed on country stock exchanges of the Organisation for Economic Co-operation and Development (OECD) or the European Union. The National Bank of Serbia is charged with overseeing the program and will provide further details on the investments.

Sources: *Social Security Programs Throughout the World: Europe, 2004*; "Serbia and Montenegro: Serbia Consolidated Collection and Pension Administration Reform Project," Project Appraisal Document, Report No. 31655-YU, World Bank, 2005; SeeNews, September 7, 2005; Reuters News, September 29, 2005; Global News Briefs, September 2005; "Law on Voluntary Pension Funds and Pension Schemes," September 2005; "Law on Changes and Amendments to the Law on Pension and Disability Insurance," September 2005; USAID Europe and Eurasia, U.S. Agency for International Development Web site, October 25, 2005.

Asia and the Pacific

Bahrain

The pension administrator for public employees and military personnel, the Pension Fund Commission (PFC), has proposed reducing retirement benefits and increasing contribution rates to avoid insolvency. A recent actuarial study concluded that without corrective measures the PFC will be unable to meet its obligations to government workers by 2026 and to the military services by 2035. The PFC is allowed to make such changes with Cabinet approval, which is expected soon.

The PFC proposal would increase the employees' monthly contribution rate from 6 percent to 7 percent of salary and the government's contribution from 12 percent to 14 percent. Also, pension benefits would be indexed to the rate of inflation instead of receiving the current annual 3 percent increase.

The higher contribution rates are expected to generate an additional BD12 million (US$31.8 million) in annual revenues. This would extend the PFC's ability to meet its obligations to government employees until 2032 and to the military until 2042. The commission is also considering investing a greater portion of PFC reserves outside of Bahrain—in other members of the Gulf Cooperation Council and in China, Europe, and the United States. The PFC will conduct a financial review every 3 years to determine whether additional corrective measures are needed.

The PFC provides a monthly pension at age 60 to public employees after 25 years of service and to military personnel after 20 years of service. The fund covers approximately 78,000 civilian public employees, and in 2004 it paid out BD50.8 million (US$134.7 million) in benefits. (Details on military personnel coverage are not published.)

Bahrain's retirement system for private-sector workers, the General Organization for Social Insurance (GOSI), covers some 159,000 employees or about one-half of the labor force. Mounting expenses in the PFC and the GOSI are causing the government to consider reducing benefits in both systems.

Sources: *Bahrain Tribune*, December 27, 2004, and October 12, 2005; *Pensions in the Middle East and North Africa: Time for Change*, 2005; *Bahrain Business*, October 4, 2005; Bahrain News Agency, October 11, 2005; *Gulf Daily News*, October 6, 12, and 25, 2005.

Reports and Studies

International Monetary Fund

The International Monetary Fund (IMF), on behalf of the Group of Ten (G-10) nations, issued a report in September that examines the economic and financial changes needed to make the transition to an older society. The report, *Ageing and Pension System Reform: Implications for Financial Markets and Economic Policies*, updates a report from 1998, *The Macroeconomic and Financial Implications of Ageing Populations*. Since the 1998 report, many of the G-10 countries have undertaken pension reforms with an emphasis on funded private pensions.

The new report examines the macroeconomic implications of aging populations and the increasing importance of funded retirement plans. Its recommendations consider the impact of global aging on public finances, financial markets, and international capital flows.

The report concludes that

- growth of public and private pension funds will significantly affect capital flows;
- governments will need to develop and expand the variety of financial instruments to accommodate pension funds—the largest G-10 institutional investor;
- regulations will need to reflect better risk management and accounting standards, transparency, and consistency in managing private pension funds;
- financial literacy will need to be improved as more investment risks are shifted from governments and corporations to individuals.

The G-10 countries have taken steps to address the increased costs of pensions resulting from aging by raising retirement ages, increasing contribution rates, reducing replacement rates, moving from defined benefit to defined contribution plans, and shifting market risks from governments and corporations to the individual. However, the report concludes that more drastic changes will be needed to accommodate an aging population and to ensure the sustainability of the pension systems.

The report suggests a greater emphasis on the use of long-term and index-linked bonds to meet the expected future demand from growing pension funds. Britain and France have responded by issuing 50-year bonds, and the United States has announced plans to reintroduce the 30-year bond next year.

The report also warns that the implied health care costs that accompany aging populations may prove to be more substantial than pension costs. Additionally, it discusses the likely influence that an aging population will have on monetary policy and the need for central banks to prepare for the possibility of sudden shifts between asset types (stocks, bonds, real estate) as the elderly sell off one asset class for another.

The G-10 countries participate in the General Arrangements to Borrow (GAB), a supplementary borrowing arrangement that can be invoked if the IMF's resources are determined to be below members' needs. The G-10 countries comprise 11 industrial countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, and the United States.

Sources: Bloomberg, February 23, 2005; *Financial Times*, May 26, 2005; CNNMoney, August 3, 2005; "Ageing and Pension System Reform: Implications for Financial Markets and Economic Policies," International Monetary Fund, September 2005; Reuters, September 26, 2005; Bloomberg, October 19, 2005; Yahoo! Finance, October 20, 2005.

Organisation for Economic Co-operation and Development

A new report by the Organisation for Economic Co-operation and Development (OECD) warns of aging populations overwhelming public finances and recommends policies to keep older workers in the labor force longer by reforming public retirement systems and establishing better employment opportunities. The report, a synthesis of 21 country studies, was presented at the OECD's conference held in Brussels on October 17 and 18, "High-Level Forum on Ageing and Employment Policies." (More information on the forum can be found at http://www.oecd.org/olderworkersforum.)

All 30 OECD countries are expected to face increased longevity and declining birth rates over the next 50 years. However, if work and retirement patterns do not change, by 2050 some member countries will see their worker-to-retiree ratio drop to one worker for each retiree. By that year, more than one-third of the population in Italy, Japan, and Korea will be aged 65 and over compared with about one-fifth or less in Mexico, Turkey, and the United States.

Until recently, the average retirement age in most OECD countries has declined, resulting in a considerable increase in the number of years a worker spends in retirement. In 1970, the average man spent less than 11 years in retirement and the average woman less than 14 years compared with 18 years and 23 years, respectively, in 2004. Today, more than 4 out of 10 people aged 50 to 64 across OECD countries are either unemployed or inactive in the labor market—almost double the figure for younger people aged 25 to 49.

Over the last 20 years, most OECD countries have taken steps to restrain the growth of their public pension systems. Pensions have been reduced by changes in benefit calculations and indexing methods, and normal retirement ages have been increased. Beyond these efforts, the report recommends further reforms to affect a worker's decision of when to retire and to encourage more flexible retirement and work arrangements.

The report concluded that current workplace practices discourage older workers from remaining in their jobs or from being hired at an older age. Recommendations include

- establishing policies to promote greater labor force participation of workers aged 50 to 64,
- using pension reform and tax incentives to encourage later retirement,

- curtailing the use of disability and unemployment programs that encourage an early exit from the work force,
- encouraging job creation through labor market reforms and sound macroeconomic policies in conjunction with pension reform, and
- monitoring and evaluating these measures.

Source: "Synthesis Report: Ageing and Employment Policies," OECD, October 2005.

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