Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

November 2016

Europe

Germany Approves Law on Flexible Transitions from Work to Retirement

On October 21, the German parliament approved a new "Flexi-Pension" (*Flexi-Rente*) law that modifies the earnings test for old-age pensioners who work, allows individuals who work after the normal retirement age to qualify for higher benefits by making pension contributions, and lowers the age at which workers may make "compensatory payments" (*Ausgleichszahlungen*) that reduce the penalty for retiring early. The law will be implemented in phases in January and July 2017. According to the government, the new law will give workers more flexibility in transitioning from work to retirement while increasing the incentives to remain in the labor force past the normal retirement age.

Under the current rules, workers aged 63 to 67 may continue to work while receiving a pension that varies depending on individual earnings. For those with monthly earnings up to €450 (US$496.13), the full pension is paid; for those with monthly earnings above €450, 33.3 percent, 50 percent, or 66.7 percent of the full pension is paid, depending on earnings. The new law replaces this earnings test, effective July 1, 2017, with an arrangement that reduces the penalty for working. For those with annual earnings up to €6,300 (US$6,945.75) (or €525 [US$578.81] per month), the full pension is paid; for those with annual earnings above €6,300, the full pension is reduced by 40 percent of the amount of earnings above €6,300 per year.

Other key provisions of the law include:

- Effective January 1, individuals who work after the normal retirement age (including those who work while receiving partial pensions and those who defer claiming entirely) can choose to continue making pension contributions for higher benefits. Currently, individuals who continue to work after the normal retirement age do not pay pension contributions; employers contribute on their behalf, but the contributions have no effect on benefit amounts.
- Effective July 1, the age at which workers may make compensatory payments will decrease from 55 to 50. At present, workers may claim an early pension from age 63 (or higher, depending on birth year). For those who claim early, the pension is reduced by 0.3 percent for each calendar month the pension is claimed before the normal retirement age. Compensatory payments are lump sum or gradual payments that allow workers to retire early with less or no benefit reduction by prepaying their pension contributions.

Germany's old-age pension system covers employed persons; certain self-employed persons; military personnel; and under certain conditions, caregivers and recipients of unemployment, sickness, and certain other benefits. In general, the normal retirement age is 65 and 5 months (gradually rising by one month a year until 2024 and then by two months a year until reaching age 67 in 2029) with at least five years of contributions. (The normal retirement age may be lower under certain circumstances, including for those with significant periods of unemployment after age 58 and 6 months and for those with at least 45 years of contributions.) An early pension is available at age 63 (gradually rising to age 67 by 2029 when the benefit will be abolished) with at least 35 years of contributions, subject to specific exceptions. In addition, the pension may be deferred (under certain conditions) up to age 70 for a benefit increase of around 6 percent per year of deferral.

Sources: *Social Security Programs Throughout the World: Europe, 2016*, U.S. Social Security Administration, September 2016; "Bundesregierung Beschließt Flexirente," Zeit Online, September 14, 2016; "Entwurf eines Gesetzes zur Flexibilisierung des Übergangs vom Erwerbsleben in den Ruhestand und zur Stärkung von Prävention und Rehabilitation im Erwerbsleben (Flexirentengesetz)," 2016; "Arbeiten Über die Regelaltersgrenze Hinaus," "Die Flexirente: Fragen und Antworten zum Thema," and "Veränderung bei den Hinzuverdienstgrenzen," Deutsche Rentenversicherung, accessed on November 10, 2016.

The Americas

Chile to Expand Investment Options for Pension Funds

On October 13, the Chilean government enacted a new law that will give Chile's six pension fund management companies (AFPs) a range of new investment options and permit them to invest a greater share of their funds in so-called "alternative" assets. Effective November 2017, the AFPs can purchase infrastructure bonds and invest directly in closely held companies (companies with only a limited number of shareholders) and real estate. At the same time, the maximum share of pension funds that the AFPs can allocate to alternative assets will immediately increase from 3 percent to 5 percent and potentially keep rising to 15 percent (the Chilean Central Bank will be responsible for reviewing the limit and setting it between 5 percent and 15 percent).

The government expects the regulatory changes to improve investment returns and diversification in the mandatory individual account program that the six AFPs administer. Compared to their international peers, the AFPs invest less in alternative assets. Among member countries of the Organisation for Economic Co-operation and Development, large pension funds allocate around 15 percent of their investments, on average, to alternative assets—in Chile, the comparable figure is around 2 percent. In addition, since its inception in 1981, the Chilean individual account program has generated diminishing returns—returns averaged 12.3 percent in the 1980s, 10.4 percent in the 1990s, 6.3 percent in the 2000s, and 4.3 percent from 2010 to the present. The Chilean Superintendent of Pensions estimates that average annual returns would increase by 2 percent and future pension benefits would increase between 4 percent and 5 percent if 10 percent of the program's 115 trillion pesos (US$175 billion) in funds were invested in alternative assets.

Chile's pension system consists of a mandatory individual account program, a defined benefit (DB) program, and two social assistance programs. Employees who entered the labor force after 1982 are required to participate in the individual account program and contribute 10 percent of their covered earnings (plus 1.39 percent in administrative fees) to a selected AFP. The DB program only provides benefits to employees who joined the labor force prior to 1983 and who have worked at least 1,040 weeks (men) or 520 weeks (women). To fund the DB program, eligible employees contribute 18.84 percent of their covered wages if they are wage earners or 20 percent to 30 percent of their covered earnings if they are salaried. The social assistance programs offer needy retirees who have resided in Chile for at least 20 years since age 20 either a top-up benefit or a basic pension. The normal retirement age for the individual account and DB programs is 65 for men and 60 for women; for the social assistance programs, the retirement age is 65 for both men and women.

Sources: *Social Security Programs Throughout the World: The Americas, 2015*, U.S. Social Security Administration, March 2016; "Annual Survey of Large Pension Funds and Public Pension Reserve Funds," OECD, April 21, 2016; "Macías: Ley que amplía inversiones de AFP podría elevar pensiones entre 4% y 5%," *El Mercurio*, May 13, 2016; "Valores de Cuota y Fondo," Superintendencia de Pensiones, October 1, 2016; "Chile to Open Up a New Range of Investments to Pension Funds," Bloomberg, October 13, 2016; "Super de AFP detalla efectos de Ley de Productividad en pensiones," *El Mercurio*, October 24, 2016; Ley N°20.956, Diario Oficial de Chile, October 26, 2016.

El Salvador Borrows Funds from Mandatory Individual Accounts to Finance Existing Pension Debts

On September 29, El Salvador's government enacted a reform that allows it to borrow funds from the country's mandatory individual account program to service debts owed to the two pension fund management companies (AFPs) that administer the program. Since 2006, the government has been borrowing funds from the individual account program by selling a special type of low-interest bond called the Pension Investment Certificate (*Certificado de Inversión Previsional* or CIP) to the AFPs. By law, the AFPs are required to purchase all CIPs issued by the government up to a set limit—the limit was originally 35 percent of assets under management, but it rose to 45 percent in 2012. The proceeds from CIP sales are deposited into a special trust—the Pension Obligations Trust (*Fideicomiso de Obligaciones Previsionale* or FOP)—and used to pay benefits owed under two defined benefit (DB) programs that are being phased out. Previously, the government had to draw on its general revenues to finance the CIPs it issued to the AFPs. As of October 7, however, the latest reform permits the government to sell new CIPs to pay the interest and principal it owes on existing CIPs.

Since the introduction of CIPs and the FOP, the government has relied heavily on borrowing from the

AFPs to cover its legacy pension costs. Since 2006, the government has issued over $6.5 billion in CIPs to the AFPs, which had $9.2 billion in assets under management at the end of September. The Salvadoran Association of Pension Fund Administrators, which represents the two AFPs, expects the government to issue $227 million in new CIPs for the 2017 fiscal year to service its outstanding CIP debts with the AFPs. This amount will be on top of the $613 million that the government needs to borrow from the AFPs to finance DB pension benefits for the same period.

El Salvador's pension system consists of the mandatory individual account program, the two legacy DB programs, and a universal basic pension program. The government instituted the individual account program in 1998 as a replacement for the DB programs, which separately covered public- and private-sector employees. At that time, employees who were aged 36 or younger or not insured under one of the DB programs were required to participate in the individual account program; other individuals, however, were allowed to remain in the DB programs. The government introduced the universal basic pension program in 2014 to provide a pension to needy retirees who have never participated in any of the other programs.

Sources: "El Salvador," *International Update*, U.S. Social Security Administration, May 2012; *Social Security Programs Throughout the World: The Americas, 2015*, U.S. Social Security Administration, March 2016; "Boletín de Rentabilidad," Superintendencia del Sistema Financiero, September 2016; "Gobierno usará fondo de pensiones para llegar a fin de mes en octubre," El Faro, September 30, 2016; "GOES pagará deuda con ahorros para pension," *La Prensa Gráfica*, September 30, 2016; "Reforma a uso de fondos de pensión ya está vigente," *La Prensa Gráfica*, October 11, 2016; "El Gobierno planea 'tomar prestado' otros $613 millones para pagar pensiones de 2017," *El Diario de Hoy*, October, 13, 2016; "¿Qué es el FOP y qué tiene que ver con mi pensión?," *El Diario de Hoy*, November 7, 2016.

International

Organisation for Economic Co-operation and Development (OECD) Report Highlights Changes in Pension Markets

On October 31, the OECD released "Pension Markets in Focus, 2016 Edition," a report published annually since 2005 that provides a comprehensive overview of public- and private-sector funded pension systems in 35 OECD member countries and 45 nonmember countries. The report also analyzes other types of pension funding arrangements, including pension insurance contracts and personal retirement plans managed by banks and investment companies. In its analysis, the report draws on a recently expanded database of pension funds developed by the OECD in collaboration with the International Organization of Pension Supervisors and the World Bank that includes data from emerging and developing economies.

According to the report, the value of pension fund investments has been increasing in recent years after declining due to the financial crisis beginning in 2008. In 2015, private pension assets worldwide were worth more than $38 trillion, including $36.9 trillion in the OECD countries and $1.3 trillion in a sample of non-OECD countries. Of the total assets reported, pension funds held $26 trillion (or 68 percent), banks and investment companies held $7.7 trillion (or 20.2 percent), insurance companies held $4.3 trillion (or 11.3 percent), and employers held $0.2 trillion (or 0.5 percent) (through book reserve plans, which are funded through employers' balance sheets). However, the report notes that while pension fund investment returns in 2015 were positive in most countries, they were lower than in 2014.

Other report highlights include:

- The relative size of private pension investments varies significantly across countries, with the largest share of private pension investments found in North America, Europe, Australia, and Japan. In 2015, the United States, United Kingdom, Australia, Japan, and the Netherlands together accounted for 85 percent of all OECD private pension fund investments. Comparing the amount of private pension assets with the size of the economy, as measured by gross domestic product (GDP), provides a good indicator of the relative importance of private funded pensions to the domestic economy. That figure was highest in Chile, Denmark, and South Africa, where private pension assets in 2015 accounted for 70 percent, 206 percent, and 97 percent of GDP, respectively. However, private pension assets represented 20 percent or less of GDP in more than 50 countries inside and outside of the OECD area.
- Although pension fund assets and real returns on the assets (net of expenses) have grown over the past decade, the number of funds has declined in some countries due to cost saving consolidation and, possibly, competition. Between 2005 and 2015, the number of pension funds decreased in 15 of the

35 OECD countries (14 of which are European) and 9 of the 45 non-OECD countries.

- Countries with relatively few pension funds seem to have performed better from 2005 to 2015 than countries with a larger number of pension funds. An econometric analysis conducted for 20 countries (including some of the largest pension markets, such as the United Kingdom and United States) found that countries with 30 to 149 pension funds were more likely to experience higher real net rates of return than those with 150 or more pension funds.

Source: "Pension Markets in Focus, 2016 Edition," Organisation for Economic Co-operation and Development, October 31, 2016.

International Update is a monthly publication of the Social Security Administration's (SSA's) Office of Retirement and Disability Policy. It reports on the latest developments in public and private pensions worldwide. The news summaries presented do not necessarily reflect the views of SSA.

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SSA Publication No. 13-11712
Produced and published at U.S. taxpayer expense