Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

January 2015

Europe

Germany

Effective January 1, contribution rates for the old-age, survivors, and disability insurance (OASDI) public pension program were reduced and the contribution ceiling was raised. The decrease in contribution rates (€2 billion (US$2.4 billion)) in 2015, was made possible by a record-high level of reserves because of a strong economy and labor market.

OASDI contributions reached their lowest level in 20 years, 9.35 percent of earnings each, for the employer and the employee (previously 9.45 percent). At the same time, the maximum earnings used to calculate contributions were raised from €71,400 (US$86,687) to €72,600 (US$88,144) in West Germany and from €60,000 (US$72,846) to €62,400 euros (US$75,760) in East Germany. (Although the social security systems of West Germany and East Germany were merged in 1992, differences remain.) The labor ministry expects the rates to remain at the new level until 2019, rising thereafter to a combined 20 percent for employers and employees by 2020, and to 22 percent by 2030.

Additionally, the scheduled 1-month increase in the retirement age, to age 65 and 4 months, was implemented for workers born in 1950. Since 2012, the retirement age has been rising gradually by 1 month each year until 2024, and then by 2 months until 2029. Workers born after 1964 will receive a full retirement benefit at age 67. In July 2014, the retirement age for a length-of-service pension (for workers with at least 45 years of contributions, generally in physically demanding jobs) was lowered from age 65 to 63 for a limited period. The length-of-service retirement age will rise by 2 months per year beginning in 2016 until it eventually returns to age 65 for those born in 1964 or later.

Sources: "Germany," *International Update*, U.S. Social Security Administration, July 2014; *Social Security Programs Throughout the World: Europe, 2014,* U.S. Social Security Administration, September 2014; "Germany Cabinet Cut in Payroll Taxes to Lowest Level in 20 Years," Dow Jones Institutional News, November 19, 2014; "Germany: Adjusted Contribution Ceilings Effective 1 January 2015," IBIS eVisor, December 28, 2014; "Germany: Adjustments in Mandatory Contribution Rates as of 1 January 2015," IBIS eVisor, December 28, 2014.

Italy

New pension fund investment regulations entered into force on November 28, 2014. The new rules, intended to reinforce prudent management of investments, requires fund managers to have a more diversified portfolio and provide more efficient fund management. Two types of pension funds are affected: (1) second-pillar voluntary private pension funds and (2) mandatory first-pillar social security pension funds for self-employed professionals; assets under management in mid-2014 were roughly €116.4 billion (US$159.3 billion) and around €50 billion (US$68.4 billion), respectively. Under prior investment rules, those funds (especially the second-pillar) have had low-risk portfolios with investments mainly in government and corporate bonds.

Since 2012, the second-pillar funds are required to formalize their individual investment policies in an official investment policy document and establish a financial office to strengthen internal governance. Although some quantitative restrictions remain under the new rules, funds can now acquire investments as long as they match their approved policy statement. The pension regulator (COVIP) monitors fund activity to ensure it meets that requirement. Allowable investments include mutual funds, derivatives, commodities, and currency. Short-selling remains prohibited, and pension funds must allocate at least 70 percent of their portfolio to listed financial instruments.

Although the same investment limits and efficient management requirements apply to the first-pillar funds, they are not yet required to create an investment policy statement. In December 2014, public consultation on similar provisions for first-pillar funds ended and new regulations are pending.

The pension funds supplement Italy's public pension system, classified as a notional defined contribution program, for workers who began working on or after January 1, 1996. Transitional rules apply to all other workers. A means-tested social pension is paid to those who do not qualify for the contributory pension.

Sources: "Italy: A New Order," ipe.com, July 2012; "Italy: Still Waiting," ipe.com, July 2013; "Italy: Freedom Beckons," ipe.com, July 2014; *Social Security Programs Throughout the World: Europe, 2014,* U.S. Social Security Administration, September 2014; "Italy Approves New Investment Rules for Second-Pillar Pension Funds," ipe.com, November 14, 2014; "New Regulation Regarding Occupational Pension Investment Parameters in Effect," e-Visor, November 22, 2014; "New Italian Pensions Regulation Now in Force," eversheds.com, December 9, 2014.

The Americas

Organisation for Economic Co-operation and Development (OECD) Report

On December 1, 2014, the OECD released Pensions at a Glance: Latin America and the Caribbean, the first publication on the Americas in the *Pensions at a Glance* series. Produced together with the Inter-American Development Bank and the World Bank, the report examines pension systems in the region, including recent trends and two major policy challenges—pension coverage and adequate benefits. Pension coverage refers to both workers who are enrolled in a pension program and people of retirement age who are receiving some type of pension.

According to the report, despite the pension reforms implemented in Latin America and the Caribbean (LAC) over the past few decades, the proportion of the labor force with pension coverage has remained about the same, about 45 percent, on average. However, when considering active participation, the question of adequate benefits arises. Active participation is often expressed as contribution density—the portion of months a worker contributes to social security compared with the maximum number of months the worker could have contributed. Workers often have irregular contribution patterns (also called low contribution density) because they go in and out of the formal labor force during periods of unemployment or time spent in the informal labor force. Low density, a recurring problem in the region, means that at retirement, a worker may be eligible for a minimum or low benefit or may not qualify for any type of contributory benefit.

The report finds that education, gender, and income determine participation rates. Workers who are more educated and have higher incomes are more likely to contribute. Women have lower rates than do men, on average, 56 percent and 83 percent, respectively. Other factors affecting the participation rate are the type of employment (64 percent of salaried workers compared with 17 percent of self-employed persons) and the size of the employer (71 percent in companies with more than 50 employees participate, 51 percent in companies with 6 to 50 employees participate, and 24 percent with fewer than 6 employees participate).

The report indicates that to address the low coverage issue, many countries in the region (and around the world) have implemented some type of noncontributory pension program (also called social pensions). Since 2008, nine LAC countries have either introduced new social pension programs or expanded existing ones. Coverage of social pensions varies among countries in the region. For example, Bolivia's social pension is universal (reduced for persons also receiving contributory benefits); Venezuela pays social pensions only to those who do not receive any contributory pension; and, Chile's social pension is paid in addition to a low (or no) contributory benefit.

According to the report, social pensions have increased coverage of the overall population aged 65 or older in the region. Currently, more than half of that population receives social pensions in six LAC countries. However, there are also countries with minimal coverage (El Salvador, Paraguay, and Peru) and others with no coverage (Haiti, Honduras, and Nicaragua).

The report provides current demographic data and projections for the region. On average, life expectancy at age 65 is expected to reach 22 years for women and 18.9 years for men by about 2050. In addition, the old-age support ratio (the ratio of workers to retirees) is projected to decrease from the current 8:1 to 2.5:1 by 2060, on average.

The report compares gross replacement rates (the percentage of preretirement earnings that the pension replaces) across the region. The gross replacement rate for workers with average earnings throughout their career who start working today is estimated at 62 percent on average in 26 LAC countries (ranging from less than 30 percent in the Dominican Republic, Mexico, and Surinam, to more than 90 percent in Ecuador, Nicaragua, Paraguay, and Venezuela).

The report recommends that to help close the coverage gap, countries should implement measures to incorporate more workers (especially women) in the formal labor market so they can increase their pensions "in their own right." At the same time, the report praises the effectiveness of social pensions; but, based on the aging of the population, it advises countries to evaluate the future financial sustainability of the current programs. Finally, the report emphasizes the importance of evaluating how well the contributory and noncontributory pension programs interact.

Source: Pensions at a Glance: Latin America and the Caribbean, OECD/IDB/The World Bank, December 2014.

International

Organisation for Economic Co-operation and Development (OECD) Report

On December 8, the OECD released *Pensions Outlook 2014*, the second in a series of public policy reports that examine public and private pension programs in OECD countries. The 2014 edition is divided into five chapters: (1) the challenges of population aging and longevity risk, (2) recent pension reforms, (3) the role of private pensions, (4) expanded coverage through automatic enrollment, and (5) the importance of national pension statements and public education campaigns.

According to the report, in OECD countries, rapid population aging and rising life expectancy are increasing the fiscal pressures on public pension systems. By the end of the century, there could be one worker for every retiree, on average, across the OECD region. In addition, the number of years spent in retirement is projected to increase by 1 year per decade. As a result, with no changes, the European Commission projects that spending on public pensions will increase by 8 to 10 percentage points of gross domestic product by 2060. To address the impact of aging on pensions, the OECD recommends the following:

- *a multipillar pension system*—a public pay-as-you-go (PAYG) program as the first pillar, occupational pensions as the second pillar, and personal pensions as the third pillar.
- *a link to life expectancy of certain parameters, with regular adjustments*—for retirement age, number of contribution years, or differences in socioeconomic levels.
- *an increase in the number of years required*—when benefits are based on accumulated assets (defined contribution (DC) plans).
- *partial annuitization*—for DC plans.
- *delayed retirement*—to make sure the differences in mortality rates and life expectancy across socioeconomic groups are considered.

The second chapter of the report describes pension reforms in 34 countries between February 2012 and September 2014. Measures implemented to address fiscal sustainability include making small benefit cuts (in only a few countries); raising taxes on pensions and/or on contributions to PAYG systems; freezing or lowering the indexation of benefits; raising the retirement age; discouraging early retirement; and, encouraging later retirement. Measures to address income adequacy include extending coverage (that is, to the self-employed) and raising the level of mandatory contributions to DC programs. The issues that still need to be addressed in many OECD countries include the following:

- an increase in the effective retirement age,
- intergenerational sharing of the financial burden,
- insufficient participation in and contributions to voluntary pension plans, and
- lack of trust in the system.

The third chapter examines the importance of private pensions in relation to overall retirement savings for the working-age population in six OECD countries (Chile, France, the Netherlands, Norway, the United Kingdom, and the United States). Their importance depends on a number of factors including voluntary or mandatory participation; incentives (if participation is voluntary); maturity of the system; contribution level; retirement age; and, the economic conditions in the country.

Among the six countries studied, 29 percent to 42 percent of the working-age population has projected pension income (based on the current value of accrued benefits or savings) lower than the average pension income of current retirees. Those workers, generally, have the following characteristics: low-income, older generation (except for Chile because of transition benefits), female, and self-employed. The report recommends that private pension policy target groups such as the self-employed, who need the coverage the most.

In chapter four, the report examines the effect of automatic enrollment on increasing coverage in private pension programs. The elements that help determine the success of such programs include the following:

- an opt-out feature,
- the contribution-rate levels,

- incentives,
- defaults,
- fees, and
- the costs to the government and the employer.

The report advises countries setting up an automatic enrollment feature to consider identifying which groups need higher private pension coverage; targeting those groups; eliminating barriers to enrollment; limiting the opt-out period; defining default contribution rates; providing financial incentives to individuals with low- and middle-income earnings; and, limiting early withdrawals and contribution holidays.

The last chapter emphasizes the importance of national pension statements and public education campaigns, especially when major reforms are implemented. The report indicates that the ideal statement incorporates information from all components of the pension system; it should not be a "passive document." The statement should generate the member's interest and provide information on the effect of increasing contributions and delaying retirement. (The best way of presenting meaningful projections has not yet been determined.) The statement should be accompanied by more detailed online information, which provides a more flexible format. In addition, national pension communication campaigns (NPCCs) should be short and simple, with clear and measurable goals that are regularly evaluated. Also, NPCCs should be conducted as part of major changes to a pension system or to quickly communicate government action relating to financial crises, and so forth.

Source: *Pensions Outlook 2014,* OECD, December 2014.

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