Social Security

International Update:

Recent Developments in Foreign Public and Private Pensions

June 2007

Europe

Slovak Republic

In the 2 years since its introduction, Slovakia's mandatory individual account pension sector tripled in value from 9 billion SK (US$361.2 million) at the end of 2005 to 28 billion SK (US$1.1 billion) today. About 1.54 million workers, or 60 percent of Slovakia's workforce, participate in a mandatory individual plan. These plans are funded and form the second pillar of Slovakia's three-pillar pension system.

There are six pension fund management companies authorized to offer mandatory individual accounts. These companies are licensed by the Slovak Financial Market Office and regulated by the state-run Social Insurance Institute.

The Slovak Republic added a mandatory individual account system in January 2005 to its existing public and voluntary pension systems (see also the February 2004 and February 2005 issues of *International Update*). The goals of the pension system are to

- ensure long-term sustainability of public finances,
- ensure that future pensions reflect contributions made, and
- increase the profile of voluntary pension schemes.

When the mandatory individual account system began in 2005, new entrants to the workforce were required to participate in this system. All other workers had the option to join the new plan or remain in the public pay-as-you-go (PAYG) system. As a result, the majority of mandatory individual account investors are relatively young. The age breakdown of current contributors is as follows:

- 38.10 percent are aged 20 or younger,
- 38.48 percent are aged 21–30,
- 20.52 percent are aged 31–40,
- 0.70 percent are aged 41–50, and
- 2.20 percent are aged 51 or older.

Workers participating in the new mandatory individual account pension system choose their pension fund management company and may switch companies once a year. Workers can select pension funds among three risk categories: growth, balanced, and conservative. Currently, 65 percent of Slovakia's mandatory pension funds are invested in the growth category, 31 percent in the balanced category, and 4 percent in the conservative category. Some economists attribute the high percentage of funds invested in the growth category to the generally long-term retirement strategy that younger workers tend to prefer.

In 2006, growth funds produced real returns from 3.1 percent to 5.2 percent, balanced funds from 3.2 percent to 4.8 percent, and conservative funds from 2.8 percent to 3.7 percent. About 20 percent of all occupational fund assets is invested in bonds and equities. The remaining 80 percent is invested in bank accounts earning returns of around 2.0 percent to 2.5 percent. To ensure against unexpected fluctuations of participants' account assets before retirement, the mandatory individual account system requires assets to be shifted to a balanced or conservative fund at least 15 years before the participants reach retirement age.

Workers contribute 7 percent of their gross monthly earnings to the public PAYG pension system but do not contribute to their mandatory individual account pension plans. Employers contribute 8 percent of their gross monthly payroll to the public system and 9 percent of gross monthly payroll to the workers' mandatory individual accounts. The minimum earnings for contribution purposes in both cases are equal to the minimum monthly wage of 6,900 SK (US$276). The full retirement age for both the PAYG system and mandatory individual pension plans is age 62 for men and age 55 and 3 months for women (rising to age 62 by 2015) with at least 10 years of contributions.

Sources: BIATEC (Volume 14), May 2006; *Social Security Programs Throughout the World: Europe, 2006*; "Economic Survey of Slovak Republic," Organisation for Economic Co-operation and Development, April 2007; *Investment and Pensions Europe*, May 14, 2007; "Economic and Financial Data for Slovak Republic," Statistical Office of the Slovak Republic, May 22, 2007.

The Americas

Mexico

On April 19, 2007, the Mexican Congress passed an amendment to the 1997 Retirement Savings System Law that changes the administrative fee structure for the system of individual retirement accounts. Beginning in 2008, pension fund management companies (AFOREs) may no longer charge account holders a fee on their monthly contributions and may only charge a fee on the individual account balances. The amendment also requires CONSAR, the Mexican pension regulator, to establish a *net rate-of-return indicator* that will allow account holders to compare easily the net rates of return among all 21 AFOREs. The AFORE trade association predicts that by 2010, fees based on the account balances could decline by about 45 percent because the new rules on administrative fees are likely to increase competition among the AFOREs.

AFOREs may currently charge account holders two types of fees: on their monthly contributions and on their account balances. Many AFOREs also offer a *loyalty discount* to account holders who remain with the same AFORE for a number of years. From 2005 through 2007, when a number of new AFOREs entered the market, fees as a percentage of monthly contributions decreased by 25 percent among all of the AFOREs and fees on the account balances increased by 77 percent.

Separately, in May 2007, CONSAR announced that it will raise the allowable limit on AFOREs' investment in equities from 15 percent to 30 percent of their assets. Also, each AFORE will be allowed to offer five different types of funds (instead of two currently) with varying levels of risk designed for certain age groups. These new funds will range from Fund 1 (intended for workers aged 18–26) with up to 30 percent in equities to Fund 5 (targeted toward workers aged 56–65) with fixed income and international investments.

CONSAR estimates that these three provisions—eliminating the fee on the monthly contribution, broadening the allowable AFOREs' investment portfolios, and increasing the number of funds that each AFORE can manage—could raise, by at least 17 percent, an average worker's individual account balance by the time he or she reaches retirement.

All of these changes to the individual account system follow recommendations in a November 2006 report by Mexico's Federal Competition Commission. The report concluded that current administrative fees in Mexico are more than double the fees in the other Latin American countries with individual account systems. The Commission also found that the fees in Mexico are so high that the net rate of return for current account holders is almost zero in real terms.

As of December 2006, about 36 million Mexican workers had individual retirement accounts with total assets under management of about 8 percent of gross domestic product (nearly US$14.3 billion) and an average gross real rate of return since 1997 of about 7.8 percent. Workers may switch AFOREs once a year or more often if they are changing to an AFORE with lower administrative fees.

Workers contribute 1.25 percent of monthly earnings and employers contribute 5.15 percent of payroll to the workers' individual accounts. The Mexican government provides a subsidy (currently about US$0.028) for each day of an entire working life that workers contribute to individual accounts. This subsidy is deposited into the workers' accounts every 2 months.

Sources: *Social Security Programs Throughout the World: The Americas, 2005*; Comisión Federal de Competencia, "Oficio PRES-10-096-2006-162, el 22 de noviembre de 2006; *Boletín Estadístico AIOS*, Número 16, diciembre de 2006; CONSAR, "Consideraciones sobre los cambios a la ley del SAR," abril 2007; Reuters Noticias Latinoamericanas, el 19 de abril de 2007; *El Economista*, el 23 de abril de 2007; *El Norte*, el 28 de abril de 2007; IMF Country Report No. 07/164, May 2007; *The Fund Pro Latin America*, May 16, 2007.

Asia and the Pacific

Singapore

Beginning July 1, 2007, Singapore's provident fund contribution rates will increase for most members, while employee and employer contribution rates for low-wage workers will decrease. The government will introduce a new income supplement program to offset the reduction in contributions for these low-wage workers. In addition, the relatively high provident fund sales charges and expense ratios on member accounts will be capped. The government action to cap these fees is intended to help raise the returns on member accounts. These costs are currently about 2.8 times and 1.8 times, respectively, those for similar funds in the United States.

Singapore's provident fund is the state-run mandatory savings program for workers aged 55 or younger. Employees generally contribute 20 percent of their monthly earnings above S$500 (US$327) into three separate accounts: (1) for home purchase and education, (2) for retirement, and (3) for medical expenses. Participants aged 50 or older contribute at lower rates.

The new rules for provident fund contributions will

- increase the employer contribution rate from 13 percent to 14.5 percent of an employee's monthly wages for the majority of workers;
- decrease the employer contribution rate for workers older than age 35 who earn S$1,200 (US$784) or less, to encourage employers to hire older lower-income workers; and
- decrease the employee contribution rate for employees with monthly earnings from S$500 to S$1,500 (US$980) in an effort to increase their take-home pay.

Under the new income supplement program, low earners aged 35 or older will have semiannual payments deposited into their member accounts based on their age, earnings, and occupational status over the previous 6–12 months.

The government of Singapore is mandating that provident fund sales charges and expense ratios be reduced in an effort to increase investment returns. Fund managers have up to 12 months from the following implementation dates to comply with the new rules or risk cancellation of their licenses:

- Effective July 1, 2007, front-loaded sales charges (provident fund member account fees paid to distributors, such as insurers and banks *or* financial advisors) on new investments will be reduced from 5 percent to 3 percent.
- Effective January 1, 2008, licensed investment funds must limit their expense ratios (annual investment management fees) from 0.65 percent to 1.95 percent of the fund's average net assets, depending on the risk profile of the fund.
- Each year, the provident fund pays its members a guaranteed nominal rate of return of at least 2.5 percent to the home purchase and education account and 4 percent to the other two accounts. Provident fund members in search of higher returns may invest their provident funds with any of the more than 400 licensed investment funds. At the end of 2006, the private sector managed S$31.4 billion (US$20.5 billion) in provident fund assets, approximately 26 percent of gross domestic product.

Sources: Central Provident Fund Board, December 28, 2006; Singapore Ministry of Manpower, February 16, 2007; Singapore Budget 2007; *Social Security Programs Throughout the World: Asia and the Pacific, 2006*; Watson Wyatt, April 2007; Pension Research Council Working Paper (WP2007-12), May 2007.

Africa

Kenya

On May 21, 2007, Kenya's Retirement Benefits Authority (RBA) approved the Zimele Personal Pension Plan, a voluntary retirement savings program for all public- and private-sector workers. The Zimele Personal Pension Plan will be operated under the auspices of the RBA and will be managed by the private firm Zimele Asset Management Company.

The Kenyan government established the RBA under the Retirement Benefits Act of 1997 to provide for the regulation, supervision, and promotion of private-sector retirement benefit plans, the development of the retirement benefit sector, and other retirement-related purposes. The priorities of the RBA, as established by the trustees, are to

- educate workers on the benefits of saving for retirement,
- educate pension plan members and trustees about their rights and obligations,
- expand voluntary participation in retirement plans under its supervision from the current rate of 15 percent to the entire labor force,
- obtain greater tax incentives for retirement benefit plans,
- protect members' benefits from fraud and loss, and
- increase domestic savings and economic growth.

Currently, about 15 percent of Kenya's labor force is covered by a voluntary private pension plan under the authority of the RBA. These pension plans hold assets of approximately 207 billion shillings (US$3.13 billion), which is 18 percent of gross domestic product.

Kenya also has a government-operated provident fund system covering private-sector workers, the self-employed, some farmers, and employees in the informal sector. Approximately 67 percent of Kenya's workforce is covered by the provident fund. Workers contribute 5 percent of monthly earnings and employers contribute 5 percent of monthly payroll to the fund. The self-employed contribute a mandatory 5 percent of monthly earnings to the fund and may contribute more voluntarily. The retirement age is 55 for both men and women. Upon retirement, benefits are paid as a lump sum equal to total contributions and interest accrued, rather than as a monthly pension. The provident fund also allows for preretirement distributions, generally for significant life events such as the purchase of a house, medical expenses, and education expenses.

Kenya has a separate system for public-sector employees called the Civil Service Scheme (CSS). Approximately 22 percent of Kenya's workforce is covered under the CSS pay-as-you-go system. The retirement age is 55 or older for men and women, with CSS retirees receiving a monthly pension benefit based on salary and years of service.

Sources: *Social Security Programs Throughout the World: Africa, 2005*; *CIA World Factbook*, 2007; Retirement Benefits Authority, 2007; *Zimele Weekly Update*, April 10, 2007; *The East African Standard*, April 10 and May 21, 2007.

Reports and Studies

Organisation of Economic Co-operation and Development

On May 10, 2007, the Organisation of Economic Co-operation and Development (OECD) issued guidelines to help member governments and their pension fund regulators improve the oversight and financial prospects of occupational pension funds. The guidelines address such issues as the funding and valuation of pension plans and the protection of employee interests in company pension plans, particularly defined benefit plans. Occupational pension plans are common in many OECD member countries, including Canada, Germany, Japan, the Netherlands, the United Kingdom, and the United States.

The guidelines identify best practices for regulating occupational pension plans in the following four areas:

- *Occupational pension plan management.* Plan assets in defined contribution plans should be held in a pension fund or managed directly by financial institutions through a pension insurance contract or authorized retirement savings product. Assets in defined benefit plans should be managed through a pension fund or insurance contract. The guidelines recommend an insolvency guaranty scheme for defined benefit plans financed through a book reserve system reported as pension liabilities on the employer's balance sheet.
- *Actuarial evaluations.* An actuary or equivalent specialist should be required to calculate defined benefit pension plan liabilities at least once every 3 years. Accurate liability estimates should consider the vesting of pension plan members, the increasing life expectancy of beneficiaries, and the long-term cost of adjusting benefits to changes in the cost of living.
- *Targeted funding.* These rules would require identifying and maintaining a targeted funding level sufficient to meet a defined benefit plan's potential liabilities. Targeted funding should require contribution increases if the plan becomes underfunded and adjustments when benefits or retirement ages change. Additionally, funding rules should provide incentives to build pension plan reserves as protection against market downturns.
- *Plan termination.* Pension plan rules should indicate how to allocate funding excesses or surpluses when assets exceed promised benefits. Alternatively, there should be rules concerning the allocation of benefit payments when assets are insufficient to cover promised benefits. The guidelines recommend establishing rules to determine the extent of a plan sponsor's responsibility for any unfunded liabilities when a plan is terminated. Creditor rights of pension plan members and beneficiaries should be recognized if a plan sponsor goes bankrupt.

The OECD expects these guidelines to influence the pension plan regulatory activities in OECD member countries, where over 1 million occupational pension funds managed more than US$16 trillion in assets at the end of 2005. The pension industry, business groups, and trade unions in these countries assisted in developing the guidelines. The OECD will evaluate the impact of these guidelines in 2010.

The full text of the guidelines is available at http://www.oecd.org/dataoecd/3/22/38547978.pdf. The report name is *OECD Guidelines on Funding and Benefit Security in Occupational Pensions*.

Sources: OECD, press release and *OECD Guidelines on Funding and Benefit Security in Occupational Pensions*, May 10, 2007; AFX International Focus, May 10, 2007; *Pension & Benefits Daily*, May 14, 2007.

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Editor: Denise Lamaute.

Writers/researchers: Richard Chard, Barbara E. Kritzer, Jennifer McNabb, and David Rajnes.

Social Security Administration
Office of Policy
Office of Research, Evaluation, and Statistics
500 E Street, SW, 8th Floor
Washington, DC 20254

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