“Solving the Pensions Crisis across the Globe”

by Mark Cobley, **Financial News, 10 Dec 2013**

In 2014, it will be the 125th anniversary of the pension scheme. Otto von Bismarck, the Chancellor who unified Germany, introduced the world’s first state pension in 1889 – but the concept has not aged well.

The basic design of the Bismarckian contributory pension – you pay into a fund throughout your working life, which entitles you to a guaranteed income from the age of 65 onward that is closely related to your previous salary – has been undermined by radically shifting demographics. Ageing societies in the west can no longer afford these pensions, and most people in the world’s poorer countries have never had one anyway.

Yet something must be done to finance the world’s old age. Global policymakers, together with private-sector leaders, have finally accepted that they can no longer delay. Larry Fink, the chief executive of BlackRock, the world’s largest asset manager, has been among those urging action. He told Financial News: “The fact is, a lot of national pension plans often don’t pay enough to fund a satisfactory retirement, and the problem is compounded by many of them being underfunded. “Just as individuals have to be more proactive, so do governments. The current structures in place in most countries are simply insufficient to address retirement needs, especially in light of increased longevity.”

The demographic challenge is, in the words of Indian pensions expert Kavim Bhatnagar, “awe-inspiring”. He points out that population ageing is not just a western problem. About 100 countries, including India, Bangladesh and Venezuela, are set to double their populations of older people in the next couple of decades, he said. European nations such as France or the UK took more than a century to make the same transition.
He added: “These are also the countries where the coverage of old-age social security is almost missing, with 80% to 90% of the current working populations with no social security or pensions. The majority of older women are either widowed or deserted.”

Michael Herrmann, economic adviser to the UN Population Fund, said: “In countries like these, ageing is typically financed through informal family transfers. But people are moving into cities and those traditional family structures are breaking apart. That system won’t be sustainable.” Hundreds of millions – if not billions – in rural areas and the informal economy in much of southern Asia and Africa are outside western-style financial systems. Many do not even have bank accounts, let alone pension schemes.

Economies in East Asia are often more developed, but the demographic challenge there is even more pressing. Robert Palacios, senior pensions economist at the World Bank, said: “Much of east Asia is in a race against time; a race to expand coverage of pension systems as the population ages. Japan has obviously a very high pensions coverage. But if you look at China, Thailand, Vietnam… when they converge on the demographic profile of Japan, and you look at how fast they have to expand coverage, it’s a monumental task.”

In China, the world’s most populous nation, a looming demographic crunch is unlikely to be alleviated by the government’s recent “rather mild” relaxation of its one-child policy, according to Stuart Leckie, chairman of Hong Kong-based consultancy Stirling Finance and an expert on the Chinese system. He explained: “Previously, if two only-children married, they could apply to have a second child. Now what they are saying is that if only one of the parents is an only-child, they can apply. Over the last few years, about 16 million children have been born in China every year. People say that this new policy might encourage an extra one million births a year. “Going from 16 million births to 17 million, in a country of 1.35 billion, is not going to solve the problem.”

In many developed economies, meanwhile, the guaranteed pension payable after 65 – the contributory defined-benefit scheme – is under severe pressure, if not already abandoned. A contributing factor to DB's demise has been that many nations have operated state DB systems on a pay-as-you-go basis: contributions into the system from current workers are paid directly to current pensioners. The workers build up a paper entitlement instead of an actual fund, and their pensions are then paid out of the contributions of tomorrow's workforce.

Nick Sherry, a former Australian pensions minister, recently addressed an **industry conference** on pensions reform in Hong Kong, organised by the **W**orld **P**ensions **C**ouncil. Speaking at the sidelines of the conference, he told Financial News: "There is nothing wrong with pay-as-you-go in principle, if you are able to keep the cost manageable. "Most countries have failed to do this. When retirement ages were set 100 years ago, they were set at the early to mid-60s, and most people did not live far beyond this. Countries like Greece, Spain and Portugal have got into trouble because the level of promise was much too generous and applies to most people.
"Clearly, Italy and France and ultimately Germany and Japan have similar promises that have been made. Demographics is creating enormous cost pressures on government."

In the UK and US, he said, these same pressures apply to schemes in the public sector. In the private sector, DB promises tend to be funded, and have now been withdrawn because the funds were insufficient to pay for rising longevity. Sherry added: "I predict that public-sector DB in the US and UK will be gone in five to 10 years."
Radical pensions reforms have a political cost and can lead to strikes and demonstrations.
Nevertheless, the demographics are inexorable. Last week, the UK set out new plans to raise the retirement age to 70 in the long term – putting it at the vanguard of international efforts to tackle rising life expectancy. Denmark and Italy have raised it to 69 in recent years; Ireland, the Czech Republic and Greece (see boxout) to 68.

Reforms can have immediate benefits. Last week the ratings agency Moody's said Spain's plan to decouple state pensions from inflation – announced in September – was "positive" for its outlook on the country's debt, which it rates one notch above junk. The agency did not upgrade Spain, but it did shift its outlook from "negative" to "stable". The response to these twin challenges – reforming systems in the rich world, and extending them to the global poor – is taking a variety of forms, but a couple of outline trends are increasingly discernible. The first and clearest is that most pension systems, whether public or private, will be based upon the principle of defined contributions. Unlike DB, DC schemes do not promise a guaranteed pension income.
Instead, contributions are saved up in a personal account for each worker, which is swapped for a pension upon retirement.

From its beginnings in Chile, Sweden, Australia and the US in the 1980s, DC has spread around the world in the past couple of decades. Latin American nations such as Mexico, Peru and Colombia followed Chile's lead in the 1990s and early 2000s, shifting from public social security systems towards private DC funds. Following the collapse of Communism, many eastern European states followed this model as well. Meanwhile, the Anglo-Saxon nations have replaced private DB systems with private DC systems. Today, both India and China are in the process of developing DC-based public systems and extending them to broad swathes of the population. Brazil is planning to introduce a DC top-up for its federal employees.

A shift toward investing pension contributions in the financial markets is often – but not always – coupled with the move from DB to DC (see accompanying article: "*Private sector eyes increased role*"). However, some observers now detect a new trend emerging, especially in the global south. Chile, the test-bed for privatisation in 1981, embarked on a fresh reform in 2008, introducing a new public "safety net" pension, funded out of general taxation. Palacios believes that such non-contributory systems, or contributory systems where the state matches payments-in from people without formal employment, will play a large role in extending pensions to the world's poor. He said: "In Mexico this year, the government has declared that it's going to have a universal, non-contributory pension. In China, you have this expansion of the rural pension system, which is probably the most ambitious and rapid expansion of pensions coverage in history. It will be partly financed by matching contributions from federal and local government, and contributions from the individual.

“Globally, there is an increasing shift away from dependence on the old Bismarckian system; on payroll taxation and contributions, and the link to formal-sector employment.”

• Greek woes lead to ‘drastic’ remedy

During the past few years of crisis, bailout and political upheaval, at the behest of its international lenders Greece has implemented probably the most radical pensions reforms undertaken by a developed country. And there may be more to come, writes Mark Cobley. Georgios Symeonidis, a board member at the Hellenic Actuarial Authority and adviser to the Greek Labour Ministry, describes the redesign of Greece’s state system – which accounts for about 99% of all pensions paid – as “drastic”. In 2010, payouts were cut, with the earnings-related portion of the state pension linked to career-average salaries instead of final salaries, which tend to be higher. A cap on increases in public pensions spending: 2.5 percentage points of GDP between 2009 and 2060 was also introduced that year. The Hellenic Actuarial Authority is to run projections every two years and if it estimates that the increase is exceeding that limit, pensions will be adjusted.

Symeonidis said: “This clause makes the system a self-correcting one.” In 2012, the system of additional public occupational schemes, which overlies the state system, was converted to “notional defined contribution” – meaning that its payouts can be reduced if life expectancy climbs. The state pension age was lifted from 65 to 67, with further increases in this also tied to longevity. The OECD predicts 68 by 2050.

Launching the OECD’s Global Pensions Report in London last month, Stefano Scarpetta, director of the organisation’s employment, labour and social affairs directorate, said: “In our last publication [in 2011] we were forecasting that public pension expenditure in Greece would rise to 24% of GDP by 2050. Following the troika reforms, we now think this will be 15.4%.” The current OECD average is 9.3%, predicted to rise to 11.7% by 2050.

This year Greece has overhauled its pensions administration and data systems, and there has been a crackdown on contribution evasion – commonplace in previous years. The government has also convened a “special committee” of pensions experts to recommend further reforms, with a possible implementation date of 2015. Nick Sherry, a former Australian pensions minister, is preparing a survey of 15 pension systems worldwide for the Bank of Greece. Symeonidis said there were discussions between policymakers, politicians and pensions experts over a defined-contribution reform of some elements of the Greek system. He said: “One part of the system will have to change to DC, because we are all living longer.”