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The Icelandic Pension System in 2004

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I. Overview

The pension system in Iceland is chiefly characterized by the operation of occupational pension funds.[1] These funds became general in 1969 and mandatory by law in 1974. This resulted from general wage settlements after tri-party negotiations between labour unions, the Federation of Icelandic Employers, and the state. Under the agreement, every wage earner working in the private sector is obliged to contribute a minimum of 10% of his wages to an occupational fund of his choice or, in most cases, a fund predetermined by his trade union. However, more than half of the burden is carried by the respective employer, who currently contributes a minimum of 6% of the total contribution. Although the minimum contribution rate is set by law, the system is not a pure defined contribution system since the minimum benefits are also stipulated in the pension law – the minimum replacement ratio for a 40-year contribution is 56%. If the benefits go below this threshold, the contributions have to be raised. The system is thus a hybrid between a defined benefit and a defined contribution system.

State employees have a similar, but more generous, arrangement as full pensions rights are earned by contributing for 32 years, compared with 40 years on the general labour market. The state employee system is a defined benefit system – the employee contribution rate is fixed at 4% of wages by law. Despite the prevalence of the occupational funds, two other pillars also support the pension system. These are a tax-financed, pay-as-you-go income-tested social security system and a voluntary individual accounts scheme with tax incentives. The importance of the former is likely to diminish in the near future since the general public pensions are mainly aimed at the lowest income earners, and the mandatory nature of the occupational funds makes it unlikely that anyone will reach retirement age without owning a significant balance in private funds. On the other hand, the appearance of the individual account system is relatively recent, since legislation granting this privilege only went into effect in 1999. However, it is estimated that about 52% of wage earners are already paying into individual accounts and around 10% of the total assets of the pensions system is in such schemes.

The social security system pays a basic pension from the age of 67 and a means-tested supplementary pension after retirement. Occupational pension schemes pay somewhat different old age pensions, depending on their financial position and the relative weights of other forms of pensions. It has been estimated that a typical general occupational pension fund will, at full maturity, be able to pay a pension amounting to 60-70% of full-time earnings, giving a total replacement ratio of up to 80% when the social security pension is added.

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1 This overview is based on the paper: Iceland: Country Overview 2003, compiled by Arnór Sighvatsson, Chief Economist of the Central Bank of Iceland, for the National Association of Pension Funds in Iceland.

The age distribution among the Icelandic population is relatively favourable, compared with continental Europe, and the number of retirees, compared with the working age population, is currently low and is estimated to remain so for the next few decades. The asset-building nature of the current pension system therefore makes it unlikely that a higher dependency ratio will result in a fund shortage or require higher taxes to finance retirement schemes in the future. Although the current situation is favourable in Iceland, early retirement will most likely increase as the population grows older. In addition, the establishment of the individual accounts system in Iceland might encourage early retirement when the system has matured, as withdrawal is possible from the age of 60 until the official retirement age.

II. Pensions

The social security system

The Icelandic social security system was founded in 1936 with the main goal of ensuring the livelihood of those unable to work because of old age or disability. In order to enjoy full benefits, individuals must have lived in the country for at least 40 years. The system provides basic old-age pension benefits, supplementary means-tested pensions, disability, sickness, maternity, survivor, etc., benefits. Furthermore, there is a special system for unemployment benefits, and the municipalities provide housing benefits and poverty assistance.

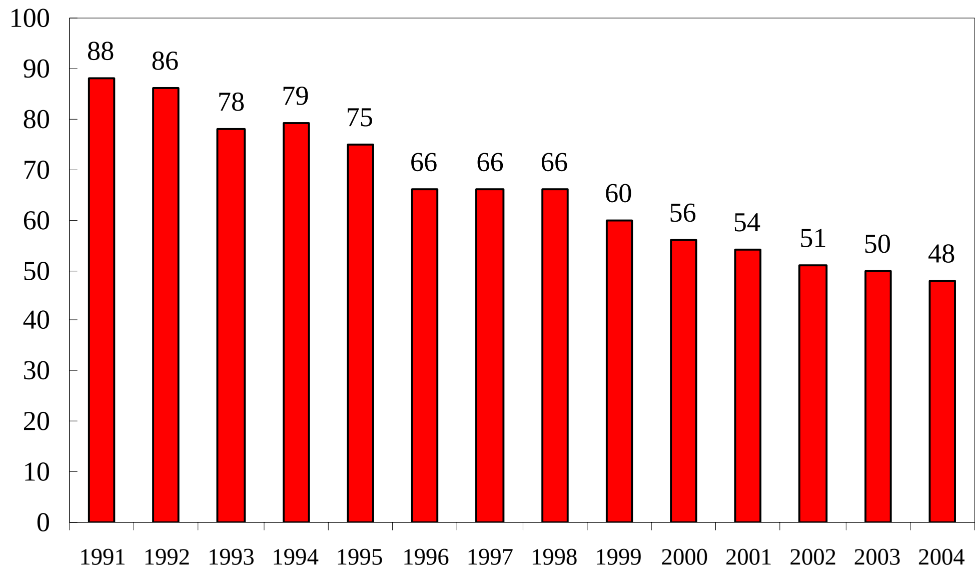
The pension payments consist of basic flat-rate payments and supplementary additions to single or low-income people. The basic pension is low or roughly 10% of the average earning of unskilled workers. The main transfers are through the supplementary pension. The supplement is means-tested with a reduction rate of 45 per cent after a certain income threshold. The income base against which the supplementary pension is tested is broader than the one used for the basic pension: the supplementary pension is also tested against half the income of a spouse and pension payments from occupational pensions above a threshold. All additional payments are also means-tested. If the only income that a single person receives is from the social security system, there is a special household allowance for single persons, which is reduced króna for króna if the individual has other income. Full pension from the social security system for an individual with no other income is approximately 45% of the average earning of unskilled workers. The system is financed directly out of taxes.

Occupational pension funds

Only those entities offering a retirement pension until death, disability pension and survivors' pension are legally entitled to call themselves pension funds and receive mandatory contributions. As of year-end 2004, there were 28 occupational pension funds open and operating without an employer guarantee; 10 were no longer receiving contributions, and 11 had employer guarantees from the government, municipalities or banks, see Figure 1.

The size distribution is very uneven. A few large funds own the lion's share of the assets (the two biggest ones own over one third of total assets), but a number of smaller funds coexist. The funds are controlled jointly by the labour union involved and the federation of employers, and their number has decreased in the last twenty years. This is partly because of conglomeration of the labour unions whose members are mandated to contribute to fund the management controls, but there are factors like savings in operational costs, risk diversification, etc., that are also important. The funds are highly regulated by the government, which specifies the members' pension rights.

Figure 1. Number of pension funds in Iceland, 1991-2004



According to Icelandic law, all wage earners and self-employed persons are obliged to belong to a pension fund, which operates either according to law or has been specially approved by the Ministry of Finance. Currently the laws codify the mandatory payment to be at least 10 per cent of wages and salaries received in order to acquire pension rights, although the burden is divided between the employer and the employee. The general rule is that every wage-earning person working in the private sector is obliged to contribute 4 per cent of her total salary to a predetermined occupational fund, which in turn is matched by a 6 per cent contribution from the employer. As a result of wage settlements made in 2004, the employer's mandatory fund contribution will increase from 6% to 7% in 2005 and from 7% to 8% by 2007.

At year-end 2004 the average fund had net assets of around 20.5 billion króna (approximately €245 m) but the biggest had assets of 180 billion króna (approximately €2.2 bn). There are significant differences between funds with employer guarantees and ordinary private funds regarding the level of contributions and benefits and also regarding risk-bearing. Guaranteed funds are exempted from the requirement of full funding. However, only the government and municipalities can guarantee pension funds. Furthermore, full funding will become the general rule for all public sector employees in the future and is currently applied to all new employees. The Pension Fund for State Employees is the largest public sector pension fund. The total contribution to the A-Department of the fund, which is the new fully funded scheme, is currently 15.5% of total salaries.

All pension funds in Iceland pay lifelong old age, disability pensions, and survivors' pensions. The main rule in the private sector is that members can begin to withdraw old-age pensions at the age of 67, while in the old public sector scheme the limit is 65. It is possible, however, to start withdrawing pensions in the private sector as early as 65, but then with a reduced benefit, or as late as 70 with additional benefits. The benefit rule in the new public sector scheme and in the private sector is in general neutral towards the choice of early or late retirement. The benefit level can vary significantly between pension funds. First, there is a difference between funds with employer guarantees and others. The benefit level is usually higher in guaranteed funds. Second, there are differences between the old (B Department) and new (A Department) public sector schemes. Third, the benefit level of ordinary private sector funds will ultimately depend on their investment returns, which will in turn vary between individual funds.

Individual savings accounts

Since January 1, 1999, all employed persons in Iceland, aged 16 to 70, have been accorded the right to establish individual retirement accounts, either with the pension fund to which they pay their compulsory minimum premium or with any other qualified financial institution. Employees are allowed to deduct from their taxable income a contribution to authorized individual pension schemes of up to 4% of wages. Employers have furthermore accepted in wage settlements to contribute 2% to voluntary pension saving if matched with the same percentage by the employee. The total contribution can therefore amount to 6%. The schemes have to be authorized by the Ministry of Finance. The pension saving is not redeemable until the age of 60 and has to be paid in equal instalments over a period of at least seven years, or it is paid out as a lump sum at the age of 67.

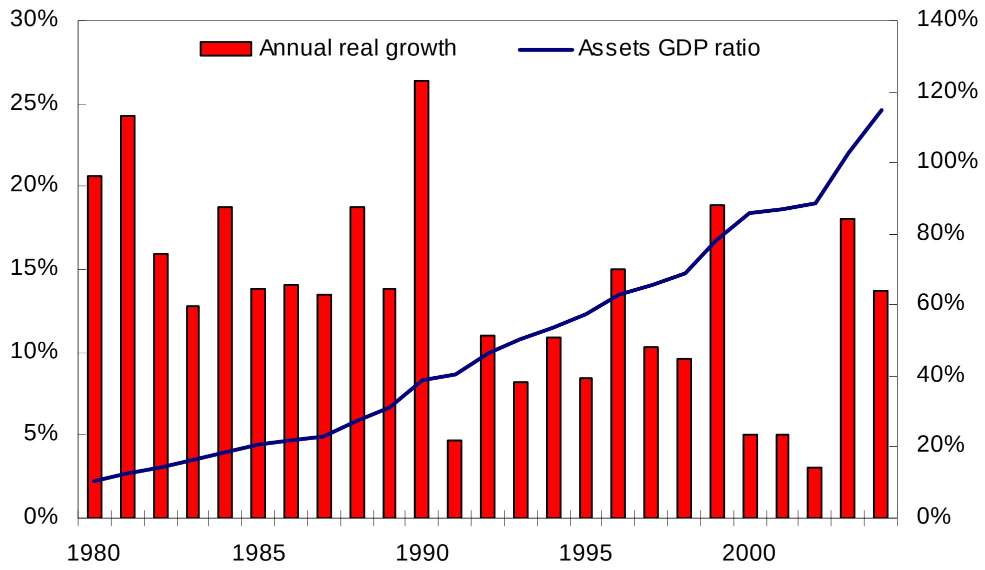
III. Taxation

The employee part of contribution is fully deductible from taxable income if it does not exceed 4%. The employer can charge his part as a cost in his accounts, making it fully deductible for tax purposes, even when it exceeds 6%. The investment returns of pension funds are exempt from tax. Pension benefits are taxed as regular income.

IV. Assets and investments

Assets of the Icelandic pension funds amounted to 986 billion króna (€11.8 bn), over 115% of GDP, at the end of 2004, up from 821 billion króna (€9.8 bn) in 2003, see Figure 2. These assets have increased almost 16 times in real terms from 1980. The net average real rate of return was 5.8% for the occupational funds the last 10 years and amounted to 10.4% in 2004, down from 11.3% in 2003, see Figure 3.

Figure 2. Annual real growth of pension fund assets and assets GDP ratio 1980-2004



Current legislation stipulates that the investment policies of the pension funds should aim at achieving the best return-risk composition that is available at any given time. The law includes certain ceilings on the asset composition of the funds, based on the principle of diversification of risk, see Figure 4.

Figure 3. The average real rate of returns of pension fund assets, 1991-2004

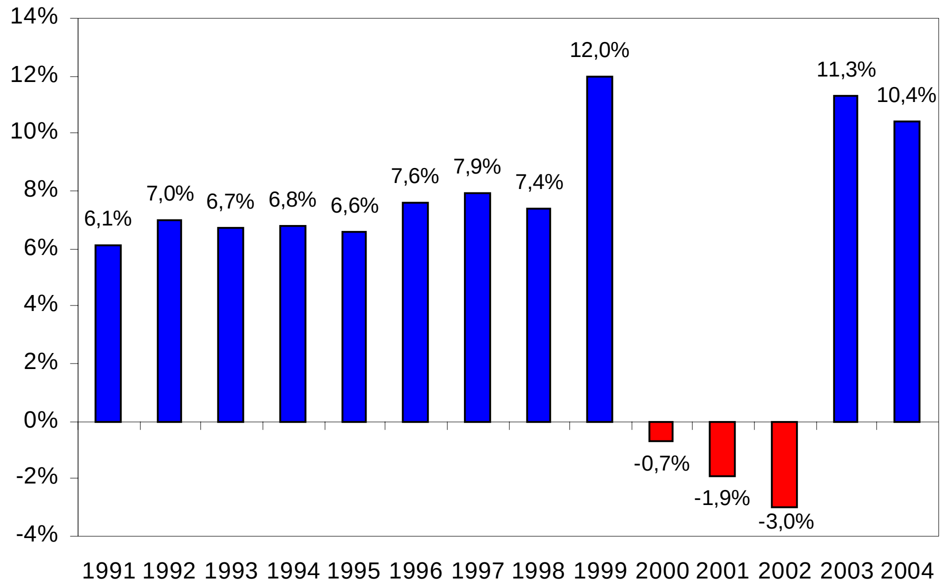
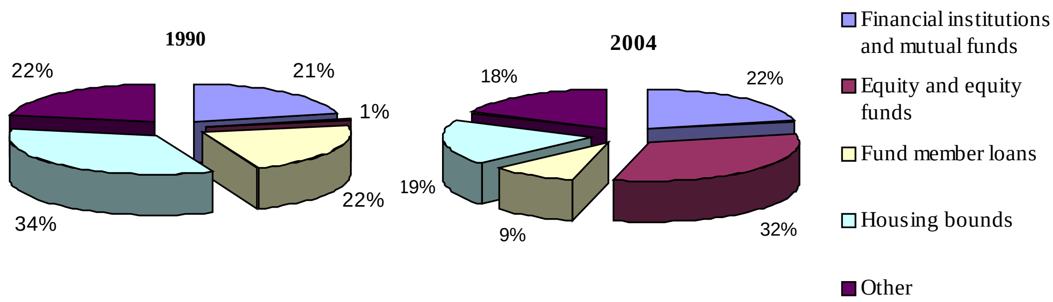
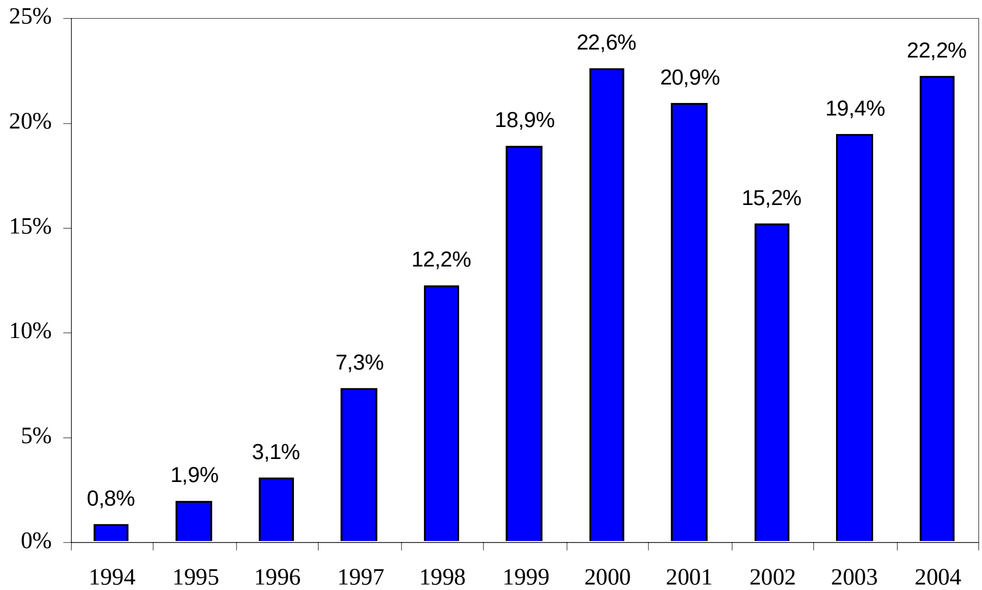


Figure 4. Pension fund asset classes, 1990 and 2004



Total uncovered foreign exchange risk was initially limited to 40% of assets, but in the spring of 2000 it was lifted to 50% of assets, see figure. If a fund wants to invest more abroad, it will have to hedge the excess position. The ceiling for equity, municipal bonds, bank bonds and other bonds is 50% for each class of assets. There is no ceiling on mortgage bonds although their loan-to-value ratio must not exceed 65% in general and 35% in the case of specialized commercial property. The general rule is that bonds and equity should be listed on recognized, organized exchanges. But the funds are allowed to invest 10% of assets in unlisted securities, provided that they are issued by entities within the OECD countries. Unlisted equity, however, has to be fully transferable, and the annual statements of the companies involved have to be public. Regarding individual credit risk, exposure of funds towards a single entity is limited to 10% of assets, 15% of the stock of a single firm and 25% of the shares in any mutual or equity fund.

Figure 5. Share of assets invested abroad, 1994-2004



Until the middle of the 1990s, the funds invested mostly in domestic bonds and lent directly to their members. Domestic bonds were predominantly with government guarantees, and a significant part of them went to finance the public housing loan system. In 1990 claims on the government, local authorities and the public housing system accounted for 43% of pension fund assets, and lending to members accounted for a further 22%. Equity was only 1%, and foreign assets were non-existent. As can be seen in Table 1, this composition has changed dramatically in recent years.

Table 1. Pension fund assets

	1990	1995	2003	2004
Assets as a percentage of GDP	38.5	57.6	102.2	114.9
Assets in billions of euro/ecu *	1.9	3.1	9.1	11.8
Composition (percentages): **				
Marketable bonds and mutual funds	21.6	47.9	49.4	56.0
Other bonds and loans	68.9	41.1	19.3	14.0
Equity and equity funds	1.2	2.8	28.2	26.3
Foreign assets	0	1.9	18.9	21.4
Share of selected sectors:				
Central and local government	9.5	12.6	5.0	5.0
Housing sector	33.9	40.7	21.9	9.7
Fund members	21.8	14.3	11.3	8.8

Source: Central Bank of Iceland.
* Year-end exchange rate.
** Does not sum to 100 due to the double counting of *Foreign assets* and the absence of the category *Other assets.*

At the end of 2004 claims on public authorities were down to nearly 14.7%, and lending to members was a little less than 9%. The share of equity, however, had increased to over 26%, and foreign assets were above 21%. The bulk of their foreign assets is in the form of equity and shares in open-end and closed-end mutual funds. This foreign asset accumulation is very significant with reference to the national economy. Pension funds' foreign assets accounted for 65% of all foreign portfolio assets of Icelandic residents at the end of 2003 and over 24% of total foreign assets as recorded in the international investment position of the country.

Behind the shift in the asset composition in recent years was a change in rules and legislation governing limitations on pension fund investment. But there was also a growing awareness among pension fund managers that they needed to move more into equity and foreign assets to earn a satisfactory return as their total assets soar in relation to the local economy.

A few figures will indicate the relative importance of the pension funds for domestic financial markets. Their assets were equivalent to 13% of the credit system in 1980, but that share had increased to 37% in 2003. The development of their share in domestic financing of the credit system is even more pronounced, rising from just over a fifth to around a half during the same period. Some indication of the importance of pension funds for the domestic bond market is given by the fact that their estimated share of the total stock of marketable bonds was 27% at the end of 2003. At the same time they held an estimated 40% of the stock of housing bonds. At the end of 2003 the funds owned domestic equity and shares in equity funds amounting to around 14% of organized equity market capitalization. This figure really underestimates their importance for the equity market, due to extensive cross-ownership of listed companies.

V. Outlook

The pension system was reformed in the late 1990s with comprehensive legislation on pension funds, the re-organization of the pension funds for public sector employees and the decision to give tax incentives for voluntary private pension saving. Major changes to the pension system are therefore not foreseen in the near term, and the trends that have emerged in recent years will continue. However, the two major challenges at the moment are mergers of pension funds and the effect changing demographics have on the funds. The number of funds has been reduced by almost half in a little more than a decade, and it is likely that this trend will continue. Currently, a majority of the funds base their rules for accumulation of pension rights on the unit method, i.e., old members earning the same pension rights for a króna of contribution as the young. As the demographics are changing rapidly in many of the funds, this cross-subsidy has caused problems. Many of the funds are now changing to the age-attained method, where the young earn more pension rights than the old for a króna of contribution, thus eliminating the cross-subsidy. At the start of 2006, all funds under general wage settlement will have changed to the age-attained method.

Pension fund assets will grow strongly and are estimated to become at least 1½ times GDP around the middle of this century. It will be a challenge for the funds to earn a satisfactory return and secure a good risk distribution in an environment that is much less favourable for investments than the second half of the 1990s. A revision of life expectancy tables in 2002 further weakened the actuarial positions of the funds. Nevertheless, Icelandic bond and equity markets performed very well in 2004. Furthermore, the Icelandic economy has entered a new upswing which will become very strong in the next few years as major-investment, heavy-industry projects gather momentum. The world economy has also turned the corner, and rates of returns on the foreign assets of the funds are again in positive territory.

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