Icelandic Pension Funds Merge and Change their Benefit system

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Background

The Icelandic pension system as known today was established in 1969 when an agreement was made between the largest associations of employees and employers. Previously there existed a few occupational funds. The system was certified by Law in 1974 when all employees, who were members of unions, were required to save in an occupational pension fund. In 1997 the Parliament passed a Law which required that at least 10% of every salary payment should be transferred into a legal pension fund. Usually 4% are taken directly from the wages and 6% are paid by the employer.

When the system was established it was a known fact that if rights were earned according to the actuarial value of the premium, the older part of the work force would receive very low benefits at the age of retirement. Therefore a system was introduced in which premiums earned the same amount of pension rights in each year of age. In other words, a premium of 10,000 ISK every month could for instance give rights to a monthly pension of 1,500 ISK every year of payment. In this example, a person earning ISK 100,000 in monthly salary would after 40 year of work receive 60,000 ISK, giving earning rate at 1.5% a year. This system became known as the ‘agreement between generations’. The thought behind this was that in younger ages, people would earn lower rights in relation to the actuarial fair value of the premiums, relying on that when they got older there would be a new generation that would sacrifice their fair value of the premiums to balance the actuarial position of the pension fund.

The 1997 Law established the occupational fund system further. On the other hand people had more freedom to choose their pension fund if they were not bound by an employment contract to pay to a certain fund.

The assets of the pension funds have increased by 240% since 1997, and were estimated at 1,200 billion ISK at the end of last year (or 12 billion euros) amounting to 120% of GDP.

In the years passed since 1997 more and more funds have experienced that the ‘agreement between generations’ is not working as expected as the funds are not recruited as before.

In this article I will therefore discuss recent changes in the Icelandic pension system and the mergers and changes of systems that have occurred in the period since 1997.

Legal environment and supervision

Pension funds are regulated by the Ministry of Finance and supervised by the Financial Supervisory Authority (FME), which also is responsible for the supervision of the credit, securities and insurance markets. This means that the Ministry of Finance has to accept every pension funds' articles of associations, but in practice FME is consulted and is supposed to have sufficient expertise available to secure the efficiency and reasonability of the pension system.

FME also collects data from the pension funds and publishes some of it on its website.

The different benefit systems of pension funds

We have mainly three different kinds of pension funds' systems.

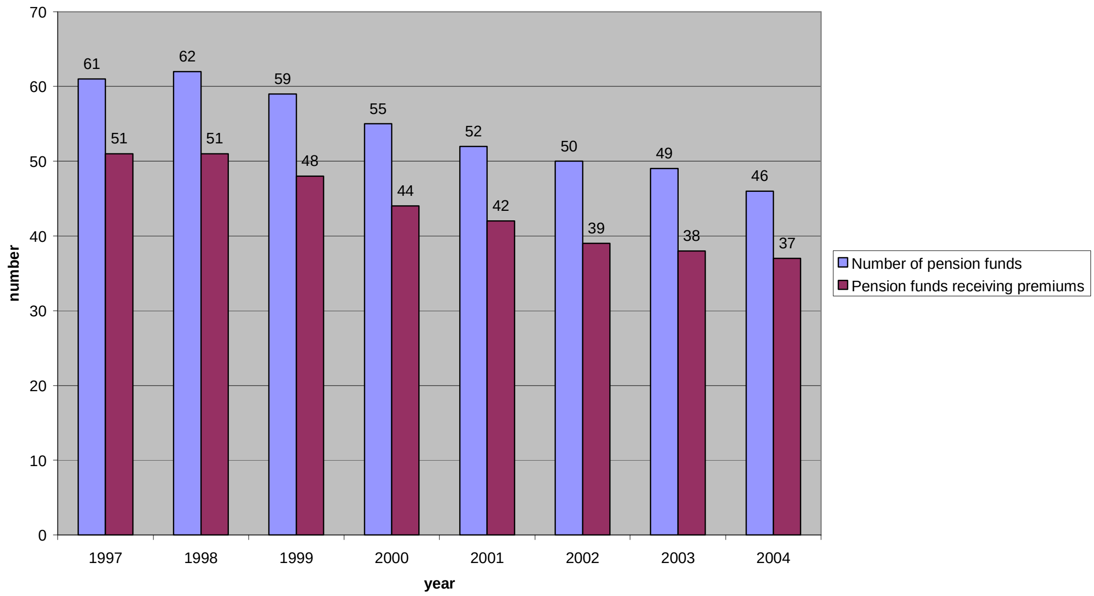
Most of the pension funds of employees in the private sector have defined contribution system with coinsurance. This means that premiums earn certain rights which will benefit members in older ages and in case of disability. The spouse and the children will receive limited benefits in case of death but the remaining value of benefits otherwise paid to the member the rest of his/her life goes to the fund. Those funds are required to have balance between assets and liabilities, but are not obliged to take any action until the surplus/deficit is more than 10% of assets, or more than 5% for 5 years in a row. The possible action usually is to change the benefit system.

The open funds for state and municipal employees are similar, but the difference is that they are defined benefit funds. That means that if there is imbalance between assets and liabilities, the employers should increase/reduce their contribution. Currently premiums are 15.5% where 11.5% are paid by the employer.

Finally we have some closed funds for state and municipal employees, who are closed in the sense that they are closed to new members, but members of the funds before the end of year 1997 (1996 in some cases) still can pay to these funds. They are backed by the state or the municipality, and do not have to meet the requirement of balance between assets and liabilities. The benefits are fixed ratio of the last wage and the benefits follow the developments in the wages of the state and municipal employees. As those funds operate on a different basis than other funds, they will not be discussed further in this article.

Mergers in the pension market

Figure 1: Number of pension funds in Iceland 1997-2004



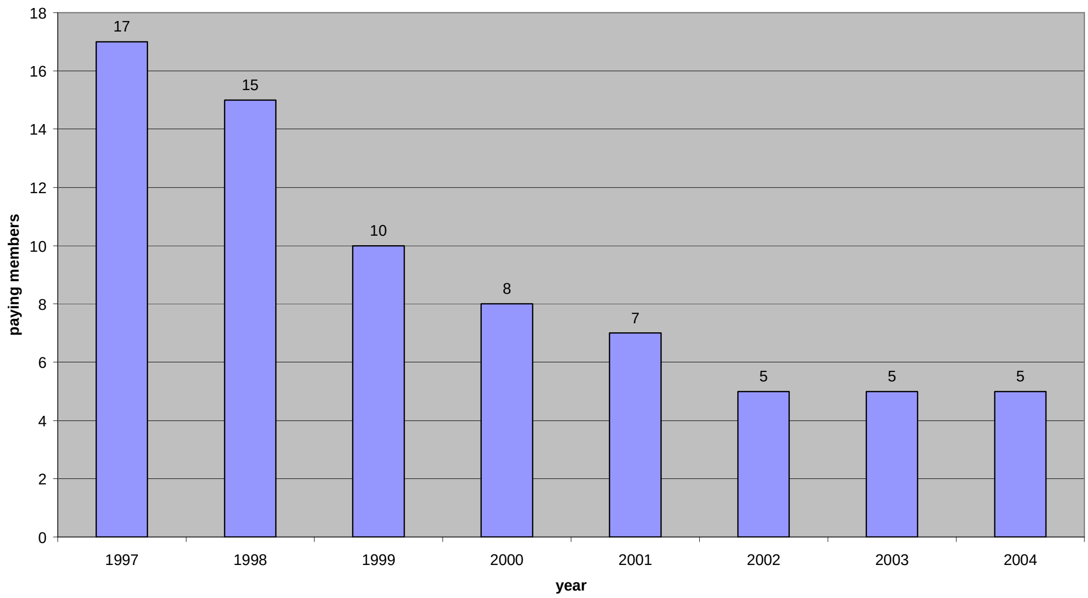
As can be seen in Figure 1 the number of pension funds has been reduced since 1997, or by 25%.

One of the novelties in the 1997 Law was that pension funds should as a general rule have at least 800 paying members. This rule was however not applied to the government or municipal backed funds, as they operate under a special exemption. Figure 2 shows the number of non-backed pension funds with fewer than 800 paying member in the years 1997-2004.

The figure shows that the biggest decrease happened in the years 1997-2000 and most of the mergers in this period can be accounted for as a consequence of the paying members limit. The five funds remaining at the end of 2004 either have cooperation with another fund in the same situation or are insured against adverse developments. The number of these funds will probably be further reduced in 2006.

In recent years mergers between larger funds have become more widespread, creating even fewer and bigger funds than before. In the period 2005-2006 there are 3 mergers between two of the 12 largest funds in 2004, which either have taken place or are scheduled to take place this year.

Figure 2: Number of pension funds with fewer than 800 paying members



System changes

As mentioned in the introduction, the pension system was originally established with a so called equal-earning system. This means that members earn equal rights every year, independent of their age. The vast majority of funds had that system when the Law was passed in 1997.

The equal-earning system is especially beneficial for the older part of the work force for two reasons:

1. The premiums do not earn rights according to the actuarial fair value and do not reflect the time value of money.
2. People tend to increase their salaries as they get older.

The pension funds had negative returns from their investments in the years 2000-2002. That revealed that the equal-earning system was not suitable for modern environment. That can be put down to the fact that the recruitment of new members in many funds was not sufficient and the trend that wages increase with age makes the equal-earning system even more difficult to balance.

This development led to the change that more and more funds introduced a so called age related system, where members earn the actuarial fair value of premiums. The pension funds have taken different routes in establishing the new system. Usually they have tried to make it up to older members who were expecting to receive the benefits of the equal earning system in the last years before retirement.

The funds with equal earning system usually had assets which were higher than earned liabilities (related to premiums already paid), because before 2000 the investment return was higher than the discount rate of 3.5%. However the funds also have to take into effect the balance between the actuarial value of future premiums and the liabilities according to benefits earned with future premiums so the combined value of assets and future premiums has to match the total value of liabilities. When calculating the assets and liabilities according to future premiums, actuaries only take account of paying members. That implies that the value of future premiums is not enough to live up to the liabilities they create.

The first pension funds that took up the age related system automatically balanced the future value of premiums and liabilities. They then used the surplus of assets over earned liabilities to increase the pension rights of the members who would be loosing the most with the system change.

After 2002 many funds had lost a lot of their surplus of assets over earned liabilities. That meant that new methods had to be invented. In 2005 the Seamen’s Pension Fund and Framsýn (a fund for members of various unskilled workers unions) merged into a fund named Gildi. They created a new system, where the thought was that if a member pays premiums in younger ages in an equal earning system, he/she earns right to also pay premiums in older ages when he/she benefits from the system. The turning age was found out to be at 42.

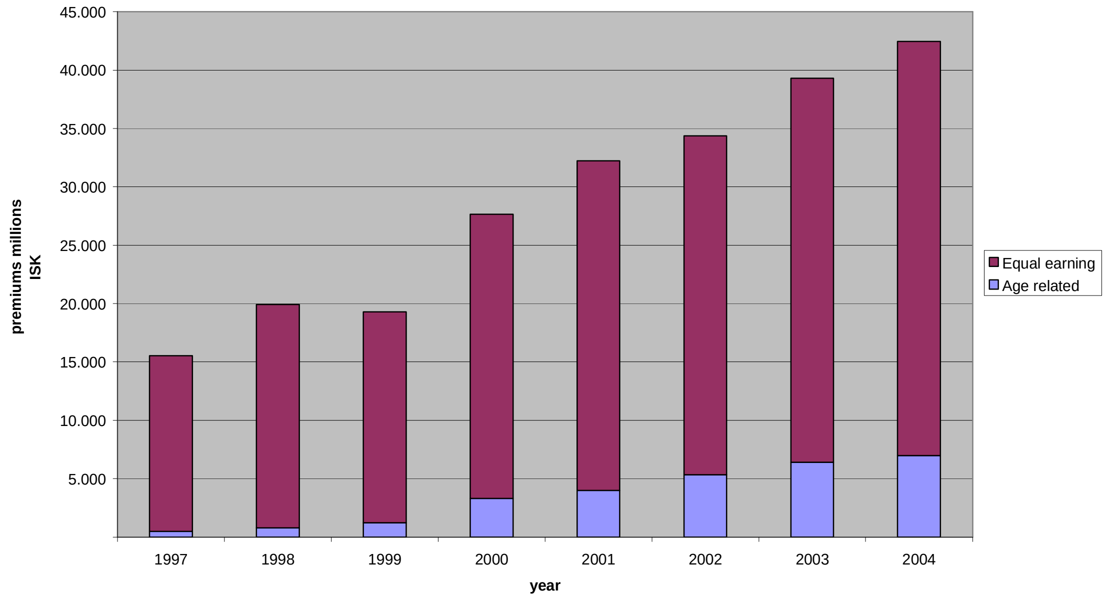
A member who has paid to an equal earning system for more than 5 years before the age of 42 has the right to pay to that system in Gildi until retirement. However the premium paid to the equal earning system can only amount to the inflation-indexed value of wages in 2003. This is done to mitigate the risk that the balance of the fund is affected by wage increases.

A member who has paid to an equal earning system for less than 5 years before the age of 42 only can continue to pay to that system for a period corresponding to the number of months previously paid in the system.

This new method of balancing the shift between the old and the new system and therefore mitigating the effect on the earned rights of members and their expectations, has paved the way for other funds to introduce similar systems. Now most funds with members working in the private sector have taken or are in the process of taking up the age related system.

In Figure 3 we can see that until now, the amount of premiums paid to an age related system has steadily grown, compared to premiums paid in an equal earning system. The situation has probably changed considerably since 2004 (unfortunately the FME did not have available newer information when this article was written).

Figure 3: Premiums paid to each system in 1997-2004



Investments and returns

Recently the Parliament passed an amendment to the law, which allows pension funds to invest 60% of their assets in stocks. The prior limit was 50%. The investment in stocks has grown considerably since the funds were permitted that in 1994. The funds have also made considerable investments abroad. This means that the return fluctuates more and the funds were heavily affected by the turbulence in the global market in 2000-2002.

Figure 4 shows the how the pension funds' real return on their assets in 1997-2004. The Association of Pension Funds believes the real return in 2005 was around 13%.

Figure 4: Real returns 1997-2004

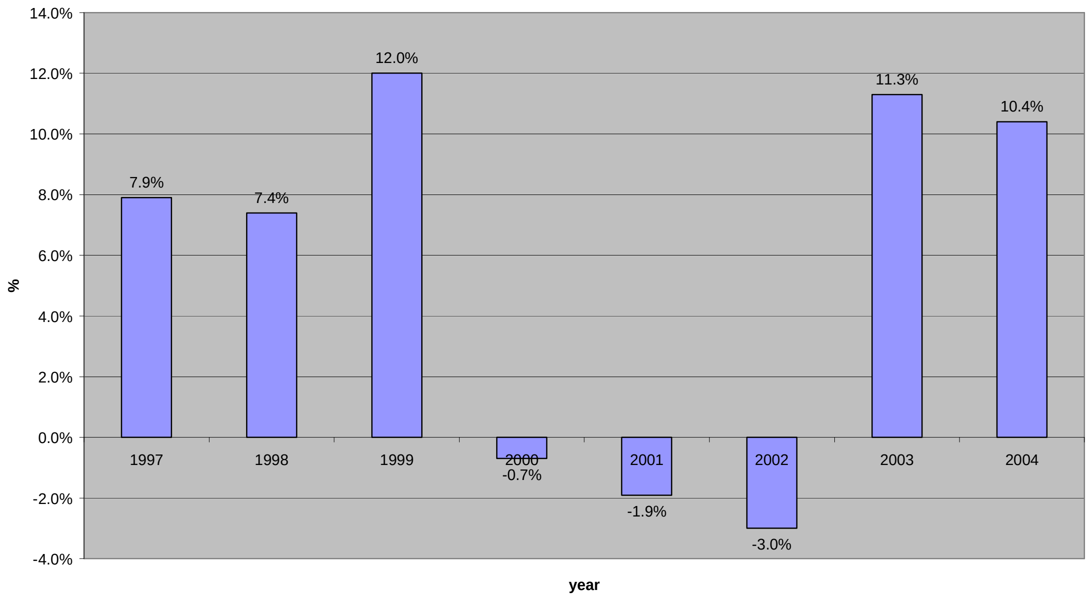
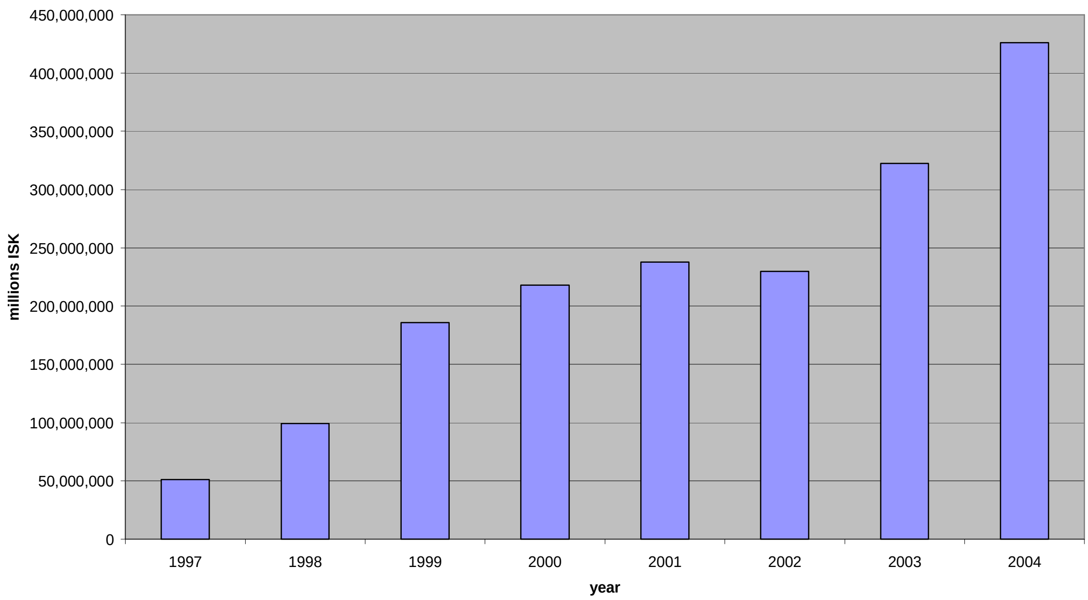


Figure 5 shows the holdings in variable yield assets in 1997-2004.

Figure 5: Holdings in variable yield assets 1997-2004



Some issues for the future

We are expecting to see fewer and larger funds in the future. The age related earning system will be in use for all private sector funds. However, as the state and municipal funds are not experiencing the same difficulties in meeting the balance requirement they are only on a small scale using the age related system.

Pension funds must be aware of the fact that they differ and large investment in stocks is not suitable for them all, although the limit has been raised. The pressure on good asset liability management will be higher, as the funds get bigger and the number of beneficiaries increases with higher age of the nation. Therefore ALM and risk management will be the most important challenges for the pension funds in the future.

Further information on the Icelandic pension system can be obtained at the following websites:

FME website: www.fme.is
The Association of Pension Funds (LL): www.ll.is.

Annex: Update of the figures with 2005 numbers 13 September 2006

Figure 1A: Number of pension funds in Iceland 1997-2005

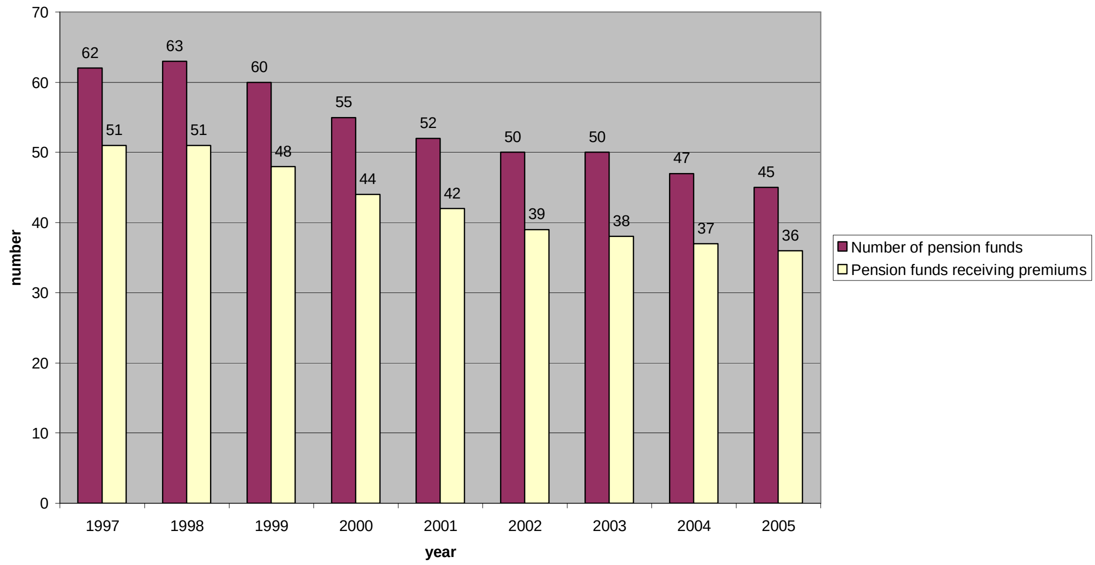


Figure 2A: Number of pension funds with fewer than 800 paying members

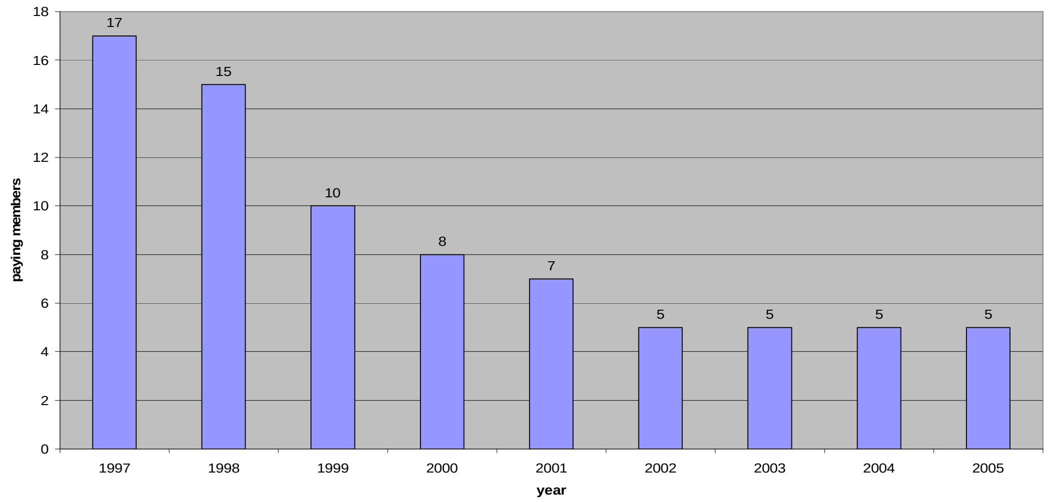


Figure 3A: Premiums paid to each system in 1997-2005

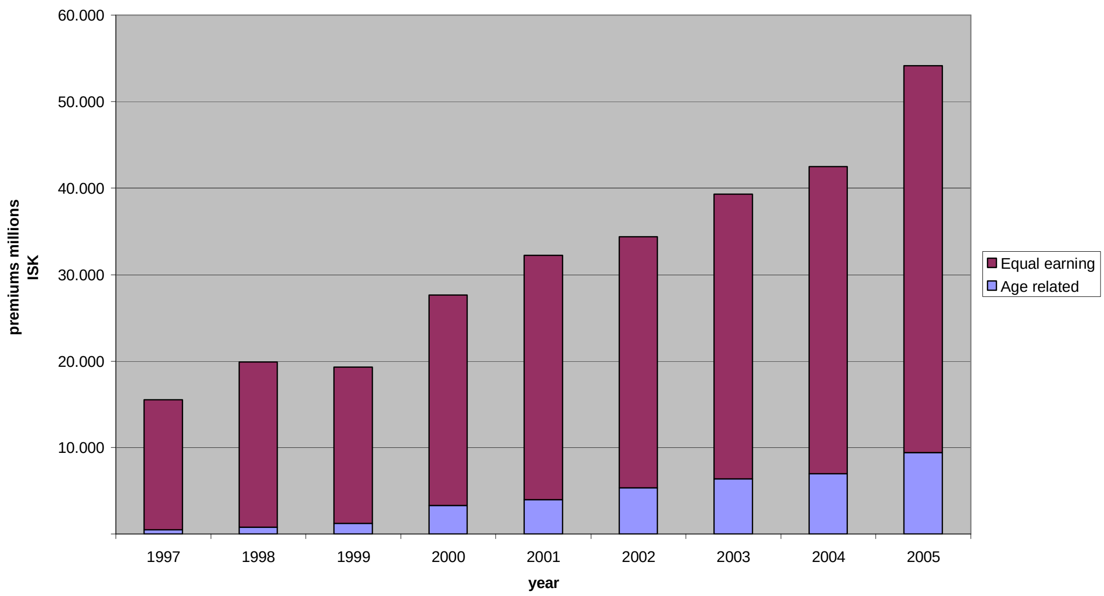


Figure 4A: Real returns 1997-2005

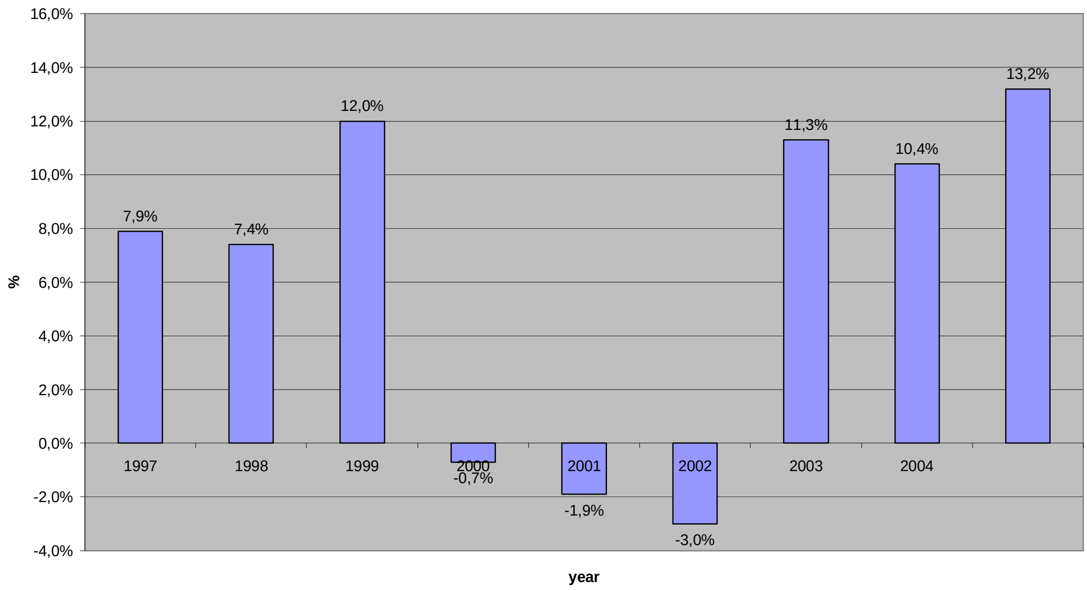


Figure 5A: Holdings in variable yield assets 1997-2005