Iceland: Country Overview

Arnór Sighvatsson
Chief Economist, Central Bank of Iceland

I. Overview of the system

The Icelandic old age pension system is composed of a tax-financed public pension scheme, mandatory funded occupational pension schemes and voluntary pension saving with tax incentives. The public pension scheme pays a basic pension from the age of 67 and a means-tested supplementary pension after retirement. Occupational pension schemes are mostly run by private pension funds governed jointly by unions and employers. They 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 50-60% of full-time earnings, giving a total replacement ratio of 60-70% when the basic public pension is added. Means testing will wipe out the supplementary public pension for most people who have paid into occupational pension funds during their working life. On present trends, the provision of retirement income will thus more and more be based on three pillars, which are a relatively small public pension, dominant mandatory funded pension schemes and voluntary private pension saving with tax incentives.

Iceland faces smaller problems due to the ageing of the nation than most developed European countries. There are several reasons. Firstly, the Icelandic nation is younger and will remain so during the coming decades. Secondly, labour participation rates of the elderly are also higher than in most developed countries and the effective retirement age is higher. The reason is that public pensions are not paid before the age of 67 and regulations governing the pension funds do not give any incentives for early retirement. Thirdly, mandatory membership of fully funded pension funds will reduce the pension burden of future generations.

II. Public pensions

Public pensions in Iceland are fully financed by taxes. The public pension system provides an old age pension, disability pension and survivor’s pension. The old age pension is in most cases paid from the age of 67. It is divided into a basic pension and supplementary pension. Both are means-tested but pensions received from other sources are treated differently from other income. These do not affect the basic pension and the level at which they begin to reduce the supplementary pension is much higher than for other income. The basic pension amounts to around 10% of the average earnings of unskilled workers but with the supplementary pension can go up to 46% of the same earnings. The occupational pension funds have been gathering strength and were by 2002 paying equal amounts in pension to those paid by the public pension system (3.3% of GDP).

III. Occupational pension funds

It is mandatory by law to contribute at least 10% of wages and salaries to the accumulation of pension rights. Formally this 10% is split between a 4% contribution from the employee and a 6% 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.

Only those entities that offer retirement pension until the time of death, disability pension and survivors' pension are legally entitled to call themselves pension funds and receive mandatory contributions. The occupational pension funds fulfil the criteria and are the main pension providers receiving these contributions. They therefore make up the bulk of the second pillar of the pension system. There were 50 pension funds in Iceland at the end of 2003. Of these, 11 were no longer receiving contributions and 13 had employer guarantees from the government, municipalities or banks. There were 28 fully operational occupational pension funds that do not have an employer guarantee. The pension fund scene is dominated by a few big pension funds with a very high share of total assets and several small pension funds. The ten largest pension funds had around 70 per cent of the net assets of all pension funds in 2001, and the two biggest ones accounted for 33 per cent. The average fund had net assets of around 16.5 b.kr. (€190 m) but the biggest had assets of 146 b.kr. (€1.7 bn). Twenty-two out of fifty pension funds had assets that were less than 5 b.kr. (€57.7 m).

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, municipalities and banks can guarantee pension funds. Furthermore, full funding will become the general rule for all public sector and bank employees in the future and is currently applied to all new employees. The Pension Fund of 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. However, since the benefit level of the fund is fully defined, it is the employer who bears the investment risk and his contribution to the fund will be in practice variable.

All pension funds in Iceland pay lifelong old age and 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. Firstly, there is a difference between funds with employer guarantees and others. The benefit level is usually higher in guaranteed funds. Secondly, there are differences between the old (B Department) and new (A Department) public sector schemes. Thirdly, the benefit level of ordinary private sector funds will ultimately depend on their investment returns, which will in turn be variable between individual funds. On the assumptions that the real rate of return on the funds will converge in the long run to 3.5% and productivity growth will be 1-2% per annum, a typical member of a pension fund who retires at 69 will receive a pension amounting to 50-60% of full-time earnings. As the basic public pension can be expected to add another 10%, the total replacement rate is likely to be around 60-70%.

IV. Voluntary private pension saving

Employees are allowed to deduct from their taxable income a contribution to authorised 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 become 6% for those who have decided to pay 4% to voluntary pension schemes. The schemes have to be authorised by the Ministry of Finance. They are in most cases defined contribution individual accounts. 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. Surveys indicate that over 40% of those active in the labour market were paying into such schemes at the end of 2002.

V. Taxation

The contribution rate to pension funds is usually 10% of wages.[1] The employee part 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 tax-free. Pension benefits are taxed in the same way as income from employment.

VI. Assets and investments

Assets of Icelandic pension funds amounted to 824 b.kr. (€9.5 bn) at the end of 2003, or over 102% of GDP. These assets increased by nearly 14 times in real terms from 1980 or on average by nearly 12% per annum. The net real rate of return was on average 5.4% for occupational private sector funds (without employer guarantee) during the period 1994-2003. The net real rate of return of occupational private sector funds amounted to 11.3% in 2003, after being negative for the three preceding years by an average of 1.9%. The variation in returns recently seems to be highly significant, with funds with a relatively larger exposure to Icelandic bond and equity markets posting positive rates of return. These markets performed well in 2003 as long-term interest rates came down and equity prices increased by 44% in local currency terms but by 35% in terms of euros.

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. Total foreign exchange risk was initially limited to 40% of assets but in the spring of 2000 was increased to 50%. This means that if funds invest more abroad they will have to hedge the excess position. The ceiling for equity, municipality 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 specialised commercial property. The general rule is that bonds and equity should be listed on recognised, organised

[1] As mentioned in part III, the employer's mandatory fund contribution will have increased by 2% in 2007.

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.[2] 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.

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. At the end of 2003 claims on public authorities were down to nearly 27% and lending to members was just above 11%. The share of equity, however, had increased to over 28% and foreign assets were around 19%. The bulk of their foreign assets are in the form of equity and shares in open-end and closed-end mutual funds.[3] 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.

Table 1. Pension fund assets

	1990	1995	2003
Assets as a percentage of GDP	38.5	57.6	102.2
Assets in billions of USD	2.6	4.0	10.7
Composition (percentages)[*]*:*			
Marketable bonds and mutual funds	21.6	47.9	49.4
Other bonds and loans	68.9	41.1	19.3
Equity and equity funds	1.2	2.8	28.2
Foreign assets	0	1.9	18.9
Share of selected sectors:			
Central and local government	9.5	12.6	5.0
Housing sector	33.9	40.7	21.9
Fund members	21.8	14.3	11.3

Source: Central Bank of Iceland
*Does not sum to 100 due to the double counting of *Foreign assets* and the absence of the category *Other assets*

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.

---

[2] Unlisted bonds issued by the government housing funds and bought during the years 1972-1994 are not included in the 10% ceiling on unlisted securities.
[3] At the end of 2003 bonds accounted for 2.5 per cent of foreign assets, open-end mutual funds 13.3 per cent, closed-end mutual funds 57.1 per cent and equity 27.1 per cent.

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 organised equity market capitalisation. This figure really underestimates their importance for the equity market, due to extensive cross-ownership of listed companies.

VII. Outlook

The pension system was reformed in the late 1990s with comprehensive legislation on pension funds, the reorganisation 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. 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. Three years of negative real returns put a strain on the funds and some had to cut their benefit levels. A revision of life expectancy tables in 2002 further weakened the actuarial positions of the funds.[4] But Icelandic bond and equity markets performed very well in 2003. Furthermore, the Icelandic economy has entered a new upswing which will become very strong in the next few years as major investment projects in aluminium and related power plants 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. Over the longer term the funds can thus be expected to carry on building up their portfolio of foreign assets but they are very far from the statutory limit of 50%.

[4] For one of the largest funds this change is estimated to have increased future liabilities by 2%.