

# The Icelandic Pension System in 2005

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## I. Overview

The pension system in Iceland is chiefly characterized by the operation of occupational pension funds.<sup>1</sup> 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 Confederation of Icelandic Employers, and the State. Under the agreement, every wage earner working in the private sector is obliged to contribute a minimum of 11% 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 7% 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 over half of wage earners are already paying into individual accounts and around 12% of the total assets of the pensions system are 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, pay a pension amounting to 60-70% of full-time

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<sup>1</sup> This overview is an update of the paper: *The Icelandic Pension System in 2005*, and is compiled for the National Association of Pension Funds in Iceland. The exchange rate used in the report is from December 31<sup>st</sup> 2005, 74.7 krónur to the euro.

earnings, giving a total replacement ratio of up to 80% for the average wage earner when the social security pension is added.

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 supplementary 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. 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.

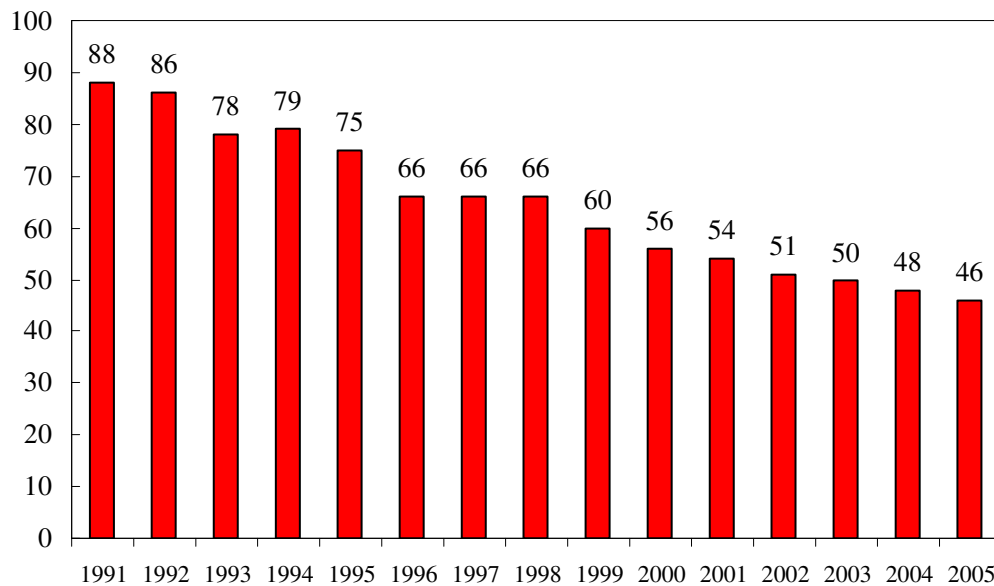
The pension payments consist of basic flat-rate payments and supplementary additions to single or low-income people. The basic pension is low or roughly 10% of the average earning of unskilled workers. The main transfers are through the supplementary pension. The supplement is means-tested with a reduction 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 2005, there were 24 occupational pension funds open and operating without an employer guarantee; 10 were no longer receiving contributions, and 10 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 three biggest own close to half 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, 1991-2005**



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 11 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 7 per cent contribution from the employer. As a result of wage settlements made in 2004, the employer's mandatory fund contribution will increase from 7% to 8% in 2007.

At year-end 2005 the average fund had net assets of around 26.5 billion króna (approximately €35,5 m), up from 20.5 billion króna in 2004. The biggest fund had assets of 227 billion króna (approximately €3 bn), up from 180 billion. 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 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 62, but then with a reduced benefit, or as late as 70 with increased 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 with tax benefits can thus 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 or later.

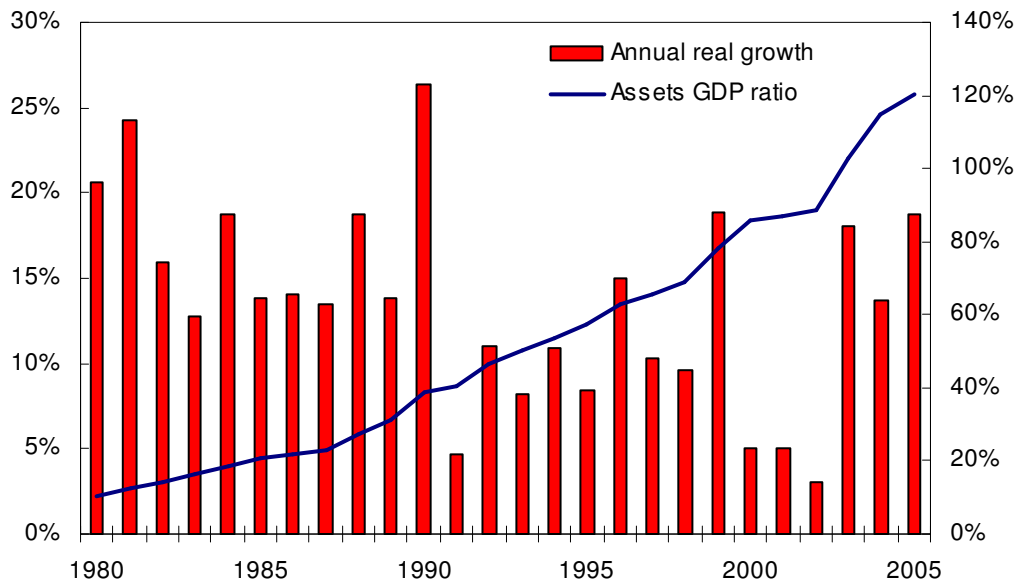
### III. Taxation

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 7%. The investment returns of pension funds are exempt from tax. Pension benefits are taxed as regular income. Taxation is thus based on EET principles.

### IV. Assets and investments

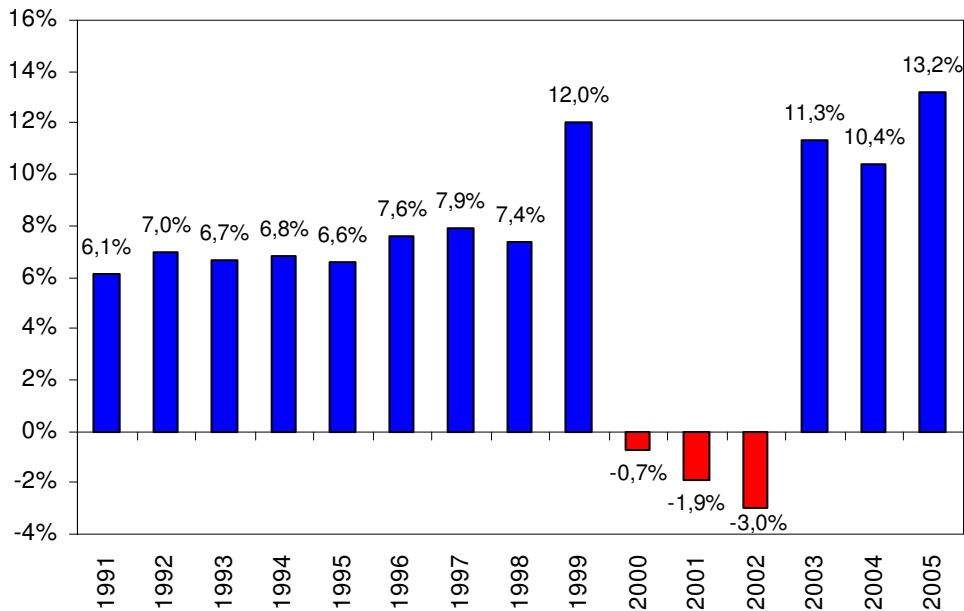
Assets of the Icelandic pension funds amounted to 1,220 billion króna (€16.3 bn), over 120% of GDP, at the end of 2005, up from 986 billion króna in 2004, see Figure 2. These assets have increased more than 20 times in real terms from 1980. The simple net average real rate of return was 6.42% for the occupational funds the last 10 years and amounted to 13.2% in 2005, up from 10.4% in 2004, see Figure 3.

**Figure 2. Annual real growth of pension fund assets and assets GDP ratio 1980-2005**

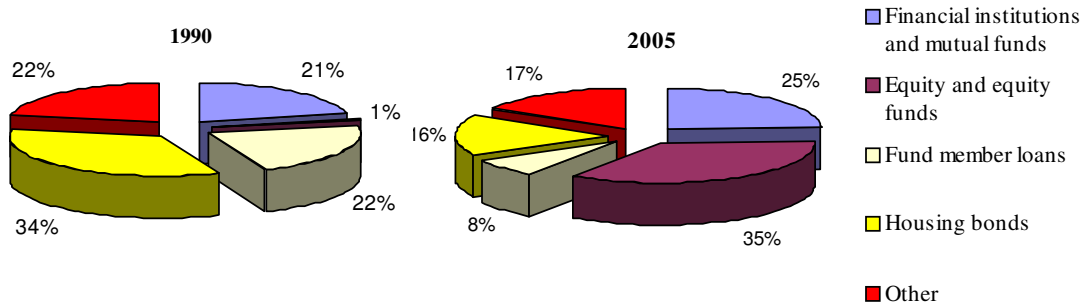


Current legislation stipulates that the investment policies of the pension funds should aim at achieving the best return-risk composition that is available at any given time. The law includes certain ceilings on the asset composition of the funds, based on the principle of diversification of risk, see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

**Figure 3. The average real rate of returns of pension fund assets, 1991-2005**

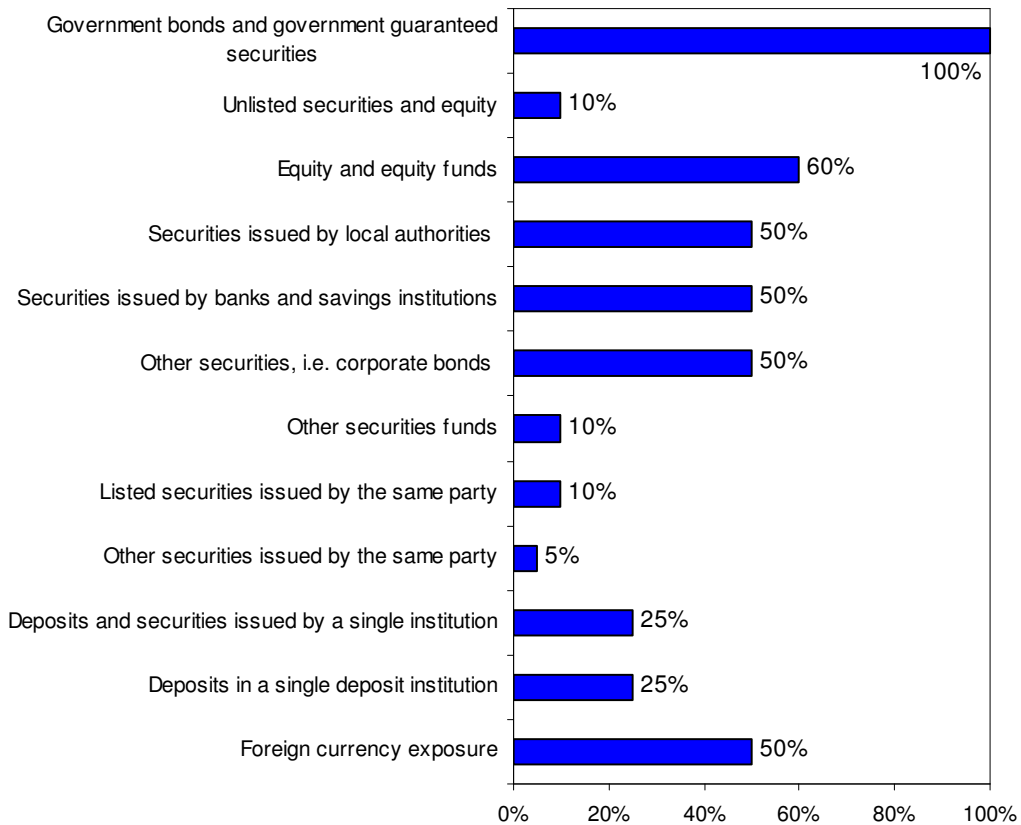


**Figure 4. Pension fund asset classes, 1990 and 2005**



The Board of Directors of a pension fund formulates its investment policy and invests the assets of the fund on the basis of the best terms available at any time, regarding the return on investments as well as risks.

**Figure 5 Investment by law and asset class**



Source: The Icelandic Pension Act, No. 129/1997

Pension funds can invest their assets in the following manner:

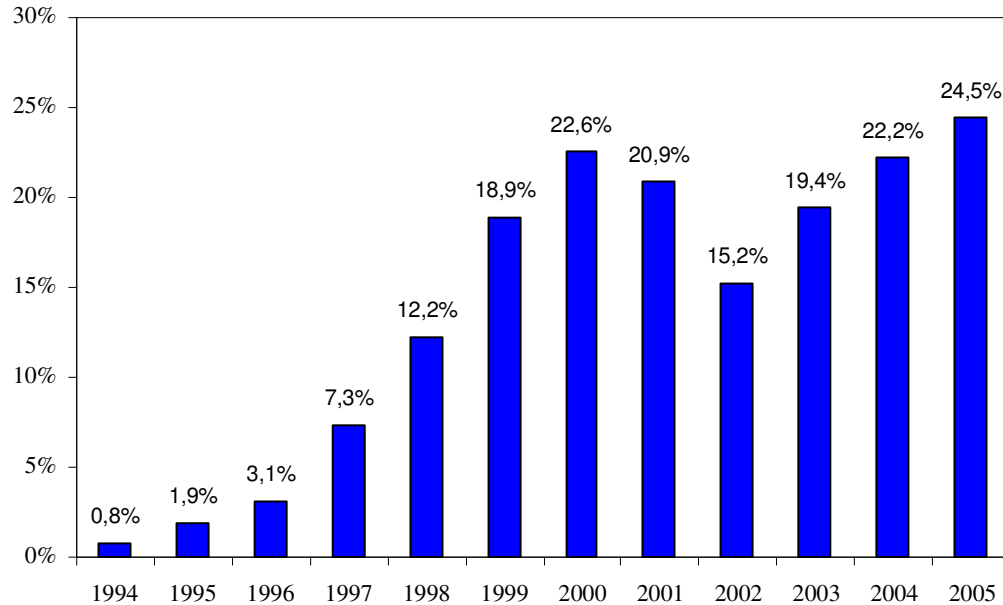
1. Treasury bills, Treasury bonds and bonds guaranteed by the Treasury.
2. Bonds of local authorities.
3. Mortgage debentures amounting to a maximum of 75% of the assessed market value of real estate, except in the case of specialized commercial facilities, in which case the maximum shall be 35%.
4. Deposits in banks and savings banks.
5. Bonds and bills of exchange issued by banks, savings banks and other credit institutions under the supervision of a public supervisory authority.
6. Equities.
7. Unit share certificates or shares, collective investment undertakings (UCITS) or investment funds.

Figure 5 shows how pension fund assets can be invested up to a maximum under the Icelandic Pension Act.

Total uncovered foreign exchange risk was initially limited to 40% of assets, but in the spring of 2000 this was lifted to 50% of assets. If a fund wants its investment to exceed this limit, it will have to hedge the excess position. The ceiling for equity is 60% and 50% for municipal bonds, bank bonds and other bonds. There is no ceiling on mortgage bonds, but their loan-to-value ratio must not exceed 75% 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. However, the funds are allowed to invest 10% of assets in unlisted securities, provided that they are issued by entities within the OECD and Liechtenstein. Unlisted equity, however, has to be fully transferable, and the annual financial statements of the companies involved have to be public. Regarding individual credit risks, exposure of funds to 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.

**Figure 6. Share of assets invested abroad, 1994-2005**



**Table 1. Pension fund assets 1990-2005**

	1990	1995	2003	2004	2005
Assets as a percentage of GDP	38.5	57.6	102.2	114.9	120.5
Assets in billions of euro/ecu <sup>*</sup>	1.9	3.1	9.1	11.8	16.3
Composition (percentages):					
Marketable bonds and mutual funds	21.6	47.9	49.4	56.0	49.0
Other bonds and loans	68.9	41.1	19.3	14.0	12.7
Equity and equity funds	1.2	2.8	28.2	26.3	35.1
Foreign assets	0	1.9	18.9	21.4	24.5
Share of selected sectors:					
Central and local government	9.5	12.6	5.0	5.0	5.0
Housing sector	33.9	40.7	21.9	9.7	5.0
Fund members	21.8	14.3	11.3	8.8	7.6

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 2005 claims on public authorities were down to 5%, and lending to members was a little less than 8%. The share of equity, however, had increased to over 35%, and foreign assets were above 24%. 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.

## 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. Most of the funds have now changed 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 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 and new morbidity assumptions further weakened the actuarial positions of the funds. Nevertheless, Icelandic bond and equity markets performed very well in 2005. Furthermore, it is likely that the Icelandic economy will perform well in the near future.