International Labour Organization

Occupied Palestinian Territory (oPt)

ILO Technical Comments

on the

Non-Governmental Pension Scheme

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Upon the request of Palestinian stakeholders, dated 13 March 2014 and 17 March 2014, the ILO is pleased to comment on the proposed "pension for non-governmental sector regulation" which introduces a voluntary pension scheme for private sector workers, based on the defined-contribution approach.

The proposed non-governmental pension scheme (NGPS) Regulation has been approved by the Council of Ministers of the Palestinian National Authority (PNA) on 18 February 2014. It will come into force through its signature by the Prime Minister of the Palestinian National Authority and sixty days after its publication in the Official Gazette.

The ILO would like to offer the following technical comments, based on international social security standards, and in particular the Social Security (Minimum Standards) Convention, 1952 (No. 102), world-wide agreed social security principles and good practices. While there is no single right model of social security, all social security systems should conform to certain basic principles so as to guarantee secure and non-discriminatory benefits, based on the principles of equity, solidarity and financial viability in the long-term. Any entitlement provided by a social security scheme should pursue its social purpose in an effective and well-targeted way.

The ILO has been closely associated with the Government of the oPt and is working jointly with the Tripartite National Social Security Committee on the establishment of a social security system for private sector workers. The policy framework for this social security system, as well as the related actuarial valuation, has been adopted by tripartite Palestinian stakeholders in December 2013. In this regard, the Government has expressed its will to introduce a sound income replacement programme of pensions and other social security benefits for workers of the private sector that would satisfy the requirements of the workers and employers in addition to strengthening the role of the state in attending to the social security needs of Palestinian people.

The comments below are divided into *General Comments* which provide an examination of the proposed NGPS Regulation in light of social security principles and the suggested ILO social security system, and into *Specific Comments* which provide comments on specific articles of the proposed NGPS Regulation.

General Comments

- **The proposed NGPS does not seem to be complementary to the suggested ILO social security system, but seems to be the central social security scheme for private sector workers**

  In the discussions surrounding the adoption of the proposed NGPS draft regulation, it has been mentioned that the NGPS would be complementary (additional) to the suggested ILO social security system, as also discussed with the Palestinian Government and tripartite Palestinian stakeholders. However, as the NGPS regulation is drafted, it appears that it will be the only private sector pension scheme in the oPt, for the following reasons:

  - The contribution rate stipulated by the NGPS regulation of 19 per cent of a worker' wage (combined employee-employer) is much too high to be complementary to the suggested ILO system, which requires a contribution rate of 18.1 per cent, as agreed by tripartite stakeholders. It would not be realistic to expect workers and employers of the private sector to pay contributions at the rates specified in the NGPS draft regulation in addition to the contribution rate of the suggested ILO social security system. In order to keep total contribution rates at a reasonable level, complementary defined contribution systems all over the world usually require a contribution rate of 2 to 7 per cent of wages.[1] Also, the contribution rate of the defined contribution pillar under the Palestinian civil servant pension scheme amounts to 6 per cent and is thus in line with world wide standards.
  - Even if voluntary, there is no mention in the proposed NGPS regulation that it will be a second pillar scheme, complementing a basic public social security system for private sector workers.

  In light of this, it should be reiterated that the Palestinian Government and tripartite stakeholders agreed to establish a compulsory social security system for private sector workers and their family members, which is based on the defined benefit (DB) approach and follows ILO standards and international good practice. It was further agreed that a defined contribution (DC) scheme could only form an additional, second pillar scheme. The fundamental principle of a DC pension approach does not follow insurance principles. The DC approach does not meet, and is in fact, contradictory to the minimum requirements of social security as stated in the International Labour Convention No. 102 where a state intervention for the provision of social security benefits is justified on the grounds of pooling

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[1] Contribution rates under <u>complementary</u> DC pension schemes

Sweden	Germany	Italy	Japan	Norway	Estonia	Czech Republic	Belgium
2.5%	4%	6.91%	2.4% to 5%	Min. employer contribution: 2%	2%	5%	4.25% (on average)

Source: OECD, Pensions at a Glance 2013 – OECD and G20 Indicators.

the resources across insured persons and providing the state with the necessary capacity to guarantee a minimum level of income security for all insured persons.

DC pensions are based on an individual responsibility to carry the risk of adequate income security in old-age including bearing the burden of the significant investment risk for each individual. The ILO internal evaluation of the World Bank pension reform advisory assistance in 2004 indicated the need to step away from such an approach due to the shortfalls it had proven in countries where it was implemented as the central public pension arrangement. Besides, the latest global financial and economic crisis since 2008 has led a number of countries, namely in Central and Eastern Europe where DC style pension reforms were adopted, to reconsider shifting back to the former social insurance arrangements that had preceded the reforms that are now adding burdens not only financially but also in terms of social discontent and the inevitable negative impact on the economy, thus compounding the problems of the crisis.

No guarantee of a decent level of pension at retirement

Defined-contribution arrangements, as prescribed in the proposed NGPS, cannot guarantee a given level of pension at retirement. Under the NGPS, it is not possible to know the amount of benefit or the replacement rate of the former earnings that will be paid at retirement, as the proposed Regulation does not prescribe:

- the investment return that will be credited to the accounts, apart from a minimum of 2 per cent,
- the level of premiums that will be deducted from the individual accounts for financing death and disability benefits, and
- the level of the administration charges that will be deducted from the accounts.

A real social security system is based on the DB approach, whereby benefits are determined according to a formula and related to the earnings on which contributions were paid. In a DB scheme, the replacement rate is established in the legislation through a clearly defined benefit formula. The replacement rate can only be changed through a change in legislation. It thus provides the necessary security to insured persons in case a social security contingency arises.

The draft NGPS regulation proposes a **retirement age** of 65, while the suggested ILO social security system provides for a normal retirement age of 60, the same as under the Palestinian Civil Servant Pension Scheme. When comparing replacement rates offered by the NGPS and the proposed ILO social security system, the difference in retirement ages must be considered since the 5 additional years of contribution under the NGPS between age 60 and age 65 will translate into a longer period of contribution and a shorter period of pension reception.

The annex to these comments presents a comparison of benefits provided by the NGPS and those provided by the proposed ILO social security system when placed on a comparable basis. It shows that the ILO social security system is more advantageous (in terms of replacement rates) than the NGPS.

- **Very low pensions to persons who start contributing late in their career**

The NGPS will offer **very low pensions to persons who start contributing late in their career** and who will retire after only a few years of contributions to the scheme. By comparison, the suggested ILO social security scheme will grant **age credits** to persons aged 46 and over at the introduction of the scheme to help them meet the eligibility criteria for the retirement pension, and possibly receive the minimum pension.

- **No indexation of pensions in payment**

The proposed ILO social security system provides for that pensions once in payment will be regularly indexed according to changes in the consumer price index, thus guaranteeing that pensions in payment will maintain their purchasing value. Under the proposed NGPS, however, at the time of conversion of the accumulated account into an annuity, a subscriber who wants to use his/her accumulated funds to purchase a pension with regular indexation he/she will have to accept a lower initial pension. This means that the costs of indexation of a NGPS pension has to be financed by the individual subscriber and will affect directly the level of his/her pension, in opposite to the suggested ILO social security system where the indexation is redistributed among all insured persons.

- **No redistribution and solidarity between workers of different levels of earnings and between generations**

The proposed NGPS does not guarantee a minimum pension which represents an important mechanism for redistribution, while the suggested ILO social security system includes a minimum pension guarantee equal to 50% of the minimum wage, or the poverty line, whichever is higher. In the NGPS a subscriber is fully dependent on the savings in his/her individual account and the investment of these savings, thus, there is no redistribution and solidarity between workers of different levels of earnings and between generations.

- **No general responsibility of the state**

It is generally recognized that the general responsibility for an effective and efficient social security system lies with the State, particularly with creating political commitment and with respect to setting appropriate policy, legal and regulatory frameworks and the supervision that guarantee adequate benefit levels, good governance and management and protecting acquired rights of beneficiaries and other participants.

The proposed NGPS regulation does not provide for the general responsibility of the state, and thus, NGPS subscribers bear the risk of bankruptcy or loss of income of the funds. Under the suggested ILO system, in comparison, the state has the general responsibility for the proper administration of the system and its funds, and has to ensure, that even in case of bankruptcy or loss of income of the funds, the benefits are paid as stipulated in the legislation. The state functions thus as the final guarantor for the payment of the prescribed benefits.

- **Gaps in coverage**

The proposed NGPS is optional. It is understood that it is designed for workers of large enterprises who have high wages. Significant pensions under a DC scheme require very high contributions by workers and employers. Taking into account that only 5 per cent of Palestinian private sector workers earn more than 3 times the minimum wage, it is expected that most workers of the private sector will not be able to adhere to the scheme.

- **Absence of real representation of workers**

Effective and efficient social security governance requires the full involvement and decision making power of social partners to improve design, oversight and efficient operation of the social security system. Social dialogue plays an important role for contributing to the permanent monitoring of financial sustainability and social adequacy, effectiveness and efficiency of management and administration of the scheme and to guarantee that funds are not diverted to other uses. It is also important in enforcing the existing social security legislation so that contributions are paid and benefits delivered. Therefore, the participation of representatives of the persons protected in the management of social security schemes is a basic social security principle and laid down in ILO social security standards.

Under the proposed NGPS, however, workers are not adequately represented and moreover, their role is only consultative.

- **High administration costs**

The determination of administration expenses linked to the management of investments and the payment of benefits under the scheme is a critical aspect of the mechanism. The proposed NGPS regulation does not indicate the level of management and administrative costs that will be charged to subscribers at the moment of contribution payment and/or those charged on accumulated accounts.

As the NGPS would be administered by several pension funds, licensed and supervised by the Palestinian Capital Market Authority, there will be competition between the different funds. A movement of subscribers between the different funds can thus be expected. Fund managers therefore will have to support important marketing costs to attract subscribers. Thus, it is expected that the NGPS will have high administration costs, which need to be financed by the subscribers.

It is commonly recognized that administrative costs have serious consequences for those insured through private, individual account pension schemes. The example of Chile demonstrated that high fees and commissions charged at a flat rate on all accounts have highly regressive effect. When levied against a relatively modest retirement account, for example, these standard fees reduced the amount available to the account holder by approximately 18 per cent, but reduced the amount in the account of an individual with 10 times that income only by 0.9 per cent.[2]

- **No precision on death and disability benefits**

The proposed NGPS regulation stipulates that the fund managers will have to enter into an agreement with an insurance company to offer benefits in case of disability and death. No indication is given on the amount of these benefits and on the level of their cost, including the part of contributions deducted for this purpose. In addition, no mention is made of any constraints that would force fund managers and insurance companies to keep the cost of these guarantees at a reasonable level, with the effect that value of the individual accounts to be used for the old-age pension (or the net investment return offered on them) and will eventually decrease considerably.

[2] See: *The Political Economy of Pension Reform: Latin America in Comparative Perspective*, by Evelyne Huber and John D. Stephens, UNRISD, Geneva 2000.

Low expected rates of return on individual accounts

The NGPS draft regulation provides for a minimum annual rate of return on individual accounts of 2%. Given the cost of the guarantees that will have to be offered by the scheme in case of death and disability (for which no precision is given and no maximum cost limit is provided), the important administration charges that will have to be supported by the individual subscribers, and the uncertainty of returns in the present Palestinian investment environment, it might be expected that this minimum guaranteed rate of return of 2% will in fact constitute the rule for crediting individual accounts.

Gender inequities

The purchase of a life annuity at retirement will provide women with lower pensions than men, if based on sex-differentiated life tables,[3] because of their longer life expectancy. Sex-differentiated tables are common in individual accounts systems. No indication is given in this regard in the proposed NGPS regulation and it might therefore be expected that annuities paid under the NGPS will be based on sex-differentiated life tables.

In contrary, a social security defined-benefit scheme does not make any difference between men and women in the determination of pensions, thus, men and women with the same contributory record will receive the same pension, irrespective of their different life expectancy.

No protection for Maternity and Employment injury

While the suggested ILO social security system includes benefits in case of maternity and employment injury, the NGPS does not cover those risks.

It should be noted that it has been agreed by tripartite stakeholders and the Tripartite National Social Security Committee to include these two benefits in the social security system due to the urgent need to

- provide compensation for victims of employment injuries, and
- move the costs for compensating maternity leave from the employer to the social security fund, so as to equalize men and women's labour costs to support women's labour market participation.

Despite setting out a high contribution rate, the NGPS falls short of fulfilling the needs of the private sector and its workers in this regard.

[3] A tabular display of life expectancy and the probability of dying at each age (or age group) for a given population, differentiating between men and women, according to the age-specific death rates prevailing at that time.

No right of the beneficiary to complain and appeal in social security

The proposed NGPS regulation does not foresee any mechanism of complaint and appeal in case of refusal of the benefit or complaint as to its quality or quantity.

The right to lodge a complaint and the right of appeal in social security matters ensure compliance with and the effective implementation of the rights of insured persons, and are thus are basic social security principles, which should be applied by all social security schemes.

Application of the Paris Protocol

It would be surprising that Israel agrees to transfer funds to a voluntary savings arrangement administered by different fund managers to respond to the intention of the Paris Protocol. It is far from guaranteed that this optional scheme of individual accounts would meet the definition of "pension insurance institution" mentioned in the Paris Protocol. The proposed arrangement (non-governmental pension scheme) would give Israel all the leeway to accept or refuse to transfer funds to the Palestinian workers, despite any verbal agreement already reached.

Specific comments on the draft regulation

Optional participation (and coordination with the End-of-service indemnity)

Workers would have the choice between:

- Subscribe to the new NGPS
- Participate to the PPA (for public sector employees)
- Be subject to the provisions of the Labour law regarding the End-of-service indemnity (EOS)

The choice is irrevocable, unless the worker moves from the private to the public sector, or vice versa. The application of these provisions is not clear in cases where a person would move several times between the private and the public sector, in particular whether this person can choose again to subscribe or not to the NGPS? Maintaining small dormant accounts generates administrative costs to fund managers and this will affect the accumulation of accounts of the other subscribers.

There can be expected administrative difficulties for employers who will have to manage the different options of their employees (different contribution deductions for those who adhere or those who do not adhere to the NGPS, payment of the End of Service (EOS) in certain cases only, etc.).

Age criteria

The NGPS does not apply to workers aged above 50 at the introduction of the scheme; they have to remain covered by the EOS.

Those aged 50 or more who would want to participate to the NGPS can do so but will have to "*convert all dues end of service benefits, saving funds (if any) from the previous period and not less than a total payment of subscriptions for (15) years in full*". This statement is not clear. Would employers have to pay at once a sum corresponding to what they would have paid under the EOS? This would represent a huge burden for employers.

Contribution levels

Worker's contribution is set at two possible levels (10 per cent or 7 per cent for employees, and 9 per cent or 12 per cent for employers). It is not clear on what basis these different contribution rates have been determined?

Form of payment

Under one option, the subscriber may determine the amount of the monthly pension payment he/she wants to receive from age 65. As contributions are optional in voluntary schemes, it is normal that some flexibility is offered to subscribers at the time of liquidation of the accumulated accounts. However, letting the subscriber full discretion to determine the amount of the pensions without any baseline is contrary to basic principles of pension arrangements.

The other choice is to purchase a life annuity from an insurance company. This represents the best benefit to ensure periodic income until death. Life annuities take care of the longevity risk. However, it may be expected that the cost of these annuities will be very expensive in the context of the Palestinian insurance industry where the life annuity market is not developed, and individuals will not be in a position to judge if these annuities are sold at a fair price.

Investments

The regulation imposes to fund managers that the proportion of investments outside of the oPt does not exceed 30 per cent. In addition, the percentage of contributions in a particular sector cannot exceed 15 per cent. These investment constraints should be viewed in the larger context of limited investment opportunities in the oPt. It may happen that certain fund managers will have to take undue risks in order to respect these rules.

Investment funds dedicated to individual savings should normally be less risky than the funds held for a social security scheme which have a long-term horizon and may support more fluctuations. It may thus be expected that the return on individual savings will be lower than the return that would normally be achieved under a real social security fund.

The guarantee concerning the credited rate of return will have an impact on the types of securities that will have to be selected by the fund managers. It is not sure that fund managers will be able to find appropriate investments in the oPt (or elsewhere) to maintain an adequate asset mix that will reduce the level of risk to be supported by the fund managers to guarantee the minimum interest rate of 2 per cent.

Annex

Illustrative replacement ratios

This annex presents a comparison of replacement rates that can be expected from (1) the proposed NGPS and (2) the proposed social security scheme. Since the normal retirement age is different between the two schemes, replacement rates are presented for both retirement ages of 60 and 65 in the case of the NGPS. Also, given the uncertainty regarding the rate of return that will be credited on individual accounts in the case of the NGPS, replacement rates for the NGPS have been calculated with the use of a 2% return (the minimum guarantee) and a 5% return.

Calculations are based on the following assumptions:

- Sex of the subscriber: male
- Contribution rate (combined employer-employee): 16% [4]
- Rate of increase of salary: 4%
- Rate of return on individual accounts before retirement: 2% and 5%
- Interest rate for the purchase of annuities at retirement: 4%
- Mortality rates: Same basis as used for the actuarial valuation of the proposed Palestinian social security scheme
- Specific bases for the NGPS:
    - Benefits at death:
        - Before retirement: return of accumulated individual account
        - After retirement: continuation of 50% of pension to the spouse
    - Administration charge: 15% of contributions paid (includes the residual cost for contracting extra death and disability benefits with insurance companies)

[4] The contribution rate of 16% suggested initially for the proposed social security scheme will have to increase eventually to reach its ultimate level, but it will be sufficient to maintain a positive reserve for several decades.

Table 1 **Non-governmental pension scheme (NGPS)**

Replacement rates according to age at beginning of contribution payment, retirement age and rate of return on individual accounts

Age at beginning of contribution payment	Retirement at 60		Retirement at 65	
	Return 2%	Return 5%	Return 2%	Return 5%
30	23.7%	36.2%	27.7%	45.4%
40	17.3%	23.0%	21.6%	30.8%
50	9.5%	10.9%	14.2%	17.6%

Table 2 **Social security scheme**

Replacement rates according to age at beginning of participation

Age at beginning of contribution payment	Retirement at 60
30	45.0%
40	30.0%
50	15.0% *

* This person would benefit from an age credit equivalent to 5 years of contribution for eligibility purposes. Depending on the level of the earnings of that person, the possibility to receive the minimum pension could increase this replacement rate.