THE ECONOMIC BENEFITS OF A NATIONAL PENSION SYSTEM

HILLARY DEVEAUX
EXECUTIVE DIRECTOR
SECURITIES COMMISSION OF THE BAHAMAS

BRITISH COLONIAL HILTON
NASSAU, BAHAMAS
19 JUNE, 2008

Good afternoon, ladies and gentlemen, and thank you, //, for the kind introduction.

The current pensions landscape in The Bahamas comprises a non-contributory pension scheme under the Public Service Pension Plan, which is governed by the Pensions Act; a pension system that is part of an overall social welfare and social insurance package offered through the National Insurance Board, under the NIB Act; and private pension funds established by companies for their employees or by individuals accessing pension schemes directly from private sector service providers. As most of you are aware there is no pension legislation in force in The Bahamas and as a result private pension funds are not regulated.

My presentation will focus on the benefits of pensions, in particular, a national pension system, to the economy of The Bahamas. In so doing I will explore the state of "the national pension structure" and make a few comments on how the system may be improved.

Before I speak further, however, I need to provide the "standard disclaimer" and remind you that as a matter of policy, the Securities Commission of The Bahamas disclaims any responsibility for the private statements of any of its employees. The views I express today are therefore my own and do not necessarily reflect the views of the SCB, its members or its staff.

The Securities Commission is not responsible for the regulation or supervision of pensions. However, pension fund managers provide securities investment advice to the public or to institutions, or are involved in the dealing and management of securities, and, as such, fall within the purview of section 29 of the Securities Industry Act. In regulating pension fund managers as broker-dealers or securities investment advisors, the Commission is charged with ensuring that persons associated with these entities are fit and proper, i.e. have capacity and character to perform their investment management functions.

Concepts and Terminology

I would like to highlight a few concepts and common terminology used to classify pensions generally that will be used during this presentation. I am sure that many of you will be familiar with the terms but in defining them, I hope to highlight some of the standard characteristics of the pension schemes which I will revert to later on in the presentation.

The term 'pension systems' is used to collectively refer to pension plans as well as pension funds. **Pension plans** are arrangements or schemes that are legally binding contracts with an explicit retirement objective. **Pension funds** refer to the pool of assets that are bought with the contributions to a pension plan for the exclusive purpose of financing plan benefits.

Pension systems generally comprise three pillars: public, occupational and personal pensions. Public pensions attempt to protect individuals from absolute poverty, or consumption below a minimum level, while occupational and personal pensions are designed to protect individuals from relative poverty, or a fall in a worker's accustomed level of consumption.

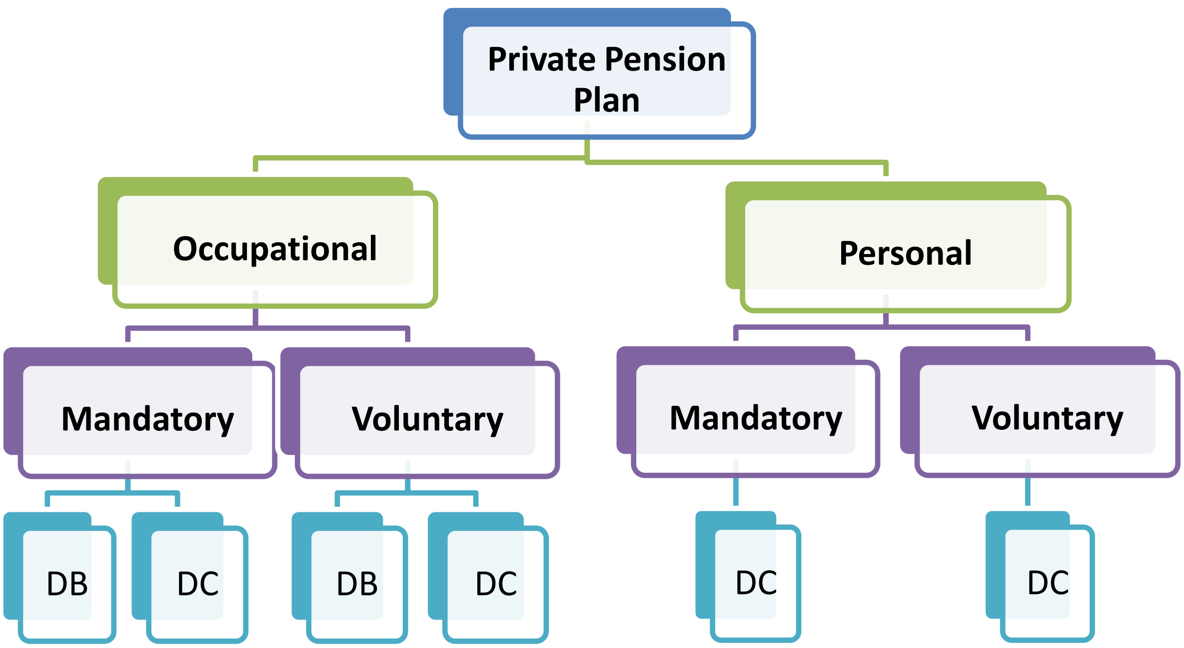
Public or state pension plans include social security and similar statutory programmes administered by the government (that is central governments as well as other public sector bodies such as a social security institution). **Private pension** plans are administered by an institution other than the general government and may be occupational or personal. **Occupational plans** are administered directly by a private sector employer acting as a plan sponsor, a private pension fund or a private sector provider. **Personal plans** do not have to be linked to an employment relationship and can be individuals accessing pension schemes directly from private sector service providers.

These pensions may be further classified: public and private pensions may be either 'defined benefit' or 'defined contribution'. **Defined benefit** plans promise retirement income based on the number of years of contributions and average earnings or, more often, an average of each participant's last few (or best) years of earnings. These pensions are often non-contributory. In contrast, **defined contribution** plans set up individual accounts for participants; retirement benefits depend entirely on accumulated contributions and on the investment return credited to each account.

Whether public or private, or a defined contribution plan, participation in the schemes may be on a mandatory or voluntary basis.

To summarise, pension systems vary widely by each country but typically consist of the following:

- At least some form of basic state pension
- Private pension plans that can be either occupational or personal (which may be in the form of savings)

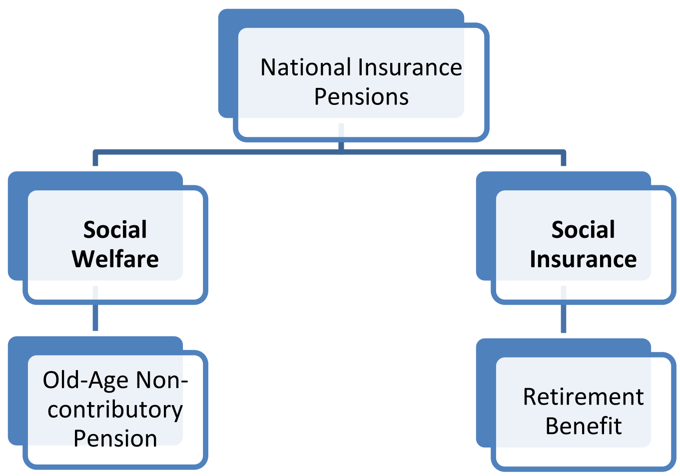


State of the National Pension System

I would now like to explore the current state of the pensions landscape in this jurisdiction.

The National Insurance Act, 1972 established the National Insurance Board (NIB). The objective of this system was to provide pecuniary payments in the event of sickness, maternity, funeral, retirement, invalidity, survivorship, injury, disablement and death. It was also to provide assistance to needy Bahamian residents who did not qualify for a particular benefit.

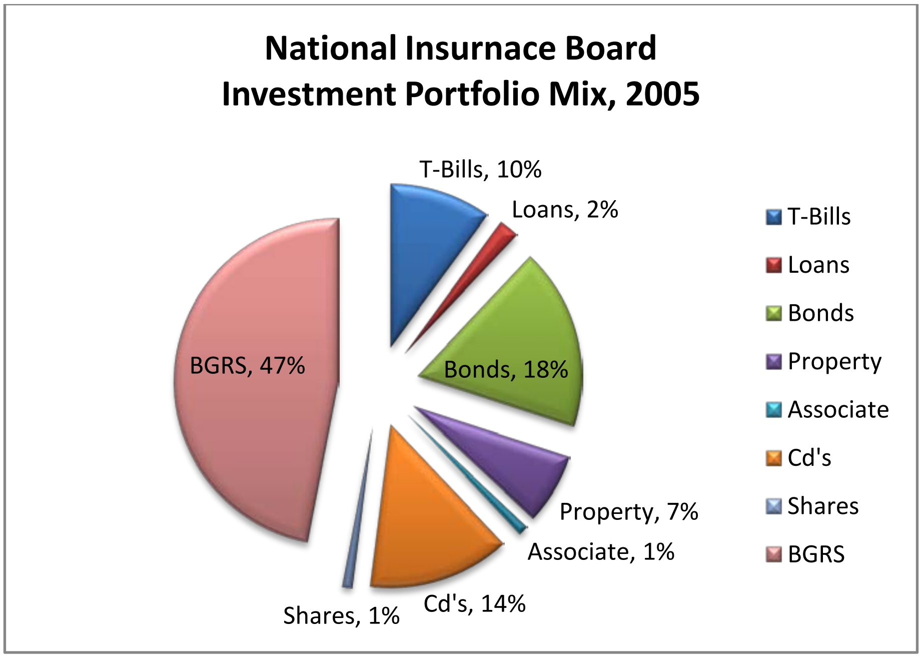
In The Bahamas the "**basic pension**" available can be considered an anti-poverty measure that guarantees a minimum income in old age, irrespective of a worker's history of earnings. Beyond that basic assistance, or what is known as the social assistance Old-Age Non-Contributory Pension, there is a **Retirement Benefit**, which is available as a part of NIB's overall social insurance package where benefits are paid to insured persons who meet prescribed contributions. The current maximum insurable ceiling is $20,800 per year or some $400 per week. Basic pension *assistance* payments to persons not qualifying for other *benefits* are currently fixed at $230 per month but adjusted from time to time. All persons in gainful employment are required to register and participate in National Insurance – whether living here legally or illegally; whether in receipt of a work permit or not; whether employed on a probationary, part-time or permanent basis. Participation in the Benefits scheme is also extended to unemployed persons on a voluntary basis and to self-employed persons.



At year end 2005, the total assets of the National Insurance Fund were approximately $1,295 million, or 21.6% of GDP[1]. At the end of the same period the portfolio mix of the National Insurance Fund included primarily Government Registered Stock at almost 50%

[1] Annual Report 2005, The National Insurance Board

and a combination of other domestic investments such as Treasury Bills, bank deposits, long-term bonds/loans to quasi-governmental corporations, equity investments, and net investment in direct financing leases. Guided by the trusteeship principles, the National Insurance Fund seeks to attain safety, yield and liquidity principles to its investments.



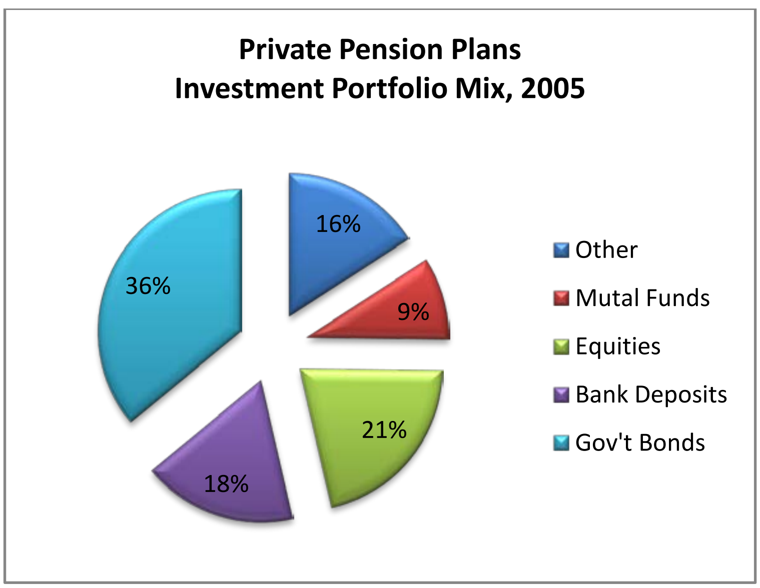
Source: Annual Report 2005, The National Insurance Board

The Government of The Bahamas provides a **non-contributory gratuity scheme, similar to a pension plan,** to its tenured civil servants. The plan provides a pre-determined monthly retirement benefit to employees based in their earnings history, years of service and age. The plan is unfunded, not having set aside assets to cover accrued benefit liabilities. Currently, benefits are budgeted for and paid out of the Government's Consolidated Fund.

Private pensions offered in The Bahamas are either occupational or personal. **Occupational plans** are offered by larger companies, particularly in the tourism, financial services, and communications & utilities sectors. In most cases, these private pensions supplement contributory retirement benefits offered by the NIB. According to the Central Bank's latest survey of private pensions, approximately one fourth of the Bahamian workforce participates in occupational pension plans.

Although many of the earlier established plans are defined benefit schemes, more employers are moving toward defined contribution plans (as is the trend in most countries). In fact, private sector survey results for 2005 revealed that defined contribution plans were most prevalent, representing an estimated 81% of organised plans, although only 21.6% of total pension assets and 14.7% of pension participants. The longer standing defined benefit plans accounted for 85.3% of participants and 79.4% of estimated total assets[2].

The total assets of the surveyed private pension funds were $954.3 million, which represented an increase of 15.9% of GDP in 2005[3]. Similar to the National Insurance Fund, the private pension funds reported investing primarily in domestic securities. Governed by no domestic legislation, pension or investment fund managers of private pensions are required to adhere to the investment policy agreement with their clients. No doubt that these agreements seek to ensure that contributions invested meet the future obligations of their respective beneficiaries.



Source: Survey of Private Pension Plans in The Bahamas (2005), Central Bank of The Bahamas

[2] Survey of Private Pension Plans in The Bahamas (2005), Central Bank of The Bahamas
[3] Survey of Private Pension Plans in The Bahamas (2005), Central Bank of The Bahamas

Personal pension plans, as defined by the OECD, either take the form of savings in bank deposits or in pension-type products offered by banks, domestic credit unions and insurance companies[4].

In contrast to the public pension plans, private plans have at least two advantages. Firstly, private schemes present the opportunity to make voluntary contributions over and above minimum requirements of a plan; unlike the current NIB contributory plan, which caps the maximum insurable amount at $20,800 per year. Secondly, some private pension plans, depending on their structure, have the ability to move from one pension fund manager to another.

Analysis

Having summarised the pension landscape in The Bahamas, and explored the state of the public and private pensions, it would appear prudent to move toward privatising public pensions and making participation mandatory.

The proposed system would:

- Separate the social security/assistance system from the pension fund components of the National Insurance Board
- Change the Public Service Pension Plan to a defined contribution scheme
- Ensure that these pension components be managed by private, licensed pension fund managers or administrators who would invest in a portfolio of assets including stocks or bonds or government debt. The operating accounts of the manager would, of course, be separate from the individual contributor accounts. The regulatory body would set diversification and investment rules, including investing in assets meeting minimum credit ratings.
- Set a minimum contribution amount that all employed persons would have to contribute, say 10% (workers may contribute additional amounts on a voluntary basis)
- Each individual would have an account where the money paid into it is owned by that worker. There is a fundamental link between what people put into their pension program and what they take out; the NIB consists of National Insurance numbers created to establish accounts on behalf of individuals. The accounts

[4] Private Pensions, OECD Classification and Glossary, 2005

primarily serve to record contributions and receive capped benefit payments. A private pension account is owned by a worker and the money paid into it owned by that worker.

- Make accumulated pension funds transferable from one pension fund manager to another, providing a healthy level of competition.
- An individual could, based on their retirement goals and preferred retirement age, contribute the amount necessary to receive the desired pension amount at retirement. For example, if one wanted to retire at 55 years of age, they could increase their minimum contribution to 15% to cover the earlier retirement date.

Benefits of Pensions to the Economy

Based on the most recent survey of total assets, the amount of these assets invested in the domestic markets is quite high. Even though the majority of assets of both public and private pension funds are invested in government bonds, there has been an increasing trend in moving toward higher levels of portfolio assets being invested in private sector investment instruments. The participation of pension funds in capital market activity is essential to its growth.

A primary benefit of the proposed system would be the incentive for individuals to save, based on the tangibility implied in accruing savings in a personal account. An increase in personal savings on a national basis would provide a greater asset base that could be used to invest in the country's development. This could be either through direct or portfolio investment. The latter, would in fact create much needed support to the local capital market and BISX.

Privatising pensions has the potential to create a cultural change that may result in the convergence of employee and employer goals. Where workers have the security of an individual pension account, which is portable and has growth potential, the worker has ownership in the market economy. It may be that the largest asset owned by individuals is their pension account, rather than their small house or used car. The effects of the individual account translate into savings, growth and capital markets.

A separate but also a primary benefit of the system described is that Government liabilities would be clearly determined, enabling clearer planning and an efficient use of resources.

Conclusion

Of course, a move from the current system to a new one would not take place over night. And it would require some basic infrastructure to be in place to facilitate what is essentially a paradigm shift. Some of the required elements include:

1. Legislation would need to be in place to support this system. Essential components of this legislation are the establishment of a regulatory body with relevant authority for licensing and registration of persons and entities, full disclosure of information to contributors and the regulator, accountability of trustees, managers, and administrators, investment limits, self-employed and persons in non-pensionable employment, and mandatory preservation and portability of pension rights.
2. Financial literacy programmes aimed at investor education which contributes to a better understanding of the paradigm shift.

I was quite pleased to read in one of yesterday's dailies that Government has taken steps to establish an informal committee to create a proposal on pension regulation. This is a very positive move and I hope that the exercise takes into consideration some of the points raised during this presentation.