The Finnish pension system, the evolution of the public sector pensions and the ongoing reformation of the pensions

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Keva in brief

- Keva handles the pension matters of employees of local governments, the State, the Church and the Social Insurance Institution Kela. We provide earnings-related pension services for some 1.3 million public sector employees and pension recipients.
- Keva is responsible for the funding of local government employees' pensions and for investing pension assets. These pensions are funded through contributions from local government employers and employees. In 2014 Keva's contribution income amounted to approximately EUR 5.2 billion. The value of our investments is around EUR 41.5 billion (31 December 2014).
- Keva is an independent public corporation that operates in accordance with the Local Government Pensions Act (KuEL). Keva is supervised by the Ministry of Finance and the Financial Supervisory Authority.

The Finnish pension system

Central features of the Finnish pension system

Statutory	Statutory	Voluntary
National pension	Earnings-related pension	Voluntary pension insurance

National pension

- Based on residency
  - time lived in Finland
- Amount of pension affected by
  - earnings-related pension income
  - family circumstances
- Guarantee pension

Earnings-related pension

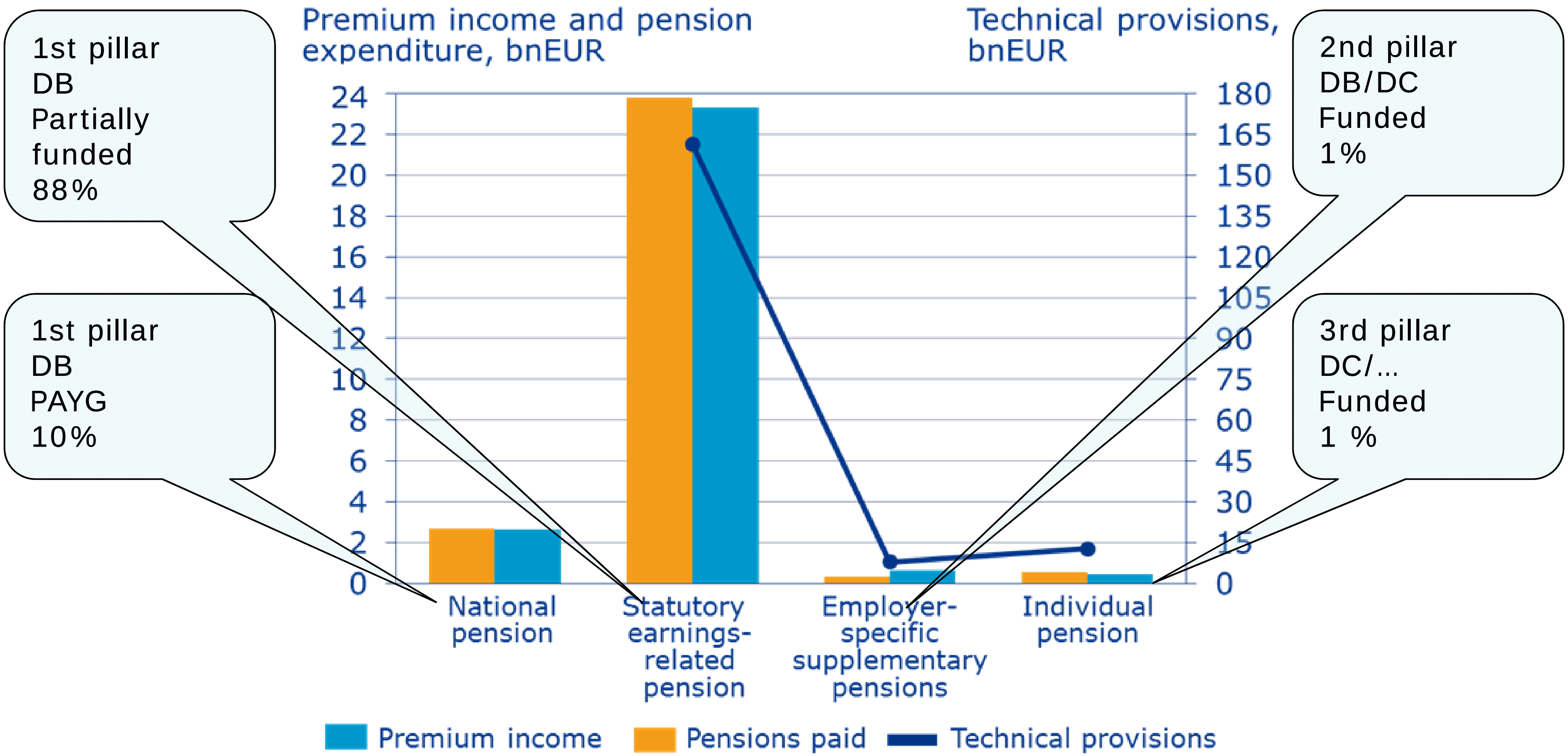
- Based on employment
- Earnings-related pension institutions
- Determined according to income from earnings

Basic cover	Income security	Supplementary cover

Central earnings-related pension acts

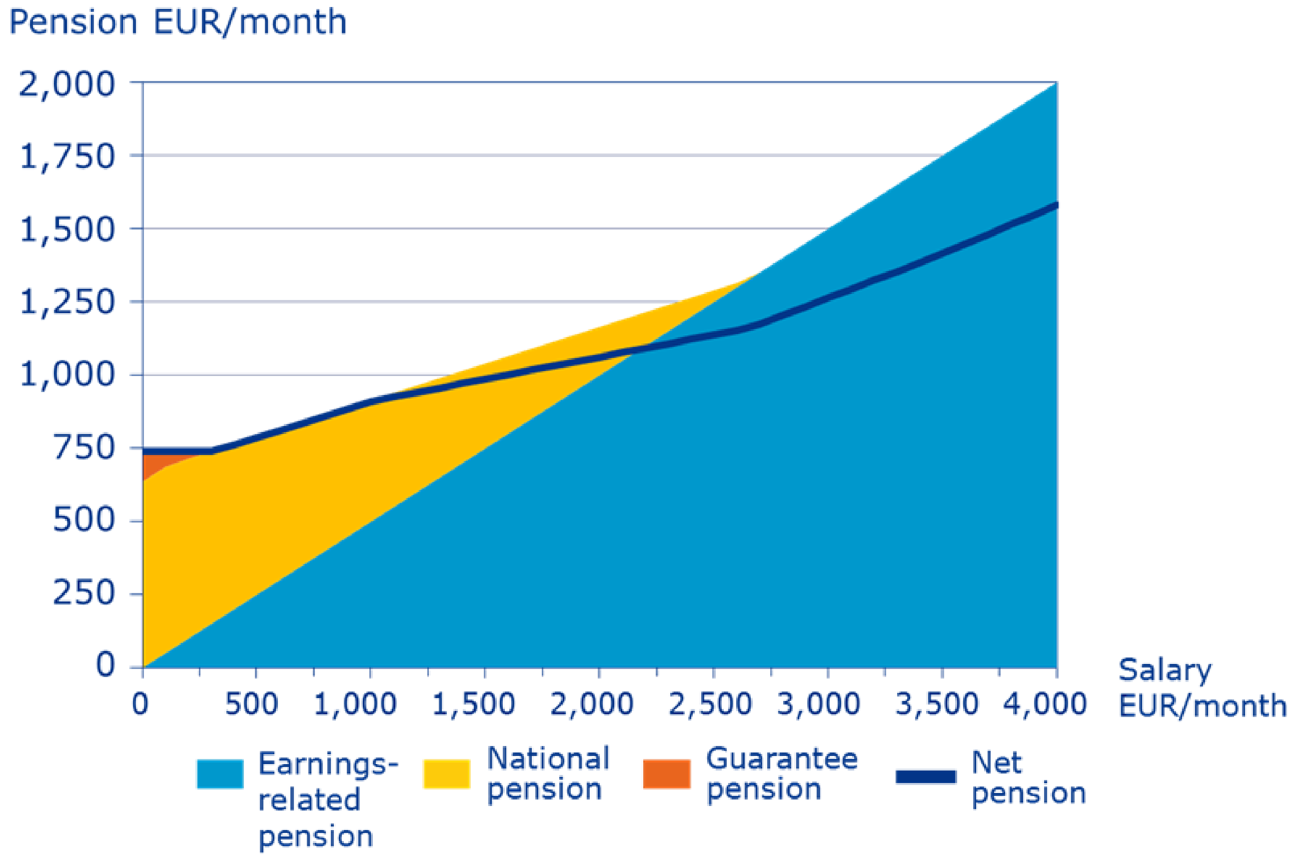
Pensions act	Act covers	Pension institution
KuEL Local Government Pensions Act	Persons employed by member organisations of Keva	Keva
VaEL State Employees' Pensions Act	Persons employed by the State	Keva
KiEL Evangelical-Lutheran Church Pensions Act	Persons employed by the Evangelical-Lutheran Church and its congregations	Keva
TyEL Employees Pensions Act	Persons serving a private employer	Pension insurance companies, pension funds and pension foundations
MEL Seamen's Pension Act	Persons performing work on board vessels in international traffic as specified in the Act	Seafarer's Pension Fund
YEL Self-Employed Persons' Pensions Act	Entrepreneurs	Pension insurance companies
MYEL Farmers' Pensions Act	Covers farmers, reindeer herders and fisherman	Farmers' Social Insurance Institution

Pension insurance in Finland in 2013



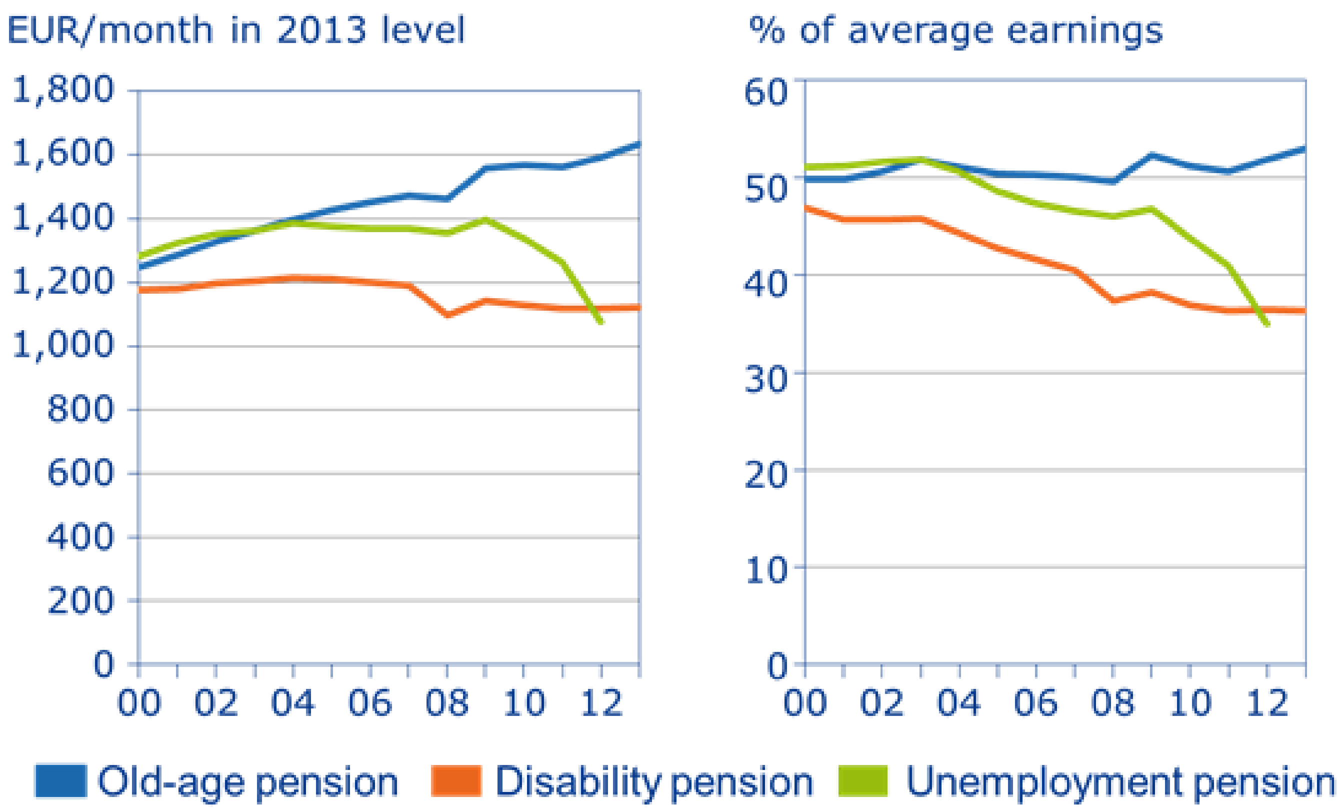
Source: Finnish Centre for Pensions

Total pension in 2015



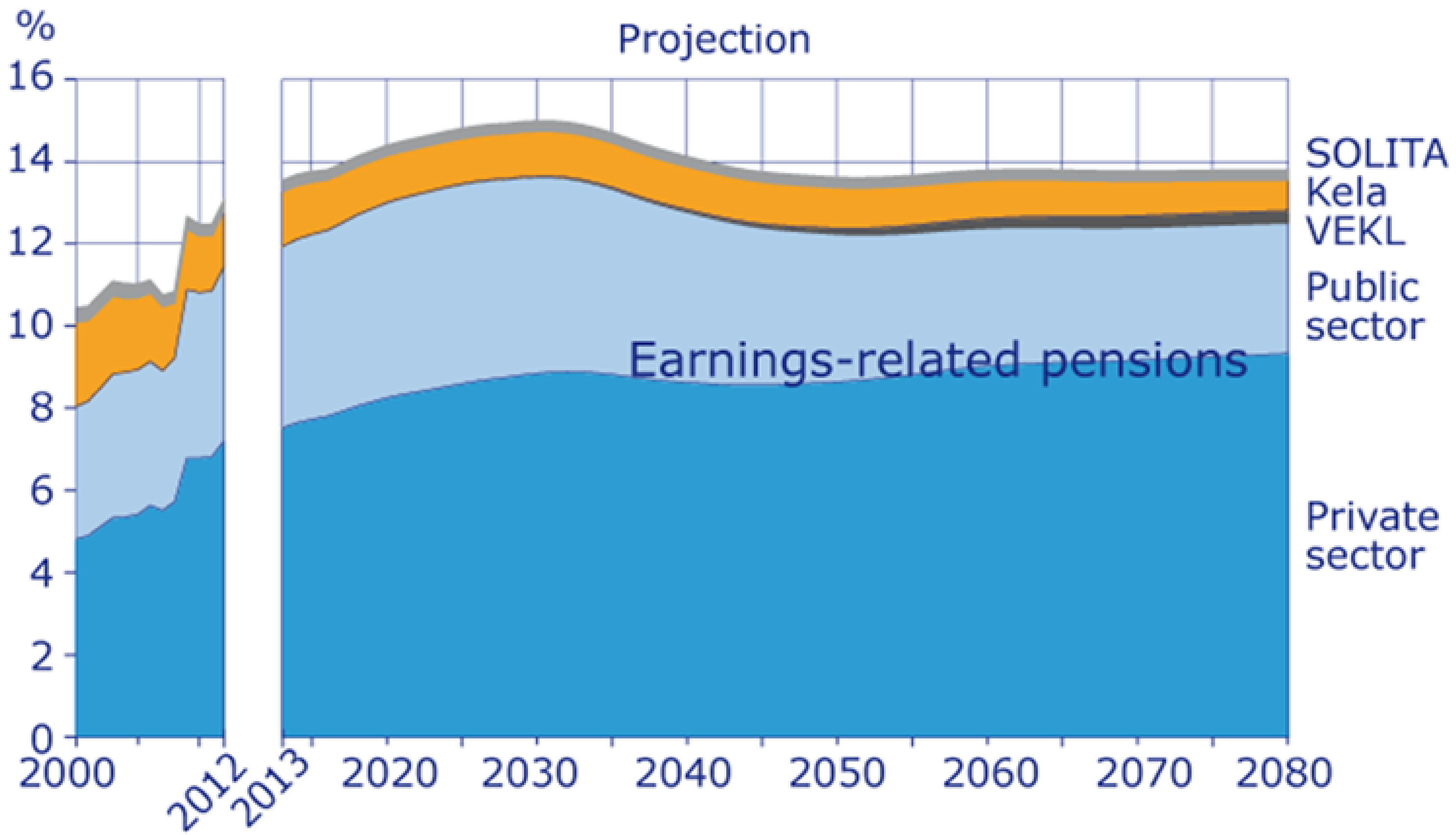
Source: Finnish Centre for Pensions

Average total pension and its ratio to average earnings 2000 - 2013



Source: Finnish Centre for Pensions

Pension expenditure, per cent of GDP



Source: Finnish Centre for Pensions

The evolution of the public sector pension systems

Case ’Local Government pensions’

(applies to the rest of the public sector pension systems)

The evolution of the Local Government pension system – the Timeline 1/4

- **Late 19th century - 1964**: cities and municipalities had their own pension plans
- **1964**: the Act on Local Government Officeholders' and Employees' Pensions
  - Defined benefit
    - Generous benefits: 66 per cent of the final salary-level, accrued in 25 – 30 yrs, professional retirement age from 53 to 63
    - Benefit level roughly 30 per cent better than in the private sector - compensated the low level of salaries
  - Financing method: Pay-as-you-go, no funding
    - Very low costs at the beginning, the problem is in the sharply rising costs

The evolution of the Local Government pension system – the Timeline 2/4

- **1988**: pension liability fund was established
  - A buffer fund, designed to be used to level out and control the growth in the contribution rate when the post-war baby-boom generation has retired
  - Estimated contribution rate maximum nearly 50 per cent of the payroll
- **1989**: cuts to the benefits – 1st step towards the private sector pension system
  - Pension calculated from each period of employment
  - Professional retirement age system – people had to choose whether to stay in the professional system or to take the more flexible system
  - The aim was to bring down the estimated cost

The evolution of the Local Government pension system – the Timeline 3/4

- **1995** : cuts to the benefits – 2nd step (a very big step!) towards the private sector pension system
  - Pension accrual to 60 per cent in 40 yrs of service
  - Pension calculated from the 10 yr average of each period of employment
  - Pensionable age to 65
  - Cuts to the indexation
  - Old public sector (better) benefits were adjusted to the new system
  - The aim was to bring down the estimated cost

The evolution of the Local Government pension system – the Timeline 4/4

- **2005**: more flexible pensions – 3rd step (a “final” step) towards the private sector pension system
  - Pensionable age flexible from 63 to 68 years.
  - Career average
  - Age dependent accrual rate: 1.5 % (18-52 yrs), 1.9 % (53-62 yrs), 4.5 % (63-67 yrs)
  - Mandatory indexation
    - accrued rights: 80% wage index - 20 % cpi
    - Pensions: 20 % wage index – 80 % cpi
  - Life expectancy coefficient
  - No upper limit for pensions
  - Old public sector (better) benefits were adjusted to the new system

The ongoing Reformation of the pensions

Reforming the Earnings-related pensions

- **The drivers,** why a new reform was needed?
  - Life expectancy has increased significantly since 2005
  - The sustainability gap of public finances ~ 4 percent of the GDP
- **The aim** of the pension reform:
  - Extend working life
  - Reduce the sustainability gap of public finances by appr. 1 percent of the GDP
  - Effective retirement age from 60.9 to 62.4 years in 2025
- **The solution** - Agreement on 26th of September
  - The central labor market organizations except AKAVA (highly educated employees) signed the agreement
  - the Finnish government stated that the targets will be reached

Reforming the Earnings-related pensions

- **The process** of amending legislation
  - the Ministry of Social Affairs and Health started the process of amending legislation according to the proposal agreed by the social partners
  - Some 10 percent of the current public sector workers have old, better pension benefits, that require further negotiations

- **The timetable**
  - Proposals to the parliament: autumn 2015
  - Into force: January 1st 2017

The main changes 1/3

- **Old age pension**
  - The earliest eligibility age rises gradually from 63 to 65 by 2027 and after that it will be linked to life expectancy.
  - The upper age limit for old-age pension: 5 years higher.
  - Target age for retirement.
- **Partial old age pension**
  - Replaces the current part-time pension.
  - The earliest eligibility age: 61 years (62 in 2025 and after).
  - Either 25 or 50 per cent of the accrued old-age pension.
  - If drawn before the earliest eligibility age for old-age pension, the pension will be reduced by 0.4 per cent each month.
  - the pension will be adjusted with the life expectancy coefficient at the time of drawing the pension.

The main changes 2/3

- **A years-of-service pension**
  - Can be applied for after a working life spanning 38 years.
  - The earliest eligibility age: 63 years.
  - Preconditions: medically diagnosed disability (illness, handicap, injury); work is either physically or mentally wearing.
- **The life expectancy coefficient**
  - will be calculated in a more lenient manner than currently as of 2027, at which time the retirement age for all age cohorts will be 65 years.
- The life expectancy coefficient will also be used when calculating a **target retirement age** for each age cohort.
  - The target retirement age indicates how much additional working will be required to compensate the monthly reduction in the pension caused by the life expectancy coefficient.

The main changes 3/3

- **Standardized pension accrual rates**
  - the annual pension accrual rate of individuals of all ages will be 1.5 per cent of the wages.
- Working after reaching the earliest eligibility age for old-age pension: **a monthly increment for deferred retirement**.
  - 0.4 per cent per month of the already accrued pension.
- **A transition period**
  - individuals aged between 53 and 62 years will accrue a pension at a rate of 1.7 per cent per year until 2025 (the employee's contribution will be increased by 1.5 percentage points).
- **Pension will accrue from the full wage** since the wage-earners' earnings-related pension contribution will no longer be deducted from the pensionable wage.

Estimated effects

- **The society:** reduces the sustainability gap of public finances, slows down the change in the dependency ratio, ...
- **The pension system:** the pension expenditure grows slower, reduces the need to raise the contribution level, ...
- **An individual scheme member:** monthly pension grows (but is drawn for a shorter time).
- The effects, when measured by current values of contributions and pension benefits:
  - People born in the eighties or later will gain some.
  - People born in the sixties or seventies will lose some.
  - Women gain relatively more than men.

Financing of the Local Government Pension Scheme

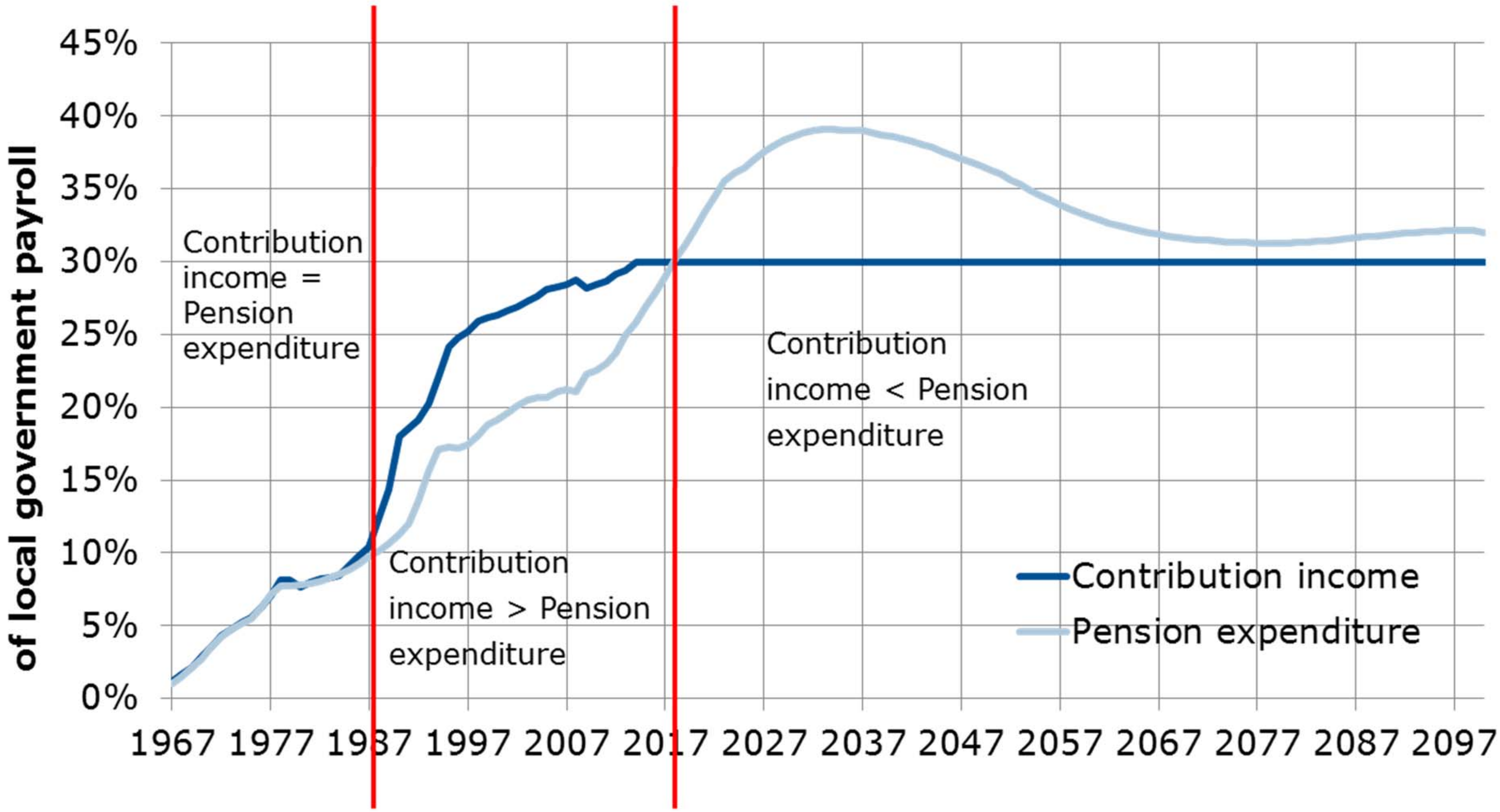
Local Government pension scheme Background

- Keva is responsible for funding the earnings-related pension cover of municipal sector employees. Keva was established 1964.
- Member organizations of Keva include all Finnish cities, other municipalities and joint municipal boards. Municipal associations and limited liability companies may also apply for membership. At the end of 2014, member organizations totaled 967.
- Financing is based on joint liability: all expenses incurred by the pension institution are divided by the member organizations.
- Initially, the system was a pure pay-as-you-go: contributions and pension expenditure were equal.
- In a PAYG system, contributions and accruing pension liabilities are not linked at the annual level; the link is long term.
- The problem is that before the system matures to a stable level, the contributions tend to rise sharply.

Local Government Pension Scheme From PAYG to Buffer Fund

- Contribution income in 2014 was EUR 5.2 billion
- Pensions expenditure in 2013 was EUR 4.4 billion
- Since 1988, contribution income not directly used for pension payments is funded to cover future pension liability
- Even now, contributions and accruing pension liabilities are not linked at the annual level. However, contributions are adjusted so that the fund investment return and future contribution income are in balance with future pension expenditure.
- Through funding, Keva is preparing to level out and control the growth in the contribution rate when the post-war baby-boom generation has retired
- The funding ratio at the end of 2014 was ~ 40 %
- Information about Keva's portfolio allocation and investment strategies is available at www.keva.fi.

Stages of local government pension system funding



Financing of the State Pension Scheme

The State Pension Scheme (1/3) Background Information

- The State Pension Scheme covers all employees of government offices and institutions.

- For historical reasons, some other institutions have remained in the state pension scheme.

- Important to note: The number of active members in the state pension scheme has reduced from nearly 300 000 (before 1990) to around 155 000 (now). This explains why pension expenditure is significantly higher than contribution income.

The State Pension Scheme (2/3)
From Pure PAYG to Buffer Fund

- Before 1991, State Pension system was a pure pay-as-you-go (PAYG) system financed from the government budget. State employers and employees did not pay any contributions.
- The State Pension Fund (VER) was established in 1990. Starting from 1991, state employers (employees 1993) were directed to pay contributions to State Pension. Contributions amount to the actuarial value of new accruing pension liability.
- VER is a pure investment organization that acts as a buffer to state pension expenditure. Funds are annually transferred from VER to State budget to alleviate, but not to fully cover the pension expenditure.
- Information about VER portfolio allocation and investment strategies is available at www.ver.fi.

The State Pension Scheme (3/3) Financial Status 2013

- Since 1990 the new pension accruals are fully funded by annual contributions from employees and employers
  - 2013: contributions 24.9 % of payroll; EUR 1.6 billion
  - Liabilities before 1990 are not funded; liabilities after 1990 are only partly funded due to transfer of funds from VER
  - The state's pension liability Dec. 31st 2013 was EUR 94 billion
- The pension contributions are "forwarded" to the State Pension Fund (VER)
  - The market value of assets Dec. 31st 2013 was EUR 16,3 billion
  - The funding ratio ~ 17 %; the target is 25 %
- VER transfers funds to the state budget; the amount equals 40 % of the annual state pension expenditure
  - 2013: EUR 1.7 billion
- The state pensions are paid from the state budget
  - 2013: EUR 4.2 billion

How the Buffer Fund Alleviates Pension Expenditure