FINANCIAL FLAGSHIP

RETIREMENT SAVINGS IN MENA

GUSTAVO DEMARCO*

DECEMBER 2010

The World Bank

* This chapter was prepared by Gustavo Demarco. Diego Sourrouille and Montserrat Pallares-Miralles were responsible for collecting and preparing the primary information used for the analysis. Long term financial projections for Egypt and Jordan were prepared by Tatyana Bogomolova. Marco Semmelmann provided research assistance in the preparation of the report.

Table of Contents

1. Introduction

An extensive literature explores the links between retirement saving and capital market development under the common assumption that funded social security has a positive impact on savings, as opposed to the negative impact of unfunded public pension schemes[1]. Several pension reforms worldwide assumed, as part of their expected outcomes, a presumably positive impact on savings and financial development. This relationship has been the object of theoretical and empirical research since the late 1950s, and the discussion revived in the 90s and early 2000s, particularly associated with the expected impact of pension reforms in Latin America and ECA.

Several authors sustain the existence of a positive correlation, but empirical evidence is not conclusive, even in countries with important development of private pensions [2]. In addition, the volume of funds managed by private pension providers in emerging countries is only significant when there is a mandate or when incentives to contribute are high. Voluntary schemes, by contrast, do not show a significant impact on savings[3]. Enhancing the development of institutional financial intermediation and instruments, on the other hand, has been the most indisputable contribution of private pensions to economic development[4].

While the links between financial markets and pensions are usually stronger in the case of a shift to funded private pensions, many public pension schemes worldwide manage substantially large volumes of reserves and rank among the most important institutional investors in their countries, so even when the net impact of public pensions on savings was not relevant at the macro level, the analysis of portfolio management by public pension funds is very relevant from a micro perspective.

In the MENA countries, private pensions do not play a significant role as providers of retirement savings, in spite of some isolated efforts to promote their growth. Public pensions, in contrast, represent the major source of retirement income, accumulate fairly large amounts of reserves and are very important institutional investors. However, public pension funds will be dramatically reduced or depleted in the short term due to aging population, inconsistencies in the design of the systems and poor management of reserves. The objective of this note is to analyze the factors explaining the dynamics of public pension reserves and the possible role of private pensions as an alternative source of retirement savings. The discussion will take into account the social insurance reform processes in the region as well as the conditions to be met in order to deepen the incipient private pension development in the region.

[1] See: Davis, E. P. and Yu-Wei Hu: "Funding, saving and economic growth" in Clark et al. (2006), pp. 203-204.
[2] See, for example: World Bank (1994), Feldstein (1998), Diamond (1999), Valdes Prieto (2002), Thompson (1998), pp. 51-69.
[3] With evidence from a panel of 50 countries, Lopez-Murphy and Musalem (2004) estimate a positive correlation between private pensions and savings when there is a mandatory shift from PAYG to funded schemes, but the correlation is weak for the case of voluntary pension schemes.
[4] Walker, E. and F. Lefort (2002).

2. Overview of Public and Private Pensions in MENA

For the purpose of our analysis, we will define "private pensions" broadly to include both privately managed pension schemes and those schemes that include a funded component where investment is delegated to private managers. Both groups are incipient or non existing in the MENA, and while some countries are making important efforts to promote their development, prospects of growth are fairly limited with the possible exception of Egypt, where a recently enacted law introduced a funded mandatory pensions component that will manage part of the mandatory contributions to pensions and unemployment insurance[5]. In addition to their small size, privately managed pension funds are unregulated or under-regulated, and therefore information regarding their size and portfolio composition is very limited.

Public pensions, on the other hand, provide the main source of retirement income and will continue to be significant in the region. While PAYG rules dominate as financing mechanism, some countries pre-fund pension liabilities and their reserves represent a high percentage of GDP[6]. Table 1 shows the relative size (as percentage of GDP) of pension funds in selected countries from MENA between 2000 and 2008.

Table 1 – Pension Assets (% of GDP)

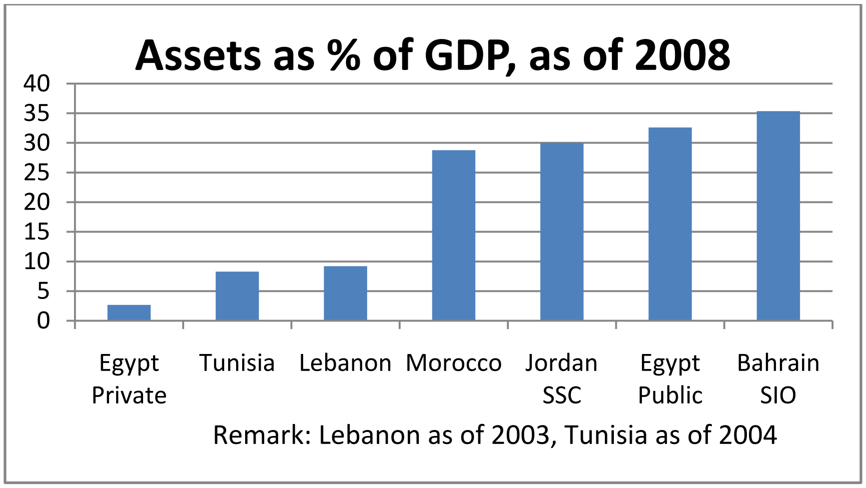
	2000	2001	2002	2003	2004	2005	2006	2007	2008
PUBLIC PENSION RESERVES									
Egypt	41.5	44.1	47.1	47.9	46.3	48.0	43.1	37.7	32.6
Jordan	22.2	23.4	23.7	26.6	31.3	47.5	34.5	39.4	30.0
Morocco (1)		12.6		14.5	16.8	18.9	20.3	22.1	28.8
Bahrain			22.3	47.5	49.8	46.8	42.5	44.1	35.4
Kuwait (2)							50.1		
Saudi Arabia (2)							2.8		
Tunisia	9.4				8.3				
Lebanon				9.2					
Oman									22.6
II. PRIVATE PENSION FUNDS									
Egypt Private	2.4	2.6	2.9	2.9	2.9	3.1	3.0	2.7	2.7
Jordan Private			3.4						

Civil service schemes only. Data for Oman as of 2009.
Source: World Bank, based on reports produced by Social Security institutions and pension supervisors.
(2) Mitchell, O. et al (2008).

[5] For details for the new Egyptian pension scheme see: Maait and Demarco (2010).
[6] As noted by Impavido, O'Connor and Vittas (2007), pre-funded pension schemes that mostly invest in non tradable public bonds can be assimilated to unfunded schemes. This is arguably the case of Egypt and Morocco, as will be later discussed.

As seen in Table 1, private pension funds are still small in the few countries for which information was available. By contrast, public pension reserves represent around one third of GDP in Jordan, Egypt, Morocco, Bahrain and around one fourth in Oman (22.6%), and therefore they constitute the major institutional investors in these countries.

Figure 1



Several reasons converge to explain the small size of private pensions in MENA. The main constraint is arguably the generosity of the public pension schemes that offer benefits well above international benchmarks and allow for benefit overlaps through permissive early retirement rules. Other factors such as poor enabling environment provide additional reasons for the poor development of private pensions. Several factors explain the limited relevance of private pensions in the region, including the poor development of financial institutions and the lack of incentives to compete with very generous benefits offered by the public schemes in most of the countries[7].

The generosity of most pension schemes in MENA represents one of the major barriers, not only to potential growth of funded schemes, but also to the reserves of the current pension schemes. The relative immaturity of public pension schemes has been an obstacle of stronger actions to reform public pensions, although an increasing number of countries in the region are becoming aware of the need to reform and a few have recently adopted actions in that direction[8]. Financial projections conducted in several countries in the region reveal that in the absence of important reforms, the reserves of most public pension schemes in MENA will be depleted. With a fairly young covered population, pension systems in MENA have traditionally not been prone to introducing reforms, but the situation has changed recently, since two important integrated social insurance reforms were approved in Jordan (September 2009) and Egypt (June 2010).

[7] See Robalino, D. (2005).
[8] Jordan (September 2009) and Egypt (June 2010) adopted comprehensive reforms by law. Other recent reforms in the region include West Bank-Gaza (2005), Djibouti (2009) and Iraq (2010). An ad hoc Pension Reform Commission in Morocco is also actively evaluating reform options.

Private pension development has a limited space in countries with generous public pensions, since lower expected benefits from the private schemes cannot compete with generous promises of the PAYG schemes. While the high IRR in MENA are unsustainable in the long term, individuals do not foresee the difficulties of public pensions to comply with their promises and cannot find enough incentives to contribute to private pension plans.

Several indicators reflect the generosity of the pension schemes in MENA. One single synthetic indicator is the average replacement ratio[9]. Table 2 shows that replacement rates at retirement in MENA are higher than in any other region, including the protective pension schemes in developed countries of the OECD. While this is valid for any income level, the difference in replacement ratio is particularly significant for average and higher income levels, where the replacement ratios tend to be much lower worldwide assuming more reliance on private retirement saving mechanisms. This element of progressivity of the pension systems is almost absent in MENA, and the last observation serves to further explain why private pensions have not developed as a complementary retirement savings mechanism for higher income earners as commonly as in other parts of the world.

Table 2. Replacement ratios for different earnings levels in different regions

Earnings level	**MENA**	**OECD**	**ECA**	**LAC**
Low	**81.3**	**74.6**	**63.7**	**77.7**
Average	**77.9**	**56.4**	**56.4**	**57.2**
High	**75.7**	**46.4**	**50.4**	**48.3**

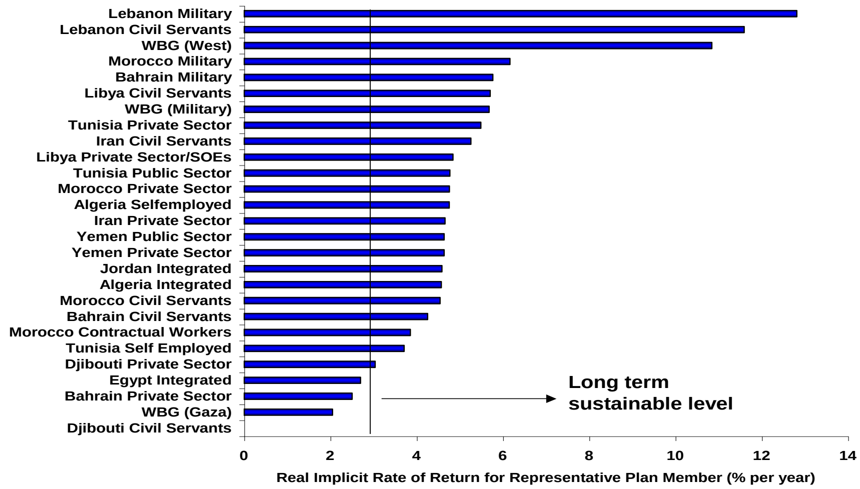
Source: Robalino (2005), p. 68.

As we will further discuss below, higher income replacement ratios are possible in schemes with young covered population, but they are not sustainable in the long term along with demographic changes associated with aging population.

While replacement ratios can be used to compare the generosity of pension schemes in MENA vis-à-vis other countries, the implicit rate of return on contributions can also be used as a synthetic indicator of sustainability. Although this rate is not an explicit parameter in unfunded (or even pre-funded) PAYG pension schemes, an implicit rate can be calculated based on the estimated flow of contributions and benefits. Rates estimated for MENA are presented in Figure 2 below. A vertical line has been traced to show the long term sustainable rate and it shows that, with the exception of the funded pension scheme of Gaza and those of Djibouti and Bahrain, the mandates of pension schemes in MENA largely exceed long term sustainable levels with IRR as high as five to thirteen percent in real terms.

[9] Replacement ratio is defined as the ratio of pensions to wages. There are several ways to define and calculate this ratio. The numbers shown in the table are based on the definition of the initial pension according to the law of each country.

Figure 2. Implicit rates of return on contributions of mandatory pension schemes in MENA



Source: Robalino (2005)

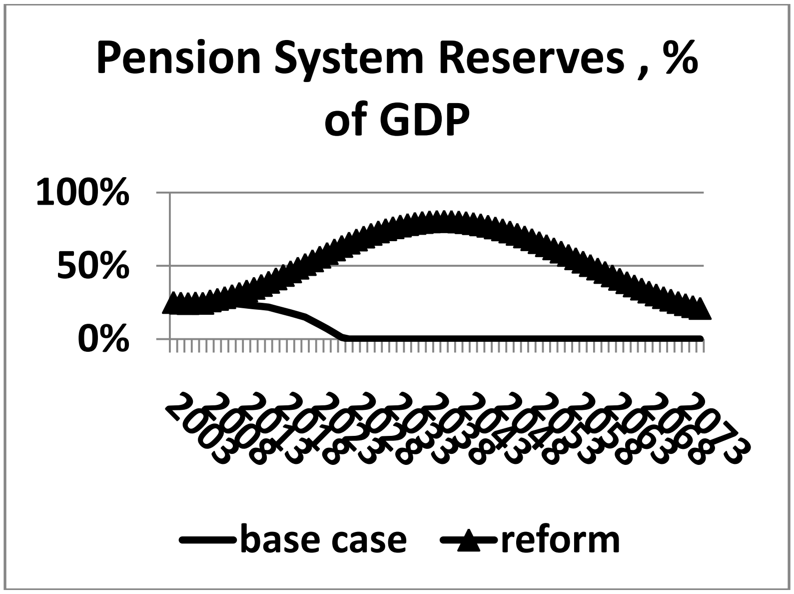
The previous analysis shows, on the one hand, that private pensions cannot expand in a context where public pension schemes are offering so high returns on contributions. How long will the public systems be able to survive with the current mandates depends on the pace of the demographic change and, in the case of pre-funded schemes, on the evolution of pension reserves.

3. Public Pensions Reserves

While mandatory public pension systems in MENA are still young, their reserves are high in countries where prefunding of pensions is a rule. As seen in Table 1, public pension funds account for around 30% of GDP in four of the countries for which data are available and around 20% of GDP for Oman. A remarkable result from Table 1 is that, with the exception of Morocco, public pension funds represented higher percentages of GDP in the years before the international financial crisis, when public pension reserves represented almost 50% of GDP in Egypt, Jordan and Bahrain. While financial markets volatility may contribute to explain this result, the dynamics of public pension reserves is determined by several other factors, and cyclical factors may only partially explain these results, while a long term trend may be determined by structural factors affecting the financial situation of the public pension schemes.

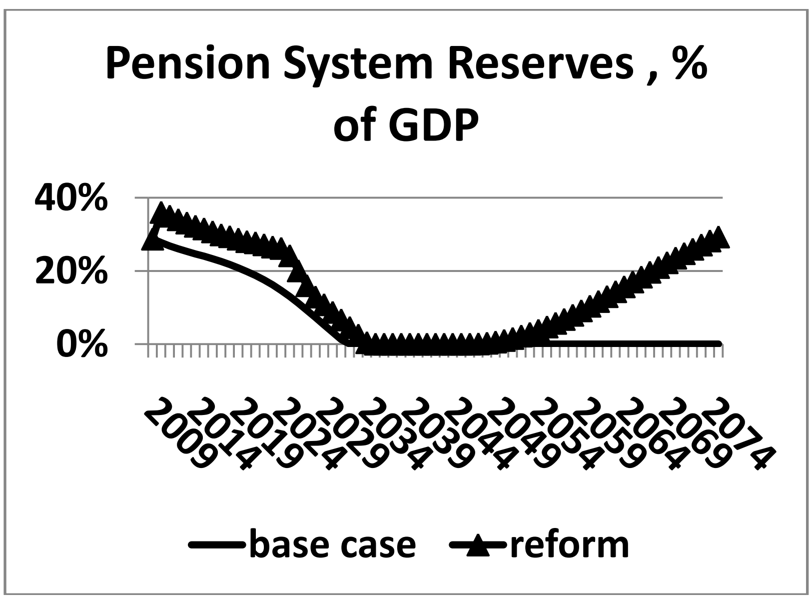
The long term evolution of public reserves is in fact determined by several factors, among which the following play a significant role: (i) the extent to which the pension schemes reach maturity (or, equivalently, the age structure of the covered population); (ii) the generosity of benefits; (iii) the returns on investments. Financial projections produced for several countries in MENA show that without important reforms, most pension systems in the region are unsustainable. This, in turn, implies increasing deficits, the use of accumulated reserves, and eventually the need of fiscal transfers. Figures 3.a and 3.b show the long term projection of reserves for Jordan and Egypt under the rules of the pre-reformed pension systems (currently still in place in both countries).

Figure 3.a. Projected pension reserves for Jordan



Source: World Bank.

Figure 3.b. Projected pension reserves for Egypt



Source: World Bank.

In both cases, a non reform scenario would imply depletion of reserves by year 2027 (Jordan) or 2032 (Egypt).

It has to be noted that both countries have adopted reforms recently, but gradual rules apply and as a result the deficits will persist and therefore pension reserves are expected to diminish over the next years. It is interesting to note that both reforms will have totally different impacts on the volume of reserves, which in turn can be explained by the different architecture of the systems and their reforms. Annex 1 and 2 provide a succinct summary of the two major recent pension reforms that took place in these two countries.

In the case of Jordan, the reform consists of parametric adjustments, but they apply to part of the current labor force producing important short term savings, particularly with regard to early retirement pensions. Reserves will increase accordingly, but in the longer term the system will be affected by longevity risk and reserves will drop again until a new parametric adjustment happens.

In Egypt decelerating the decline in pension reserves will be limited because the new rules apply mostly to new entrants, and only exceptionally to the rest of the labor force. However, given the more structural nature of this reform, reserves will increase in the longer term until the new system reaches the pay-out phase.

While no data are available for Morocco, there is evidence that the accumulated consolidated deficit of the social security institutions will have a similar effect to the non-reformed scenarios for Jordan and Egypt and that reserves will be depleted in the course of the next 10 to 15 years if no reform to assure financial sustainability of the major pension schemes is set in place before.

With few exceptions, pension fund portfolios are concentrated in public bonds or fixed investments. Out of the five countries for which information is available, Jordan shows the most diversified portfolio with a low share of fixed income investment, particularly in comparison with the heavy concentration in this class of assets in Egypt. In Morocco, an important share of portfolio (38.1%) is invested in equities but still a very high percentage (61.1%) remains invested in fixed income instruments. The Social Insurance Organizations of Bahrain and Oman, in turn, show a more diversified portfolio than Egypt with significantly higher share of equities (26% in Bahrain and 35% in Oman), but the concentration of between 40 and 50% in cash and bank deposits does not reflect a reasonable match with liquidity needs of a fairly young schemes and therefore it is not consistent with the principles of asset liability management (ALM) of the pension portfolio.

Table 3. Public pension reserves portfolio composition in selected countries in MENA, 2008

Asset Class	Egypt	Jordan	Bahrain	Morocco	Oman
Fixed Income	95.3	15.6	10.1	61.1	**3.0**
Cash and CDs	0.0	6.0	38.3	0.0	**47.9**
Real Estate	0.0	7.7	11.4	0.8	**0.0**
Loans	0.0	3.0	1.3	0.0	**0.0**
Equity	4.7	62.9	26.0	38.1	**35.2**
Others	0.0	4.7	13.0	0.0	**13.9**

Source: World Bank, based on information provided by pension institutions and other official sources

Portfolio concentration is only one indicator to assess the quality of portfolio management. Access to information of returns and investment policies and guidelines are critical missing pieces for a comprehensive analysis, but the lack of such information is another indicator or deficiencies in the investment process.

Four main reasons explain these limitations: (i) insufficient development of local financial markets and products; (ii) poor governance of the pension funds; (iii) interferences in the definition of investment policies and decisions; (iv) lack of professional portfolio management.[10] In a context of poor financial sector development and fast growth of pension reserves, funds in MENA are not managed professionally or independently of other political objectives, as recommended by best international practices[11].

Insufficient development of financial products is a common feature in the region and a severe constraint to efficient pension portfolio management. Both in the case of big public pension reserves and incipient private funded schemes, the level of sophistication of the local financial markets is excessively low. An obvious alternative is allowing investments abroad, but this is a common type of interference in the investment process mainly (but not only) originated in restrictions to operate with foreign assets. A notable example is the pension fund of West Bank-Gaza, where international political factors deterred the pension fund from investing its meager fund abroad.

Pension funds governance is a major constraint to attain best practices of investment policies and portfolio management. International best practice requires pension funds to be managed independently from the government, but this condition is rarely met[12]. In addition, investment guidelines and policies frequently do not exist or they are not disclosed, and even information to fund members and public on the portfolio composition is not provided or managed as confidential, adding concerns about the accountability of the decision makers. A notable exception in MENA is Jordan, where a separate investment unit was created to manage the fund of the Social Security Corporation. While this represents the best example of good governance and accountability in pension fund management in the region, the magnitude of its investments in strategic sectors makes the SSC vulnerable to different forms of interference in its investment strategy design.

The government is typically referred to as the main and most important interference in the investment process, although not the only one. In the early accumulation phase, when pension funds multiply their reserves exponentially, they are perceived as an important source of funding for multiple objectives. Governments in need of funding for big infrastructure or social projects see the wealthy pension funds as their ultimate solution to get easy and affordable credit. As legitimate as these objectives may be, the use of non-tradable instruments and the negative real rates of return have led to faster depletion of pension reserves. A notable example in the region is the National Investment Bank of Egypt, whose borrowing at negative rates was one of the

---

[10] Hess and Impavido (2003) reported explicit mandates in 60% of surveyed 26 public pension funds worldwide. Interference in asset management is a common practice in public pension funds, with negative consequences in expected returns.
[11] See: Robalino (2005), Musalem and Palacios (2003), ILO (2007).
[12] In their report for Cyprus, Impavido, O'Connnor and Vittas (2007) extensively discuss the relevance of good governance principles by discussing several examples from the international experiences.

major factors that led to the need for a pension reform[13]. Impavido (2009) proposes the need to include “residual claimants” (i.e., members and pensioners) in the boards of the funds, but he also notes that they may not be exempt from other forms of political interference, especially in countries (like those of MENA) where representation of workers is not independent from the political power. Other sources of interference, independent from the political process, occur when regulations establish binding conditions for the investment of reserves, typically imposing local investment, or a minimum percentage of the portfolio in certain classes of assets such as public bonds or social investments.

While best international practice recommends independent and professional portfolio management, this is normally not the case in the countries of MENA, with the exception of the SSC investment unit mentioned above. Discretionary decision of portfolio management is often decided in MENA by the boards or even the management of the Social Security, often without the necessary technical expertise or qualifications.

Information available (summarized in Table 3) is insufficient to support general conclusions for the region. In fact, portfolio diversification is just an element to evaluate the quality of portfolio management; a thorough analysis of efficiency is beyond the scope of this work and would need, in addition, an assessment of investment policies, guidelines and procedures, risks and returns[14]. According to the analytical framework of ALM portfolio management, however, the changing horizon of pension liabilities should lead to different dynamic asset allocation pattern in order to manage the different types of risks involved in the need to match assets and liabilities. The consequence would be a higher concentration in fixed investments as the systems mature and the covered population ages[15]. In the pension systems of MENA, population is still young and there are no good reasons to explain the high concentration in fixed income assets noted above from a rational theoretic perspective.

Figures 4,5 and 6 show the evolution of portfolio structure in three of the countries considered[16]. Changes in portfolio structure are very noticeable in Jordan, with a remarkable increase in equities between the years 2000 and 2008. In the case of Bahrain, changes in portfolio structure are more clearly associated with the impact of the financial crisis, partially explaining the high increase in cash and bank deposits. Egypt, on the other hand, shows an almost immutable portfolio mostly composed by public bonds and bank deposits, a situation that serves to illustrate the enormous challenges that will face the introduction of the new pension system that demands a very active pension portfolio management. The situation in Jordan is the result of the actions to develop an independent and professional portfolio management unit and this in clear in the changes of portfolio structure between 2000 and 2008 as compared with the relative immobility of the portfolio structure of Bahrain in a similar time frame.

Oman is a very remarkable example of a public pension fund where stabilization purposes superseded pension benefit goals (profitability) in the past years. Cash as a percentage of total

[13] Impavido, O’Connnor and Vittas (2007).
[14] For a comprehensive analysis of determinants of pension funds’ financial performance, see: Hinz et al (2010).
[15] See: Legros, F.: “Life –cycle options and preferences”, in Clark, G. et al. (2006), pp. 183-200.
[16] Information is also available for Egypt, but it only shows a persistently high percentage of the portfolio in public sector investments (National Investment Fund or Ministry of Finance).

investment increased significantly, while other fixed income investments decreased over time. In contrast, investments in equities remained constant as a percentage of total portfolio. Furthermore, fixed income investments are far below regional average.

Figure 4

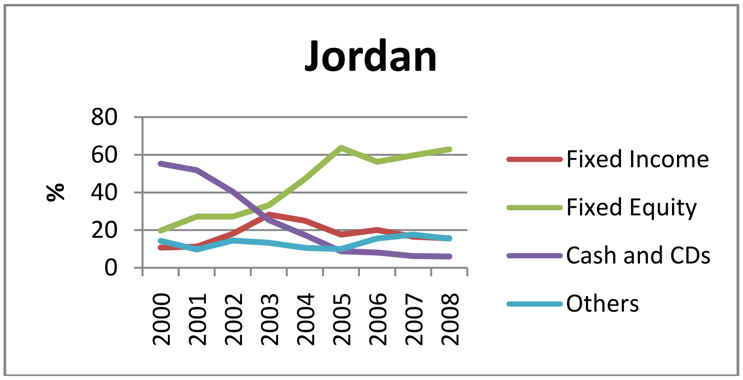


Figure 5

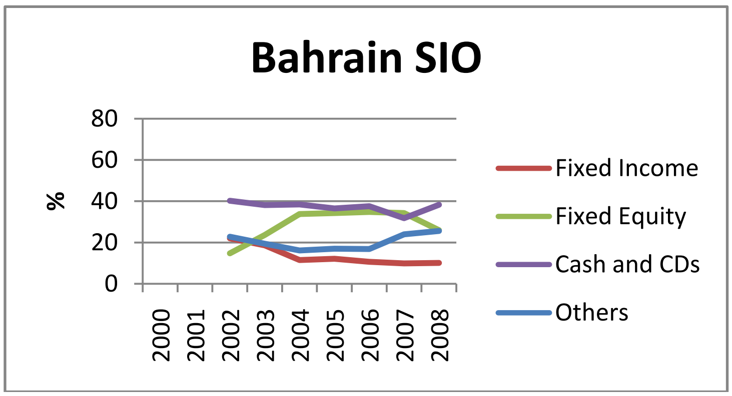
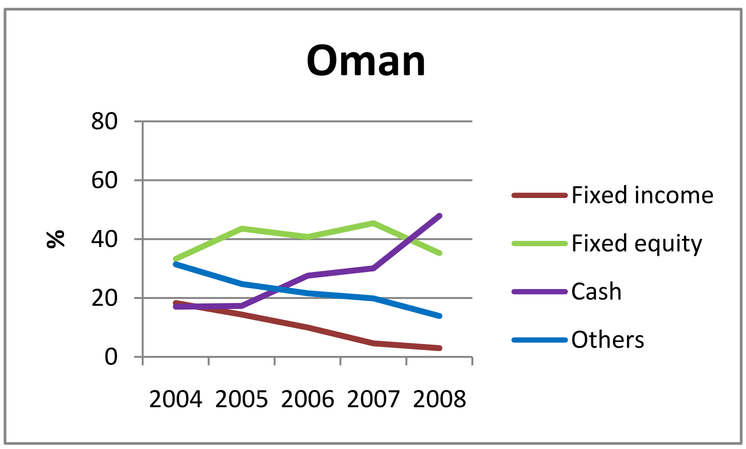


Figure 6



The analysis of previous paragraphs was focused on portfolio structure as indicator of investment decisions, but local institutional capacity constraints should not be minimized. A clear example of such a limitation is the very poor indicators of existing capacity to manage pension portfolios in MENA. Result indicators are not available for pension funds in all MENA countries, but Sovereign Wealth Funds in the region rank among the lowest as measured by worldwide comparative indicators of governance, accountability and investment (GAI)[17]. Table 4 includes the result of comparative GAI scores for a group of 37 Wealth Funds in 33 countries, out of which 8 funds (corresponding to 5 countries) are in MENA and rank in the lower levels of the index. In addition, the indices for all funds in MENA fall below the average for all countries.

The discussion of the previous section suggests that MENA pension funds operate in an environment where significant efforts need still be made in institutional and managerial capacity building in order to become efficient and credible asset managers.

Table 4. Governance, Accountability and Investment Scores of Sovereign Wealth Funds

Country	Fund	Governance	Accountability	Investment	Total
New Zealand	Superannuation Fund	**5**	**15**	**10.5**	**30.5**
US (Alaska)	Alaska Permanent Fund	**4**	**15**	**11**	**30**
Norway	Government Pension Fund – Global	**4.5**	**15**	**10**	**29.5**
US (Wyoming)	Permanent Mineral Trust Fund	**5**	**12**	**12**	**29**
Ireland	National Pension Reserve Fund	**5**	**14**	**8.5**	**27.5**
US (New Mexico)	Severance Tax Permanent Fund	**3.5**	**12**	**12**	**27.5**
Australia	Future Fund	**4**	**11**	**10.5**	**25.5**
Timor-Leste	Petroleum Fund	**3**	**14**	**8.5**	**25.5**
Azerbaijan	State Oil Fund	**4**	**12**	**8.5**	**24.5**
Canada (Alberta)	Alberta Heritage Savings Trust Fund	**3.5**	**11.5**	**8.5**	**23.5**
Chile	Economic and Social Stabilization Fund	**3.5**	**12.5**	**6**	**22**
Hong Kong	Exchange Fund	**2**	**11**	**8**	**21**
Kazakhstan	National Oil Fund	**3.5**	**9**	**7.5**	**20**
Botswana	Pula Fund	**3**	**7**	**7**	**17**
Trinidad & Tobago	Heritage and Stabilization Fund	**4**	**8**	**4.5**	**16.5**
Korea	Korea Investment Corporation	**3**	**5.75**	**7**	**15.75**
Russia	Stabilization Fund	**1**	**8.5**	**6.25**	**15.75**
Average		**2.5**	**7.7**	**5.4**	**15.6**
Sao Tome and Principe	National Oil Account	**4**	**6**	**5**	**15**
Singapore	Temasek Holdings	**3**	**9.5**	**2.5**	**15**

[17] The GAI indicators proposed by Truman (2008) are based on the response to 33 questions on structure, governance, transparency/accountability and behavior. The value associated with each question ranks between 0 and 1, so 33 is the higher value of the scale. See also Mitchell, Piggot and Kumru (2008).

Kuwait	Kuwait Investment Authority	**4**	**5.25**	**5.5**	**14.75**
Mexico	Oil Income Stabilization Fund	**2**	**7.5**	**5**	**14.5**
Malaysia	Khanazah Nasional	**1.5**	**8**	**3**	**12.5**
Singapore	Government of Singapore Investment Corporation	**3**	**5.5**	**4**	**12.5**
China	Central Huijin Investment Company	**1**	**4**	**4.5**	**9.5**
Algeria	Revenue Regulation Fund	**1**	**4**	**4**	**9**
Kiribati	Revenue Equalization Reserve Fund	**1**	**4**	**3.5**	**8.5**
Nigeria	Excess Crude Account	**0**	**5**	**3.5**	**8.5**
Iran	Oil Stabilization Fund	**1**	**5**	**1.5**	**7.5**
Venezuela	Macro Stabilization Fund	**1**	**4.5**	**2**	**7.5**
Venezuela	National Development Fund	**1**	**4.75**	**1**	**6.75**
Brunei	Brunei Investment Fund	**1**	**4**	**1**	**6**
Oman	State General Reserve Fund	**2**	**3.5**	**0.5**	**6**
Sudan	Oil Revenue Stabilization Fund	**1.5**	**4**	**0**	**5.5**
UAE (Abu Dhabi)	Mubadala Development Company	**1**	**1.5**	**2.5**	**5**
UAE (Dubai)	Istithmar World	**1**	**2.5**	**1**	**4.5**
Qatar	Qatar Investment Authority	**1**	**1.25**	**0.75**	**3**
UAE (Abu Dhabi)	Abu Dhabi Investment Authority and Council	**1**	**0.75**	**1.25**	**3**

Source: Mitchell, Piggot and Kumru (2008), based on Truman (2008) and own calculations.

Public schemes will face challenges and reforms need to be set in place, in some cases urgently. Public pension institutions in the region will continue to play an important role as major institutional investors in MENA, to the extent that these reforms preserve adequate matching of pension reserves to pension liabilities. There are no automatic guarantees that such reforms will be adopted, and this raises concerns regarding the importance of public pensions as asset managers, but there are signals that reform processes may deepen in the coming years. In parallel to the reforms in the pension schemes, important efforts need to target significant improvements in strengthening investment policies and procedures as well as in providing pension institutions with adequate governance standards.

Reforms may include diversification of sources of pension financing, as well as ceilings on mandatory contributions to the public pension schemes. Both options liberate retirement savings that may be invested in private pension schemes. This may in turn allow preserving the current level of retirement savings and, in addition, prevent a drop in replacement rates. A more diversified pension scheme may also serve the objective of minimizing risk. Whether or not these reforms (in some cases ongoing) will give way to the expansion of private pensions depends on a diversity of factors, such as the social preferences and commitment to adopt such reforms, but also on an assessment of the reform environment, and very specially the enabling environment for such reforms.

4. Private Pensions in MENA: Present and Prospects

With the exception of West Bank and Gaza, where a funded but inoperative pension component was introduced by law, Egypt is the only MENA country where a funded pillar will play a role in the mandatory pensions in the near future. Together with Egypt, Jordan is another country with an incipient market for private occupational plans, and while the reform in this country does not include any specific provision, the government has shown some interest to introduce timid reforms to enhance the development and regulation of voluntary private pensions. Separate attention deserves the situation in the Gulf Countries (GCC) where the analysis of the possible introduction of funded schemes to finance pensions for expatriate workers is in a very preliminary but promising phase.

Growth in private pension plans, however, is expected to be low in both countries. In the GCC countries, the prospects of developing portable funded pension schemes to cover the large proportion of expatriate workers leaves an open space for speculation about the possible evolution of these funds.

The space for private pension development is therefore closely linked to the existence and depth of reform processes in public pensions and the financial sector. More recently the World Bank proposed a pragmatic framework for policy dialogue purposes by adding the need to assess the readiness of a country and minimum enabling conditions to adopt reforms expanding the space for private pensions[18]. Enabling conditions include factors such as macroeconomic and policy environment (such as price stability, positive growth and fiscal balance), moderately developed financial and capital market institutions and a favorable regulatory and supervisory environment. Pre-existence of private pension schemes in small scale and a voluntary basis may also contribute to enhancing the enabling environment. As public pension reserves are reduced or depleted, reforms will need to be set in place in order to prevent the systems from bankruptcy. A secondary effect of such reforms would be the incentive to develop private pension schemes.

The analysis of the enabling environment was first introduced by the World Bank as part of the preconditions for the introduction of funded pillars. Holzmann and Hinz (2004) proposed a set of conditions to be met, including the following: (i) fiscal and macroeconomic stability; (ii) institutional capacity and professional skills of financial institutions to manage portfolios; (iii) availability of instruments, and/or regulations allowing foreign investments in order to broaden the space for diversification; (iv) institutional capacity to develop a market for annuities; (v) a clear but flexible regulatory framework, including rules on licensing, exchange of information, fiduciary responsibility, governance, investment policies and guidelines; (vi) a strong and independent supervisory body.

Arguably very few countries worldwide meet all the conditions mentioned in the paragraph above. Rudolf and Rocha (2009) propose a distinction between conditions to be met at the time of the introduction of (second pillar) reforms and those who should be met in a foreseeable medium timeframe of around five years after the reform. In addition, they distinguish "essential" from "highly desirable" conditions. In order to facilitate the evaluation they propose a scorecard

[18] See Holzmann and Hinz (2005), pp. 127-134.

with a number of key indicators grouped in four categories: (i) Institutional arrangements designed to monitor reform and implementation; (ii) fiscal sustainability; (iii) financial sector infrastructure; (iv) regulatory and supervisory framework for pension funds.

An in-depth analysis of the extent to which the countries in MENA satisfy the enabling environment conditions is beyond the scope of the present report. However, a brief discussion of these conditions will show that the region does not have an adequate enabling environment for private pension development.

Institutional arrangements designed to monitor reform and implementation exist in Egypt, Jordan and West Bank-Gaza. Morocco created a commission to champion pension reforms, but the commission is a forum of discussion and it has not produced policy recommendations. Under the category of fiscal sustainability, projections have been performed for most countries in MENA with the technical support of the World Bank, and alternative transition paths have also been analyzed. The third group of indicators (financial sector infrastructure) is an area of highest weakness in the region. In fact, financial regulations, accounting, auditing, valuation, payment systems and availability of financial instruments are essential for a satisfactory performance of private pensions, but only Morocco, Egypt and Jordan have a minimum acceptable level of sophistication. Finally, in the area of regulation and supervision only Egypt and Jordan have an authority with this competence in the whole region. In both cases, private pension supervision is under the Insurance authority, and while both countries are making efforts to set in place a regulatory body, only Egypt has a project of law to be submitted to the Cabinet. In the meantime, in private pension schemes in both countries are currently only subject to the general supervision applicable to insurance companies, and simply not subject to regulations if the plan administrators do not operate in the insurance sector.

An indicator of financial readiness is provided by the portfolio structure of private pension funds. In spite of the limited information, data are available for Egypt (2009) and Jordan (2004) and presented in Table 5. While portfolio structure is very different in both cases, and also differs from the portfolios of public pension reserves, it is also clear that private sector investments are not the result of a typical asset-liability portfolio management strategy. While the external interference from the government should not be present in these cases, it is remarkable that private pensions' portfolios in Egypt have such a strong concentration in fixed income and liquid instruments. In Jordan, by contrast, equities represent a much higher share of the portfolio, but loans to members and real estate are much higher and it is unclear if these investment decisions were taken with the objective of maximizing retirement savings or serving other objectives[19]. To summarize, private pensions in Egypt and Jordan can only be expected to grow very slowly while the countries develop institutional capacity and infrastructure requirements.

[19] The use of funds to offer loans to members is common in many pension plans and it represents a clear compromise of retirement saving maximizing to attend the members' preference for present consumption.

Table 5. Private pension funds' portfolio composition in Egypt and Jordan

Asset Class	Egypt	Jordan (1)
Fixed Income	70.5	0.0
Cash and CDs	23.8	9.8
Real Estate	0.4	26.0
Loans	1.3	40.9
Equity	2.6	18.0
Others	1.5	5.3

Sources: World Bank, based on information provided by pension institutions and other official sources. (1) World Bank survey

In Egypt, the new pension law introduces a mandatory funded pillar that is expected to substantially enlarge the role of private pensions as income providers. In fact, private schemes under the form of voluntary occupational pension schemes have developed since long time ago and provide additional old age income protection through employer sponsored plans on a voluntary basis. In 2006 there were 585 active funds covering around 8.5 million members of the public and private sectors. Most of the plans are sponsored by employers (mainly in the public sector) and only a few of them offer annuity products.

Potential growth of private pension plans may be estimated in relation with the projected impact of reforms. After the shift to a multipillar pension scheme, the evolution of private pension funds will depend on variables such as the evolution and structure of the labor force, the contribution rate and the returns on investment. Figure 5 shows the results of three of these options[20].

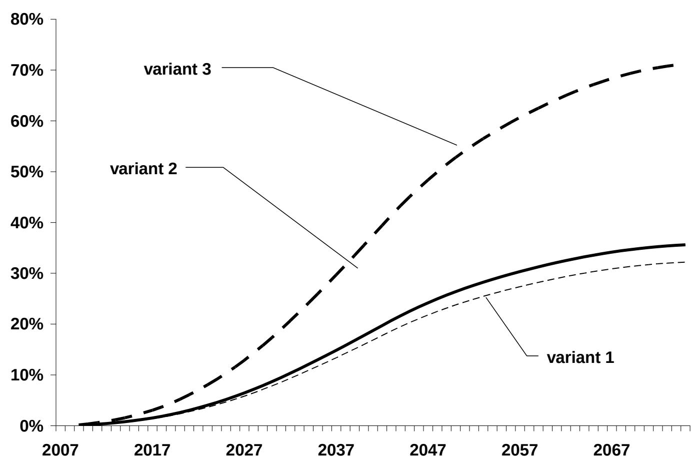
Actual growth will also be affected by many other factors, such as the costs of intermediation or the capacity of the financial sector to absorb the increased private savings. Emerging economies have found strong constraints in the capacity of the financial sector (including banks, insurance companies, the capital markets, and other non-bank financial institutions) to absorb and intermediate savings from voluntary pension plans and direct them toward productive investments. The small size of the private insurance sector, the limited long-term savings/investment products offered by insurance companies and the need to expand the scope of supervision impose constraints to the potential development of private pensions.

The expected growth of the funds will be gradual but steady in Egypt, as depicted in Figure 3.b, and this is the result of the fact that the funded pension pillar will be mandatory in the new pension system. A proposed new law to regulate and improve supervision (under Egypt

[20] Based on labor force and macroeconomic assumptions used to produce financial projections, Figure 5 shows the difference between the following policy options: 1) contribution rate of 5 percent to funded scheme and ceilings on contributions (variant 1); 2) contribution rate of 5 percent to funded scheme and no ceilings on contributions (variant 2); and 3) contribution rate of 10 percent to funded scheme and no ceilings on contributions (variant 3). In all cases, rates of return were assumed at conservative levels of real 2%. As we can observe in the figure, pension funds are expected to grow steadily to levels of 30 percent to 75 percent of GDP in the long term if the government adopts the multi-pillar pension reform.

Financial Service Authority) of voluntary pensions is also an important policy piece, but the expected impact of this market is low, given the gradualism rule adopted as part of the public pension reform. More than the macroeconomic impact of the private pension reform; the expected results are focused on compliance with solvency rules, and significant improvements in investment capacity to revert the currently poor results shown in Table 4.

Figure 7. Projected Private Pension Funds in Egypt under different scenarios (% of GDP)



Source: World Bank estimates.

In contrast with the case of Egypt, the expected role of private pensions in Jordan is to continue providing voluntary pensions, but the government expects that the existing voluntary pension schemes will grow as a result of incentives of the public pension reform such as changes in IRR, restrictions to early retirement and a gradual reduction of the ceiling on mandatory contributions. This process is expected to support the actions from the Insurance commission to provide a regulatory framework for the existing occupational schemes and life insurance products, although the gradualism of the strategy and the reliance on voluntary contributions will only produce an impact in the long term.

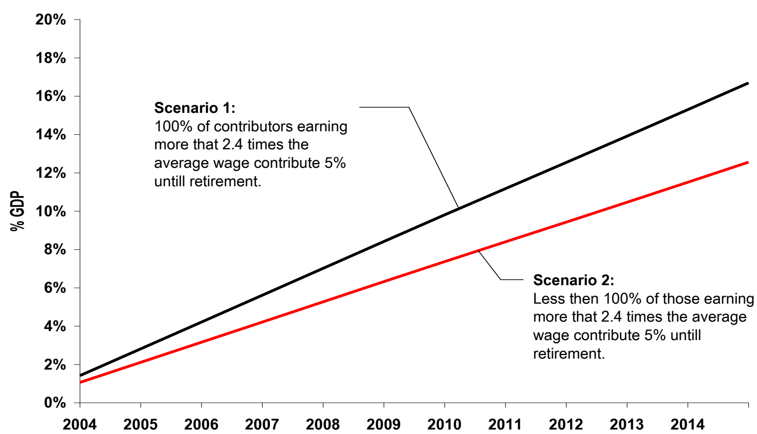
Voluntary private pension schemes in Jordan operate as individual or group plans. Individual plans are offered by life insurance companies. Group plans mainly consist of occupational or professional plans. The first group includes around 40 schemes that are not subject to any regulation or supervision, and in some cases there is no separation of the functions of the plan's sponsor and the provider. The second group includes individual plans offered by insurance companies, and they are subject to the supervision authority of the Insurance Commission of Jordan.

According to a survey conducted in 2002, the first group of privately managed pension plans covers 440,000 workers (26% of labor force). The reserves accumulated by all pension funds represented 3.4% of GDP in 2002, while annual expenditures were 0.5% of GDP. The main groups included are independent professionals (such as engineers, doctors, lawyers and pharmacists), civil servants, staff of larger private corporations, and universities. Civil servants are predominant, since they represent more than 70%.

Potential growth of private pension plans may be estimated in relation with the projected impact of the pension reforms. Figure 7 presents two scenarios for the projected growth of voluntary pension plan assets, as a result of the introduction of a ceiling of 2.4 average wages on the covered wage in the mandatory public system (SSC). The fist scenario assumes that all the contributors enrolled in the SSC with wages above the ceiling will start contributing 5% of their income above the ceiling to voluntary plans until they retire at age 60. The second scenario assumes that savings for voluntary plans would be proportionate with the level of income. This scenario assumes that, for example, 80% of those earning 20 average wages above the ceiling will decide to save in voluntary pension plans, while only 10% of those earning 2 average wages above the ceiling will save. The results show significant potential growth over the next 10 years, well above the current size of the insurance industry.

Projections for Jordan were done for a shorter timeframe under the assumption that new ceilings will be introduced on mandatory social security contributions, liberating saving capacity of higher income earners. The new law only introduced slow and gradual adjustment of mandatory contribution caps, and the results are therefore expected to be well below the projections in Figure 8.

Figure 8. Projected Private Pension Funds in Jordan (% of GDP)



Source: Authors' calculations.
Note: This simulation is based on projections of the number of contributors and the average nominal wage generated with PROST for the contributors to the SSC. The projection assumes a parametric reform in the SSC with the introduction of a ceiling on covered wages of 2.4 times the average wage, and immediate introduction of voluntary private pension funds.

Actual growth will depend on several other factors that are not included in the simulation, such as the costs of intermediation that may be particularly high in the initial phase of the accumulation phase. Another factor that will substantially affect the projections is the capacity of the financial sector to absorb the increased private savings[21]. Emerging economies have

[21] In other words, projections assume that growth in private pension funds will not produce any effect on the price of financial assets.

found strong constraints in the capacity of the financial sector – including banks, insurance companies, the capital markets, and other non-bank financial institutions – to absorb and intermediate savings from voluntary pension plans and direct them toward productive investments. The small size of the insurance sector, the lack of long-term savings/ investment products offered by insurance companies, and the supervisory infrastructure which is still under development, limit the development of private pensions. Further reforms are required in order for the insurance sector to play a role in a funded pension pillar to be an effective intermediary of reserve investment of the PAYGO schemes.

Private Pension Funds in Jordan show very poor levels of professional management and independence, with portfolios of group pension plans strongly concentrated in loans and real estate investments (Table 5). Even with limited financial instruments, the public pension investment unit of Jordan shows a far better capacity to manage a diversified portfolio (Table 3).

The investment strategy of private pension funds is primarily targeted to loans and real estate. The fact that most of the funds are sponsored by unions or employers associated with the lack of any governance rule and public supervision raises serious concerns about the extent to which investment policies serve the long term objective of long term retirement savings. On the contrary, it seems quite evident that the funds are being used to serve short term objectives of members and sponsors by providing easy access to credit and funding.

A different context may open space for private pension development in GCC countries. In fact, these countries have large contingents of expatriate labor force, representing in some cases as much as 90% of labor force, without any social insurance coverage. In addition to social policy objectives, the countries in this region are concerned about the poor incentives to retain high productivity (well performing) workers, particularly in the segment of qualified labor force. Some of the countries are considering adopting a scheme that may provide similar benefits to those of the national workers, but under a different financing mechanism that would not impose an additional burden to the public finances. Extending such schemes in the region may allow for an important increase in private pension funds, although the magnitudes have not yet been estimated.

Employer sponsored occupational plans exist in the GCC region in a small scale. The existing schemes have been designed as part of the benefit packages with the specific objective of attracting and retaining skilled expatriate workers. While the number and volume of these funds are small, investment strategies either prioritize investment abroad or they are designed with low professional standards, reflecting the limitations of the GCC region in the particular enabling conditions associated with the local institutional capacity, governance and supervision of fund managers. This is also reflected in the low rank of GCC countries in indicators of governance, accountability and investments (GAI) of Sovereign Wealth Funds (as seen in Table 4). In consequence, any proposal to increase the role of local institutional investors needs to carefully assess the institutional capacity building needs and a clear definition of standards through a sound regulatory and supervisory framework.

5. Summary and Conclusions

Public pensions are important in MENA, but their role as institutional investors remains uncertain in view of the sustainability problems that pension schemes are facing due to the over generosity of their promises. In addition to the gradual loss of reserves, portfolios are not very diversified and this, in turn, reveals a low level of professional management probably combined with an absence of autonomy in the asset allocation process. An exception to this rule is the case of Jordan, where an autonomous unit takes investment decisions with the result of a more sophisticated portfolio structure.

The role of private pensions in MENA countries is limited, and prospects of growth are limited with the possible exception of Egypt and the countries of the GCC. While several countries are considering introducing incentives to develop voluntary pension systems, prospects of macroeconomic impact are mainly associated with mandatory pension schemes.

In addition to demand side constraints, the development of sound markets for private pensions requires serious efforts to develop institutional capacity, including professional and independent portfolio management and other preconditions such as a sound regulatory framework and supervisory capacity.

Problems observed in investment decisions are not less serious in the case of the incipient voluntary pension market, where the lack of regulation and supervision is an additional constraint to improve the efficiency of fund management.

MENA countries are still far from meeting all the conditions of the enabling environment to introduce or develop funded pension schemes on a mandatory or voluntary basis. An extreme example is West Bank and Gaza, where a premature reform adopted a multipillar scheme in a context where the most basic initial conditions were not met[22]. In other cases, such as the leading reformers of the region (Egypt and Jordan), space for private pension development is expected to expand, but the analysis of enabling environment shows that an important development of the financial institutions, instruments and regulations are needed in order to provide acceptable support to such reforms.

Public pension reforms are occurring in the region, with notable recent examples in Jordan (September 2009) and Egypt (June 2010). The reform process in the region needs to address some of the critical constraints for an efficient operation of public and private pensions. An affordable definition of parameters of the public pension schemes will not only improve long term sustainability of the schemes, but also provide incentives to develop private pension programs. No less important, administrative and institutional reforms should address the inefficiencies of decision making processes at all levels, including investment decisions.

In the case of GCC, the large groups of foreign workers without social security coverage cause increasing social distress and difficulties to retain skilled workers. Some governments in this sub-region are considering adopting retirement saving schemes in the form of a funded pension scheme in substitution of the ineffective severance benefits. This prospect combined with more space to develop financial infrastructure makes the GCC a potential arena of change in the coming years, provided that substantial efforts are made in improving the poor results of Sovereign Wealth Fund management in the region.

---

[22] With support from the World Bank, the Palestinian Authority is considering a revision of this reform including a possible shift from the funded DC scheme to notional defined contributions.

REFERENCES

Clark, G., A. Munnell and M. Orszag (2006): "Pensions and Retirement Savings". New York: Oxford University Press.

Diamond (1999),

Feldstein (1998):

Hess, D. and G. Impavido (2003): "Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence". Policy Research Working Paper 3110. Washington, DC: The World Bank.

Hinz, R., H. Rudolf, P. Antolin and J. Yermo (2010): "Evaluating the financial performance of Pension Funds". Washington, DC: The World Bank.

Holzmann, R. and R. Hinz (2005): "Old Age Income Support in the 21st Century". Washington, DC: The World Bank.

Impavido, G., E. Lasagabaster and M. Garcia-Huitron (2010): "New Policies for Mandatory Defined Contribution Pensions". Washington, DC: The World Bank.

Impavido (2009): "Governance of Public Pension Plans: The importance of Residual Claimants". In:

Impavido, G., R. O'Connor and D. Vittas (2007): "Cyprus: Upgrading the Governance and Investment Process of the Social Insurance Fund". Washington, DC: The World Bank. (mimeo).

López Murphy, P. and A. Musalem (2004): "Pension Fund and National Saving". Policy Research Working Paper 3410. Washington, DC: The World Bank.

Maait, M. and G. Demarco (2010): "Introducing NDC in the new Social Insurance System of Egypt". Forthcoming.

McGill, D., K. Brown, J. Haley, S. Schieber, et al. (2010): "Fundamentals of Private Pensions". New York: Oxford University Press.

Mitchell, O. , J. Piggott and C. Kumuru (2008): "Managing Public Investment Funds: Best Practices and New challenges". NBER Working Paper Series. Mimeo.

Mitchell, O. and E. Hustead (2001): "Pensions in the Public Sector". Philadelphia: University of Pennsylvania Press.

Musalem, A. and R. Palacios (2003): "Managing Public Pension Reserves". Washington, DC: The World Bank.

Musalem, A. and P. Souto (2009): "Unveiling the Governance of Public Pension Funds". Working Paper N. 34. Mimeo.

OECD (2000): "Private Pension Systems and Issues". Paris.

Robalino, D. (2005): "Pensions in the Middle East and North Africa. Time for Change". Washington, DC: The World Bank.

Rocha, R. and C. Thorburn (2007): "Developing Annuities Markets". Washington, DC: The World Bank.

Rudolf, H. and R. Rocha (2009): "Enabling Condition for Second Pillars on Pension Systems". Policy Reseach Working Paper 4890. Washington, DC: The World Bank.

Schieber, S. and J. Shoven (1997): "Public Policy towards Pensions". Cambridge, Mass and London: MIT Press.
Society of Actuaries (2003): "Asset Liability Portfolio Management. Professional Actuarial Specialty Guide". www.soa.org/library/professional-actuarial-specialty-guides
Thompson, L. (1998): "Older and Wiser. The Economics of Public Pensions". Washington, DC: The Urban Institute Press.
Valdes Prieto (2002):
Vittas, D., G. Impavido and R. O'Connor (2008): "Upgrading Investment Policy Framework of Public Pension Funds". Policy Research Working Paper No. 4499. Washington, DC: The World Bank.
Walker, E. and F. Lefort (2002): "Pension Reform and Capital markets: Are there any (hard) links?" Social Protection Discussion Paper No. 0201. Washington, DC: The World Bank.
Whitehouse, E. (…)
Whitehouse, E. and R. Hinz (2009): "Egypt. Reforming Pensions". Washington DC: The World Bank. Mimeo.
World Bank (1994): "Averting the Old Age Crisis: Policies to protect the old and promote growth". New York: Oxford University Press.

ANNEX 1 – PENSION REFORM IN EGYPT

The Egyptian government adopted a systemic reform, with the current system being closed to new members. The rules of the new system will be applied to all new entrants to the labor market effective January 1, 2012. There will be an option to the current members to switch to the new system or to insure the part of the salary that is not insured under the current system and hence be entitled to receive pensions from the two systems. The Egyptian government is also implementing a gradual parametric reform to the current system to correct some of its problems mentioned above.

The new law was approved by the Egyptian parliament in June 2010 after a marathon of debates and discussions. The new social insurance system is a unified system designed to cover all categories of the population in a fair, transparent and simplified manner. The main features of the main scheme are:

A partial shift from defined benefits (DB) to defined contribution pensions (DC) accompanied by the introduction of the NDC and FDC individual accounts and supported by solidarity accounts.

A contribution of 20% of salaries will finance both NDC and FDC in an initial proportion of 15% to NDC and 5 % to FDC, although the proportions may change depending on financial market growth.

Disability and survivorship benefits will be financed separately, with a contribution of 2.5% of payroll paid by employers.

Universal benefits with a contributive DC and a redistributive non-contributive component to assure a minimum pension for all Egyptian elderly.

Integration of risks such as old-age, disability, survivors, work injuries, death, unemployment and health.

Increasing the normal pension age gradually from 60 years to 65 over the coming 17 years to be unified for all of the schemes old and new from year 2027.

The system includes solidarity elements such as a basic pension pillar when the benefits offered are universal and non contributive. The benefit is equivalent to 18% of the net national average salaries. It also includes a “claw back” mechanism which provides an additional proportional benefit to members who made partial contributions towards their old-age social insurance during their active life.

The following figure illustrates the structure of the new Egyptian pension system.

	Basic Pension Non-contributory component	**Individual Pension Accounts Mandatory Contributory Component**	**Supplementary Pension Schemes Voluntary Contributory Component**
Contributors	None	Employees and Employers	No restrictions
Beneficiaries	Elderly over 65 with no source of pension or income	retired employees	Plan members
Mechanisms	Budget Transfers	Notional Accounts (NDC) and FDC defined contributions	Pension Plans provided by Employers and Financial Institutions
Financing	General Revenues	Mandatory Contributions	Voluntary Contributions / Tax expenditures

The structure of the new Egyptian pension system combines both FDC and NDC as part of the mandatory scheme as an action to respond to the objective of minimizing financial risks while allowing for a level of market investments for the pension funds. It is also emphasizing the elements of solidarity, social cohesion and redistribution between its members on those risks which are social solidarity risks such as death and disability in service. Such risks and others such as unemployment and work injuries are supported by solidarity accounts. The structure of the new system has established social solidarity accounts to deal with the minimum guaranteed benefits in these cases.

The following chart summarizes the structure of benefits under the old and new law.

Before reform: **Defined-benefit pensions**	**After reform:** **Individual pension accounts**
Qualifying conditions	
Age 60 and 10 years contributions	Age 65
Any age and 20 years contributions (with no reduction for early retirement)	Age 55 (subject to reduction for early retirement)
Earnings measure for calculating pensions	
Basic wage: final salary Variable wage: lifetime average nominal salary (increased 2% for each year of contributions) Overall ceiling of LE 15 000, around 125% of average earnings	Individual pension accounts, implies based on every year's salary Earlier years' earnings protected against inflation through notional interest and real investment returns No ceiling on pensionable earnings
Pension calculation	
$^{1}/_{45}$th = 2.2% of earnings for each year of contributions	NDC: based on contributions (15%), notional interest and national average life expectancy at retirement date FDC: based on contributions (4.5%) and investment returns
Solidarity benefits	
Social assistance: LE 120 per month (= 12% of economy-wide average earnings Death and disability benefits	Universal basic pension: 15% of economy-wide average earnings Improved death and disability benefits
Indexation for inflation	
Discretionary adjustment of pensions in payment	Automatic indexation of pension is payment to price inflation

Source: Whitehouse and Hinz (2009)

ANNEX 2 – PENSION REFORM IN JORDAN

After extensive analysis and political debates, the Social Security Corporation of Jordan prepared the reform law project that was submitted to the SSC Board in January 2008. The Board endorsed the project and submitted it to the Government with a few minor changes. The project was approved by the Parliament in February 2010. It includes the following chapters:

The most substantial changes were introduced in Pensions, unemployment Insurance and Maternity Benefits. Changes in the Pension scheme are mainly parametric, but their impact in terms of increased long term sustainability of the scheme has been assessed as significant. The reformed parameters include:
increased retirement age
reduced accrual rate
increased vesting period, and
increase in penalties for early retirement.