Már Guðmundsson: The Icelandic pension system and the financial crisis

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the opening dinner of the European Pension Convention 2010, Reykjavík, 2 May 2010.

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Chairman, ladies and gentlemen,

It gives me great pleasure to address you here tonight, and I would like to thank the organisers for inviting me to do so. This is due not least to my past interest in and work on the Icelandic pension system and, more generally, my interest in the optimal design of pension systems.

During my tenure as Chief Economist of the Central Bank of Iceland from 1994–2004, I was convinced that the pension system that had developed in Iceland, partly by historical accident, was one of the strengths of Iceland's economy. This conviction had taken root earlier, when I was involved with pension reform and served for a while as the chairman of the board of a pension fund that has long been among the top ten in Iceland in terms of size. However, this view was reinforced around the turn of the century, when I made an in-depth study of the Icelandic pension system and tried to analyse its effects on the economy and the financial sector.[1]

I subsequently tried to propagate the virtues of the system abroad. I remember that the last thing I did in this respect, before I went to the Bank for International Settlements in Basel to focus on other things, was to try to sell the system to a Russian audience that was considering pension reform in their own country.[2]

On what was this view based? In order to answer that, I must first remind us of the attributes of a good pension system. Of course it is obvious that it must be a mechanism for saving for retirement. But in order to be an efficient such mechanism, it must take due account of the lifetime risks facing individuals, as well as the economic and financial risks facing society as a whole. These are, for instance, risks related to life expectancy, ability to work, demographics, the productivity of labour, and the rate of return on financial assets. Furthermore, some at least would make the demand that the system have a certain degree of income equalisation built into it, and most would accept that it should at least not be regressive. Then we would want the pension system to have some degree of flexibility and to provide scope for individual choice. Finally, we want the pension system to be designed so as to promote economic performance; that is, saving, growth, and financial sector development.

This is a tall order, of course, and in practice there are bound to be trade-offs between these goals. However, when I was writing about these issues there seemed to be a significant consensus that, in order to meet these demands, at least in part, a good pension system should be based on three pillars: first, a tax-financed public plan that provides a flat-rate or means-tested basic pension; second, a mandatory occupational or private (but publicly regulated) funded pension scheme; and third, a voluntary pension saving scheme, often with tax incentives. Three pillars, rather than one, are needed in order to accommodate the trade-offs between goals, make the overall system more resilient to different types of shocks, and

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[1] The main article referred to can be found on the Central Bank of Iceland website: http://www.sedlabanki.is/uploads/files/mb011_5.pdf.

[2] The speech can be found on the Central Bank of Iceland website: http://www.sedlabanki.is/uploads/files/MB041_7.pdf.

provide for flexibility and choice. This is, of course, familiar to most of you here, and an excellent – by now, almost classic – presentation can be found in the 1994 World Bank publication: *Averting the Old Age Crisis*.

By the turn of the century, the Icelandic pension system had taken on many of these attributes. The public pension system provided a low basic pension but a much higher supplementary pension that was, however, means-tested, also against pensions from other sources. This meant that, as the occupational or second-pillar pension funds matured, the public pension would dwindle in relative terms. At the time, pension payments from the public system were still somewhat larger than those from the occupational pension funds, but the difference was slight and, as the total pensions paid out by the occupational pension funds were growing much faster, they did overtake the public system in subsequent years. It is instructive in this regard that, according to OECD, the balance between public and private provision of mandatory pensions is heavily in favour of the private provision in Iceland, or 84%, which is the highest rate amongst OECD countries. As a result, public pension spending in Iceland is 2% of GDP, compared to the OECD average of 7.2%.

The occupational pension funds have grown very fast in the last few decades, through mandatory contributions from all wages and salaries, low operational costs, and long spells of good returns. Around the turn of the century, they were the third-largest in EU and EFTA countries in terms of assets as a share of GDP, at around 80%, after Switzerland and the Netherlands. Shortly before the international financial crisis struck, Iceland had overtaken even these countries. The funds were bound to grow much more, as they were far from reaching maturity in the sense that most of those receiving pensions had not accumulated rights based on their lifetime earnings. The clearest measure of this was the fact that the pension burden, or pensions as a share of contributions, was still below 50%. At that time, it was estimated that, at maturity, the funds would amount to 1½ times GDP. They came close to that just before the financial crisis, but this was not “real”, as I will come to later.

It is noteworthy that the funds do not obey simple classifications. Some of the funds have an employment guarantee and would be characterised as defined-benefit funds, where the employer bears the investment risk, but in Iceland only the government, municipalities and banks can guarantee pension funds. But the rest are not pure defined contribution funds. The investment risk is borne collectively by the members, and there is some scope for smoothing changes in benefits and for some risk-sharing among generations. This can matter when you have a once-in-a-lifetime shock to returns, as we experienced during the international financial crisis.

The third pillar of the pension system entered the stage rather late here in Iceland. It was only in 1998 that legislation on tax incentives for voluntary private pension saving was adopted, but these incentives were subsequently increased. Voluntary private pensions saving then increased by leaps and bounds, reaching 10% of GDP in 2002 and 15% of GDP in 2007. This saving has proven to be an important cushion during the current crisis, as early repayment was temporarily allowed. So far, these early repayments have amounted to 2½% of GDP. This is akin to a fiscal stimulus and has supported private consumption this year and last.

Let me now say a few words about the economic and financial effects of the pension system that we have built up here in Iceland. The first thing to note is that it is always those who are economically active today who support today’s pensioners, irrespective of the system. In this sense there is no fundamental difference between pay-as-you-go systems and funded systems. In a small, open economy, however, the design of the pension system can affect this burden in at least four ways: first, through its effects on the labour participation rates of the elderly; second, through its effects on the size of the capital stock and thus on productivity of labour; third, through accumulation of foreign assets that constitute a claim on the output of those economically active in other countries; and fourth, through contributing to financial sector development, which in turn might result in more efficient allocation of capital.

Although we see some of these favourable effects rather clearly in the Icelandic case, the jury is still out on some of the others. Negative incentives for labour participation of the elderly are much less in evidence than in many other countries, as the retirement age is relatively high and the system is mostly neutral vis-à-vis early retirement. However, the effects on the growth rate through higher savings and investment rates have so far been difficult to ascertain, and the national savings rate was unusually low in the build-up to the financial crisis. As regards foreign assets, however, the picture is clear, as the pension funds have indeed built up a very significant stock of these through the years, amounting to 26% of their total assets at the end of 2007. They amounted to 7% of total foreign assets and 29% of foreign securities owned by Icelandic residents as recorded in Iceland's international investment position. In addition to shifting part of the future pension burden abroad, these assets proved to be important reserves when Iceland faced a sudden stop of capital inflows during the financial crisis.

The clearest effects of the accumulation of the pension funds have been on financial market developments, where the funds contributed very significantly to the growth of these markets. At some points, there were even concerns that the funds were becoming too predominant. Thus their share of marketable bonds was almost 40% at the end of 2002. For a while, the overgrowth of the Icelandic banks laid any such concerns to rest, but when the dust has settled after their collapse, these concerns might come back. However, at the moment, with capital controls having temporarily stopped further foreign investment by the pension funds, they play an important role in the heretofore relatively easy domestic financing of the large fiscal deficit amounting to 13.5% of GDP last year and projected at 10.2% of GDP this year.

You might have noticed that I have spoken mostly in the past tense when assessing the strengths and weaknesses of the Icelandic pension system. The reason is, of course, that the view I had on the system around the turn of the century was formed before one of the biggest stress tests of all time, when almost 90% of the banking system in Iceland collapsed in the autumn of 2008 in the wake of the post-Lehman intensification of the international financial crisis. So do I still have the same view? I will have to hold you a little bit longer in suspense on that question, as I should first discuss briefly how the financial crisis has played out here in Iceland. For more detailed account, I refer you to numerous publications, including a thorough and informative report of the parliament-appointed Special Investigation Commission, which reported last month on the causes of the financial crisis in Iceland.[3]

To paint with a broad brush, we can say that economic and financial developments in Iceland during the last decade or so are a combination of two separate but interrelated stories. On the one hand, there is Iceland's boom-bust cycle and problems with macroeconomic management in small, open and financially integrated economies. This is a well-known story that has played out in Iceland and other countries several times. On the other hand, we have the story of the rise and fall of three cross-border banks operated on the basis of EU legislation (the European "passport") – banks that were mishandled by the owners and the bankers, and underregulated and undersupervised by Icelandic authorities. That story, at least for smaller countries, is somewhat more unique than the first.

However, it must be remembered that although these two stories differ, they interact in important ways. Thus the unsustainable boom that Iceland experienced during the years 2005–2007 was fuelled by a combination of favourable external conditions, macroeconomic mismanagement, and aggressive domestic bank lending.

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[3] An English version of the SIC report summary can be found on the Althingi website: http://sic.althingi.is/. For my views on the subject, I refer you to a speech I made in Bergen early this year: http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=7592 and my speech at the Annual General Meeting of the Central Bank of Iceland: http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=7699.

As so often occurs in great tragedies, the two stories converged in a grand finale in early October 2008, when nearly nine-tenths of Iceland's banking system collapsed when its three large cross-border banks – Glitnir, Landsbanki, and Kaupthing – were taken into special resolution regimes on the basis of the emergency legislation that had just been passed by Parliament. This added significantly to the recessionary forces that were already at play in the Icelandic economy as the macroeconomic imbalances created in 2005–2007 subsided. However, the question of cause and effect is still open; i.e., what is the specific contribution of the banking collapse over and above an international recession and a domestic macroeconomic adjustment? The fact of the matter is that the contraction in 2009 proved to be significantly smaller than originally predicted, with the fall in GDP turning out to have been 7½%, as opposed to the 10% forecasted earlier in the year.

There are probably several explanations for this. Automatic fiscal stabilisers were allowed to work more or less freely in 2009, with fiscal consolidation taking hold this year. Icelanders were allowed early withdrawal from their third-pillar pension funds, which last year and this year is equivalent to 2½% of annual GDP, as I mentioned earlier. The financial restructuring of corporations and households has been delayed and, although this is detrimental for medium-term recovery, it has postponed some of the pain. The depreciated exchange rate has stimulated the traded goods sector. Finally, although the destruction of wealth that Iceland has experienced as a result of the collapse of the Icelandic banks is enormous, it is not proportionate to the size of the banks, as foreign creditors will lose much more.

But we will continue to pay the price this year, as GDP will contract further between 2009 and 2010, but unfortunately I cannot give you much new detail on the prospects for 2010, nor can I discuss monetary policy, as I have entered the seven-day silent period before the announcement of the interest rate decision and the issuance of a new forecast next Wednesday. What I can say, though, is that as many other countries are already in recovery, Iceland's is now only expected to begin in the second half of this year.

But there are already several indications that Iceland is on the right path to recovery. We are on an IMF programme with three key elements: exchange rate stability, sustainable fiscal position, and rebuilding the financial sector. The exchange rate has been stable since last summer and has appreciated lately, with the support of capital controls but without supporting intervention by the Central Bank since early November. The fiscal consolidation programme has been progressing as planned. The functioning domestic banking system has been resurrected, and the final steps in the financial restructuring of the savings banks are being taken.

With the Second Review of the IMF programme just finished, Iceland will gain access to foreign currency loans in sufficient amounts to dispel any concerns that it will be able to refinance large foreign currency sovereign debt payments coming due in 2011 and 2012. Furthermore, with the dust settling after the collapse, it seems that Iceland's net foreign debt will be below 80% of GDP, including the estimated Icesave debt. This is similar to GDP in 2005; it is sustainable, and it is not on the top of the international debt league table. In short, Iceland does not face a sovereign debt crisis. It faced a foreign liquidity crisis and lack of access to foreign capital markets. The conditions for opening up that access are rapidly being created in the wake of the Second Review of the IMF programme, as is witnessed by the development of the credit default swap spread of the Icelandic sovereign and the fact that the rating outlook has improved.

But what about the pension funds? They were hit very badly, of course, as their equity stakes in the fallen banks became worthless overnight, the value of bank bonds collapsed, and asset prices of all kinds tumbled. The result was that the real rate of return on the funds was negative to the tune of 22% in 2008, and their assets as a share of GDP fell from 134% in 2007 to 119% last year. But let us remember that part of this is a correction. The asset values of the boom and the associated rates of return on pension funds, as well as banks, had a significant element of froth. To some extent, they were never real.

We always knew that this kind of shock was the major risk facing fully funded pension systems. But the system is still here. It took a hit, but it withstood the shock. So my basic belief in the strengths of the Icelandic pension system and similar systems around the world is still intact. But that is provided that we learn the lessons of the financial crisis and make it a once-in-a-lifetime event. We need to learn the lessons on incentives and risk management. We need to learn the lessons on accounting and valuations. We need to learn the lessons on regulation and supervision. We need to learn the lessons on macroeconomic management and the interplay between the macroeconomy and the financial sector.

I am still optimistic on all of these points. There is a major international effort under way to reform regulation and supervision, also regarding cross-border banking. In the wake of the Special Investigation Commission report that I mentioned earlier, I hope that Icelanders now turn to the task of facing head-on where they went wrong on top of all the international failures. And finally, I note with pleasure that the pension funds are going to draw their own lessons on where they might have done better; for instance, by being more critical going forward, as indeed we all must be.

In closing, let me welcome you to Iceland and wish you an enjoyable stay and fruitful deliberations during your convention. We need to learn from our different countries' experiences and seek out the common challenges that we face. In spite of the financial crisis, the world will remain full of interconnections and spillovers, as we can see from the spread of cash and ash across borders.

Thank you very much.