# Karnit Flug: Challenges in the field of pension savings

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, at the Pensions, Insurance and Financial Literacy Research Center, Ben-Gurion University, Beer-Sheva, 20 November 2014.

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Good morning,

The festive opening of this institute is a very important event, and its work plan seems promising. There is tremendous importance to raising awareness and research on the matter, and action in this direction is to be welcomed. It is also important to improve the public's ability to make an informed decision in this field as this is one of the most important financial decisions a household makes. I therefore see tremendous importance in working on financial literacy.

I would like to briefly touch upon a number of facts and trends that point to the challenges in the field of pension savings, and then to present a series of questions that I believe are proper to deal with in an institute such as this.

### Projected demographic trends

As we know, life expectancy is increasing, and if we look at the past 40 years, the life expectancy of those reaching age 65 increased from 80 years to 86 years for women, and from 79 years to 84 years for men. This fact, together with the fact that the retirement age increased by only two years, means that men are expected to live an average of 17 years after retirement and women are expected to live 24 years after retirement. This leads to the question of whether, during the working period, the public is saving enough to ensure a proper income at retirement age.

Another way of looking at the demographic change is to look at what is happening to the ratio between the working-age population and the retirement-age population. The trend in Israel is similar to the trend in other countries in the world, although with some lag. As of today, there are 5 working-age people for each person over age 65 in Israel, while the ratio in 2050 is expected to narrow to 3:1. This change obviously has serious implications for the labor market, the dependency ratio, and various aspects of policy.

An international comparison of retirement arrangements shows that in Israel, the retirement age for women is relatively low, and even after it is raised to 64, as is supposed to happen in 2017, it will be significantly lower than in most European countries, some of which are also in a gradual process of raising it. The retirement age for men in Israel was raised to 67, and is similar to the retirement age among European countries that have already raised it, and is at the upper threshold. The large gap between men and women in Israel is prominent, and raises a question regarding the ability of women to save enough for retirement. The more the decision on an additional increase in the retirement age for women is delayed, the more it will be necessary later on to do so more rapidly, which will be more problematic.

### And what is happening to long-term savings?

There has been a significant increase in the volume of assets under management by long-term savings plans in the past 14 years, from about 57 percent of GDP to about 90 percent of GDP. One of the significant processes behind this increase is the enactment of the Mandatory Pension Law in 2008, which requires workers and employers to set aside a significant percentage of their income for pension. In addition, during this period, there was a gradual transition in the public sector from defined benefit pensions to defined contribution pensions, with all employees who began working in the public sector from 2004 onwards contributing to defined contribution pensions. The volume of assets increased, although it is volatile: for instance, the decline during the financial crisis, such that someone who retired at that time saw lower accumulated savings that he had expected.

Looking at the distribution of main assets in the investment portfolios of the long-term savings plans, we can see a gradual and continuing decline in the share of designated bonds, together with an increase in the weight of stocks, corporate bonds and investments abroad in the portfolio, so that the share of the components that are more sensitive to developments in the financial markets is expanding over time. In terms of the composition of investment portfolios by type of plan, we see that the in plans in which more veteran members save (old pension plans and plans that ensure a yield), the weight of designated bonds is relatively high, and the weight of the assets that are sensitive to the financial markets is relatively low. In contrast, in the investment portfolios of the plans in which new members are saving (new pension funds, and profit-sharing funds), there is a much higher weight given to investments abroad, stocks, and corporate bonds, which leads to higher exposure to developments in the financial markets. These investments finance economic activity and development, but are also exposed to higher volatility.

**The impact of the trends on the replacement ratio**

In view of the trends I have presented to this point, the interesting question is what will happen to the level of the pension payout at retirement age. The commonly accepted variable to look at in this context is the replacement rate – what will the retiree's income be compared to his pre-retirement salary. In a simulation of the net replacement rates including defined benefit pensions and old-age pensions, we focus first on women with a relatively low income of NIS 7500 a month. Women who retire at age 62, whose pension savings have generated an average real yield of 2 percent per year, and whose pension contributions are 17.5 percent of their monthly salary, will have a replacement rate of 54 percent. In contrast, if the yield is 4 percent per year and pension contributions are 19.5 percent of monthly salary, the replacement rate will be 76 percent. Men who retire at age 67 and earn NIS 7500 a month at retirement age, whose pension savings have generated an average real yield of 4 percent per year and whose pension contributions are 19.5 percent, will have a replacement of almost 100 percent. In contrast, if the average real yield is 2 percent and the contributions are 17.5 percent, the replacement rate will be just 66 percent. The replacement rate will be significantly impacted by both the retirement age and the amount of contributions to savings. This situation, which is similar among those with higher salaries, raises questions on both the individual level and the policy level. These are the issues that the institute being launched now should deal with.

I will also present a number of questions, on the individual level, on the policy level, and a number of questions for research:

**Size of the payout:**

– What is a reasonable replacement rate?
– How do we deal with the increase in life expectancy?
– How do we deal with the ramifications of the low interest rate environment on the yields of pension savings?
– How do we deal with the ramifications of high volatility on the yields of pension savings?
– What are far management fees that also allow for the quality management of pension savings?

**The efficient allocation of public resources:**

– How do we use and allocate the designated bonds among the various long-term savings plans and instruments in the best possible manner?

– What is a fair and efficient allocation of tax benefits?

– What is the proper way to handle the population that will be retiring in the next few years without sufficient pension savings?

**Questions relating to the investment portfolio of the institutional investors?**

– What is the optimal composition of the investment portfolio in the context of the transition from classic investment channels to other channels (direct credit, real estate), and in the context of the diversification of investments abroad?

– What effect does the tension between the short-term measurement method of the plans' achievements and the need to create long-term yields and repayment abilities, which is what is relevant to the saver, have? Does the method of measurement not create short-term competition, which is not necessarily optimal?

– What is the proper extent of the investment portfolio's exposure to investments abroad and to foreign currency?

**Financial education:**

– What is the proper balance between the decisions of the individual and regulatory intervention?

– What are the tools that need to be provided to the public in order for them to make informed decisions about their pension savings?

**Questions for research:**

– Can we estimate the effect of savings enforced by the Mandatory Pension Law on developments in various markets (household credit, and so forth)?

– How does mandatory pension affect total savings?

– How can we balance the need to direct long-term savings to support for business sector growth and the maintenance of a reasonable level of certainty for retirement age?

In summation, the institute currently being launched has a great deal to do, both in the field of broad empirical research and in the field of research on questions of policy. The activity to increase the public's financial literacy will help all of us make informed decisions regarding the question that is perhaps the most important in the area of household financial decisions. I wish the people of this institute success in your important endeavors, and I await the opportunity to learn from the fruits of your labor.