Fintech Robos
For Savings & Pensions Apps

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The Golden Paper on Fixing Pension Systems in MENA Region

Saving Gov't Pensions by Encouraging Citizens' Savings

It's Time to See National Companies for Private Pensions in Arab World

It's Now the Turn of Corporates to Create Retirement Security and Pension Boom

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All Arab countries, except for three, have deficits in their pension funds exceeding 50%. As for the three countries, two of them started their social insurance relatively late and the third one had to significantly recapitalize its fund early last decade. Likewise, these three countries are not immune from deficits of similar proportions during the next two decades if they end up doing the same thing.

Up until now, there is one thing all Arab countries have in common in addition to the Arabic language, which is their sole dependence in their pension arrangements on public pension funds that are run by governments on a pay-as-you-go (PAYG) basis. There is no institutional framework, infrastructure, or regulatory regime for retirement income beyond these funds. These pension funds tend to be quite generous, but are facing increasingly huge funding deficits, making their long-term feasibility a mounting concern. For several years, if not decades, there has been a growing imbalance between the amount of money going into the system, and that coming out of it, leading economists to describe such funds as something of a time-bomb.

Defined benefit pensions — a guaranteed, “gold-plated” inflation-linked pension for life, based on salary and years worked — are all but dead globally in the private sector, or reformed in the public sector in many countries around the world. This trend was accelerated in the last 20 years as the cost of new pension promises has spiraled due to declining investment returns.

Damage Already Done

In most cases, fixing these funds is a difficult, if not impossible, mission, for the deficit in some countries is almost equal to their national GDP, at a time when oil revenues lost their aura to underwrite government liabilities as in the past. For some countries, we can nearly say that the damage has already been done and cannot be changed.

In some of our countries, women can retire after 15 years and men after 20 years of service till today, allowing them to live 40 years or more in their retirement life financed by these pension funds. Therefore, half of the current retirees in such countries are in their mid-40s and early fifties; contrary to even Bismarck, who invented pension funds 150 years ago, who had prescribed from that time that people should work full service until the age of 65 and then retire.

Furthermore, while it is estimated that the actuarially fair cost of financing the retirement of any individual is 30% of his current salary (a contribution shared between the employee and his employer) – and some global estimates put that at 60% of salary due to current demographic and economic environments - these funds have only been collecting half of the 30% or a little more; so you can imagine the size of the gap these funds have built up in their compound cumulative actuarial deficits.

Additionally, the defined-benefit model underpinning these funds requires rising revenue from an ever-expanding population base, which is exactly the opposite of what happened globally in the last fifty years, with declining fertility and increased longevity.

As such, these funds, or rather the governments guaranteeing them, are now facing a dilemma. The funds are untenable and recapitalizing them has become very difficult considering the prevailing oil prices, record public debt, and the exceptional expenditures governments have spent to alleviate the economic and living crisis caused by the pandemic. Nor can they afford to reduce retirees’ benefits due to the political costs of such option.

Globally, there are three models in which governments finance pension systems in a sustainable way: The first is by paying contributions (by both employer and employee) while in service in the right proportions. The second

is through the national tax system, and the third is that the government underwrites these obligations and any deficits in these funds by its economic resources such as petroleum wealth.

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مرخصة بإعتبارها شركة لحلول الفينتك من قبل وزارة الصناعة والتجارة بمملكة البحرين،
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The problem we have, as also in many countries, is that we did not take the correct contribution rate over many decades; we do not have a tax system, at least in the Arab Gulf countries, and the oil revenues that used to finance more than 80% of our national economies are no longer ample as before. Given the sensitivity of the pension topic, all information, figures, and facts related to pension costs have also been kept in the dark by the successive administrations over the years. Now that we have reached critical junctures in our funds' sustainability and are so late in introducing reforms, all the options before us are very costly in terms of political economy. So, thinking out-the-box has become imperative to get out of this bottleneck.

Big Problem, Small Solution

Global pension assets are estimated today to be around US$52.5 trillion (representing 62% of global GDP at US$84.5 trillion), with 53% of these generated via defined-contribution pension vehicles powered, in large part, by tax incentives. Governments around the world provide Financial Incentives to encourage individuals to contribute to their retirement funding, primarily by reducing personal income tax.

By thinking some Soft Reforms to our region, we can bring real change and transform the pension sector in the next 20 years. And instead of current deficits, we can build hundreds of billions of new retirement assets through private pension savings.

How can we achieve that? Well, we can think of three plausible ways at least.

First, instead of an income tax incentive (which does not exist in several MENA countries), we introduce a "Saving Incentive" for citizens who save via private pensions schemes that are endorsed and promoted by governments. With this, we are building a government-endorsed savings engine, and creating a new retirement planning mindset among citizens. These private pension schemes are to be provided by competent, regulated financial institutions qualified by government.

The investment vehicles can be skewed towards capital protection with certain performance characteristics, designed for long-term saving. And rather than re-inventing the wheel, the scheme may initially tap into readily available and proven retirement funds provided by reputed global asset managers such as Blackrock, Fidelity, Vanguard, Amundi, SSGA, and others.

As this is a government-endorsed scheme, service fees are substantially discounted to be no more than US$10 a month, and the government contributes around US$ 1500 per annum into each opened plan as a savings incentive. Citizens are then incentivized to save for their pension because the service is affordable and offers free money too.

The scheme will apply its terms and conditions, to ensure citizens save regularly and above a minimum rate for various income levels. Vesting rules shall apply:

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- No withdrawals from the plan before age 55, with exception for hardship.
- Government annual bonus may continue till age 65.
- Withdrawal at age 60 merits 100% of government contribution.
- Withdrawal at age 55 merits only 60% of government subsidy.
- Withdrawal before 10 years of saving in the scheme forfeits the entire government subsidy.

The beauty of such concept is that it is almost ready, and its implementation does not require lengthy planning. All that is required is the introduction of soft reforms in the pensions sector, initiated voluntarily through financial incentives. Additionally, the cost of implementing such a scheme, for a medium-sized Gulf country, will not exceed US$ 7 million annually, and the whole cumulative fiscal cost for 30 years will be around US$200 million. More importantly, a scheme like this could turn 500,000 households into pension savers, generating tens of billions in projected retirement assets that will gradually ease the burdens of government funds and provide people with a complementary alternative to secure their retirement income.

Second Method

The second solution is to reverse the historical context and the economic relationship between pension funds and the corporate sector. In the early phases of pension funds in all countries, before they reached maturity (when the cash outflows are greater than the cash inflows), these funds propelled the establishment of national banks, telcos, asset management, foodstuffs, and industrial companies due to the large investment assets they had accumulated then.

These funds have enabled businesses, jobs, and growth for decades. They have been key shareholders in all national blue chips. Now with these funds facing increasing burdens threatening their sustainability, the solution may be by turning the equation upside down - by having local companies, banks and large businesses establish a “national pension company” as a joint venture. Fifty years ago, pension assets created business and growth; maybe it’s now the turn of the corporates to create retirement security and pension boom.

Third Method

The third solution is a combination or hybrid between halting the rapid decline of current DB funds and building DC funds gradually and in parallel. One of the reasons for the decline of pension funds in the Middle East is the generosity that is not commensurate with contributions paid. To solve this dilemma and protect the lower paid employees, we may have to adjust the formula for calculating pension to be, for example, on the first BD3000 of salary (roughly US$8000) instead of the whole or 80% of salary (regardless of salary size) as is the case in most of these countries, with DC pensions introduced on any pay above this. The employee contributes towards this “top-up” DC, with the option of the employer contributions, too. A structure like this refocuses the philosophy of pensions to be a social service for protection and social security rather than a guaranteed wealth for life.

Understanding pensions costs means this generation of pensioners does not exhaust existing pension funds or impose financial obligations on their governments, while they have not paid the true cost of their pension. Instead, a big chunk of that cost is passed to our children and grandchildren. This is a huge breach of intergenerational fairness.

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