Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

Pension reform in Luxembourg

Despite widespread debate and criticism, the pension reform was adopted on 5 December 2012.

Without reopening the debate on whether the system is viable or not, (see also www.uel.lu / www.abbl.lu) this note merely aims to present the main changes covered by the reform.

Nevertheless, it is regrettable that the estimates used are unrealistic with regard to the growth forecasts for the economy (3%) and employment (1.5%). In a distribution system where the contributions of the working population finance the pensions of retirees, i.e. where employment remains the means of financing the system, the presentation of more realistic growth scenarios would have helped to confirm the mathematical realities long since known: in view of the demographic, economic and social adjustments, the Luxembourg pension system is not longer viable without major changes.

The main points of the reform

The main points of the Luxembourg pension system remain the same:

It is a distribution system based on intergenerational solidarity via the formation of a reserve. This reserve of 11.3 billion euros (2011) is managed by the Fonds de compensation (www.fdc.lu). Contributions are split equally between employers, employees and the State. The rate is 8% of the total wage bill for each party, therefore 24% in total.

The criteria for eligibility for early retirement between 57 and 60 remain the same, as well as upholding the legal age of 65 and the level of the replacement rate.

Pension structure and formula

The current structure for calculating pensions also remains the same: a flat-rate and pro rata enhancement component supplemented by an end-of-year allowance. The flat-rate component increases over the insurance period and is unrelated to a person's contributory income, while the pro rata enhancement component applies to the total contributory income over the insurance period. It should be noted that for the pro rata enhancement component, the applicable rate is 1.85%[1] but may increase progressively up to 2.05% when the person has completed 38 years of professional activity and reached 55 years of age.

The changes mainly relate to the rates applied to these increases in the pension formula. The biggest change affects maturing pensions. The reforms aim to progressively adapt the different elements of the pension formula and to adapt the rate of increase in order to encourage insured parties to prolong their professional lives.

[1] The pro rata enhancement component is calculated by multiplying the sum of contributory income by this rate.

The flat-rate components which consitute the basis of each pension, will increase over time from 23.5% to 28% in 2052. Therefore, the rate will vary depending on the year the person begins drawing their pension. It is also the same for the pro rata enhancement component which will progressively decrease from 1.85% to 1.6% in 2052. However, it is possible to compensate for this decrease by contributing for up to a further three years, for example by remaining on the job market longer.

An updated version of the practical examples will soon be available on the website of the National Pensions Office (Caisse nationale de pension).
(http://www.cnap.lu/publications/publications-cnap/)

Pension entitlement

With regard to entitlement, the draft maintains the current provisions: the effective and supplementary periods necessary to be eligible for an old age pension, the minimum pension and for the acquistion of flat-rate components remain unchanged. With the entitlement for early retirement at 57 or 60 years of age, the insured party must however accept the cut introduced by the modification of the pension formula which will take effect over time. Insured parties who are currently close to retirement shall not be, or shall only be slightly, affected by these changes.

Periods of study

Periods of study and training currently undertaken between 18 and 27 years of age, and which are non-contributory periods but count towards the pension scheme, have not been reduced, as initially predicted. These periods shall be taken into consideration as from 18 instead of 20 years of age (initial draft reform) as additional periods in order to complete the scheme for early retirement at the age of 60.

Voluntary insurance

The reform aims to encourage continuous or optional insurance by reducing the minimum contribution from 300 to 100 euros per month. This option of reduced-cost insurance is only available for career breaks due to family reasons and for a maximum period of five years. The option of reduced-cost insurance for career breaks due to family reasons and for a maximum period of 5 years will be reduced from 300 to 100 euros per month to encourage continuous cover.

Transition between working life and retirement

In order to keep old people in the workforce, it is possible to draw an early retirement pension and a salary simultaneously without the pension being reduced by up to half, with a ceiling set at the average of the five highest annual contributory incomes.

Furthermore, to encourage the combination of a pension and a partial paid activity, the reform aims to increase the minimum reference ceiling from 120% to 150% of the social minimum wage. For a retirement pension at 65 years of age, it is possible to draw a pension and a salary simultaneously without any reduction in the ceiling.

For invalidity pensions, it is possible to combine a salary and pension without any reduction in the latter as long as the income does not exceed a third of the social minimum wage.

At the same time as the discussions on pension reforms, different programmes and measures are being drawn up in the two Ministries: Social Security and Labour and Employment. Under review is the reform to the reclassification, the third age pact aimed at promoting and supporting the work of old people as well as different provisions allowing for a reduction in working time while drawing a partial pension.

Readjustment moderator

Currently, changes to pensions are made by a special law, bearing in mind the resources and movements in average wage levels allowing for an adjustment factor. This factor which shall be re-established every two years by way of a government proposal applies to all pensions (due and future). As part of the budgetary discussions, the government has decided not to make an adjustment in 2013.

The reform aims henceforth to differenciate between the revaluation of wages used to calculate the pension and the pension readjustment mechanism.

The first mechanism ensures the full revaluation of the insured party's wages at the time he goes into retirement. It compensates for the variation in the level of the insured party's wages as compared to the level of wages in the economy at the time of calculation / liquidation of the pension.

The pension readjustment mechanism aims to readjust pensions in payment in line with cost of living trends measured by changes to wages. In the future, the readjustment mechanism may be eased by a reduction factor when expenditure exceeds revenues from contributions.

End-of-year allowance

The reform shall maintain the end-of-year allowance[2] up until a future increase in the contribution rate, currently set at 24%.

Period of coverage

The system of financing by redistributing charges over a coverage period, with the establishment of a reserve, ensures a financial balance with the help of a contribution rate fixed at the start of the coverage period and applicable throughout the whole period. The contribution rate should therefore ensure that incoming contributions cover the expenditures, i.e. the

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[2] Currently the end-of-year allowance is € 17.74 per year of recognised insurance with a maximum amount of € 709.60.

pensions paid out during this period of coverage. The period of coverage will be increased from 7 years currently to 10 years, however the frequency with which the contribution rate is reviewed shall be guaranteed after 5 years in order to react more quickly to fluctuations in productivity and employment.

Regimes affected

The private and public sector regimes are targeted by the reform, including the new provisions related to the readjustment. Please note that the public sector regime remains a special regime with specific provisions, where one of the main provisions is not to apply a contributions ceiling[3].

Entry into force

The new provisions enter into force on 1 January 2013.

[3] For the general regime, the maximum contribution ceiling set at five times the social minimum wage is maintained.