Capital Pension Funds: the Changing Role in South and Eastern European Countries

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Summary:

Rapidly changes are occurring in the economies of South-Eastern European countries. Some areas are still undergoing reforms or are planned to be reformed. Such an area is the pension system. Capital pension funds are re-functioning from 21 years. At the end of 1990s the development of the insurance for capital pensions was regarded as compulsory element of the pension security. The last financial and economic crisis leads to some re-thinking of their role. Hungary nationalized huge part of the assets. Poland is rechanneling the bulk of the money back into the state social fund. Bulgaria, Croatia and Romania are closer to further developing the sector insurance rather than diminishing its role. The Czech Republic is more or less neutral. What are the reasons for the differences – political, social or economic in nature? The paper deals with the role of insurance for capital pension in the whole pension system in these six countries. Issues such as administrative costs, asset management results, practice of the good corporate governance and risk management are addressed. The study searches answers to questions such as what part of pension security has to be for capital pensions and what kind of state supervision should be carried out.

Key words: capital pensions, pension reform, de-privatization of pensions.

JEL Classification: *G11, G23, G35*

The topic of insurance for capital pension is of essential importance today concerning aging of the population, the extension of pension payment period, growing pressure over public schemes and the global financial and economic crisis of 2009 and its impact. Among the research goals is the analysis of the current role of capital pensions in South-eastern European Countries, the outlining of the trends and making conclusions about future development. For reasons of limited space countries with close economic development and pension systems have been selected for analysis. The used research methods include analysis and synthesis. Comparison-based conclusions are drawn.

As a result of the study 21 characteristics have been identified which have to be achieved and incorporated in insurance for capital pension in order to reach the set goal for increasing the replacement ratio. Furthermore five spheres as priorities in order to improve the efficiency of the pension security in the analyzed countries are formulated.

1. Capital Pensions Snapshot

Capital pensions were gaining influence during 1990s and at the start of 21th century. They were expanding both in western developed

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countries and in emerging economies such as in countries in Latin America and South-Eastern Europe. The latter were under the impact of three-pillar model of World Bank. This model was implemented in more than 30 countries, including 12 South-Eastern Europe (SEE) ones (Bulgaria, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Poland, Romania, Slovakia and Slovenia).

The global financial and economic crisis led to the reconsideration of the role of the capital pension insurance. There are reversals[1] in mandatory private pensions (Hungary), partial reversals/ partial reduction (Poland), reduced contributions (Slovakia, Estonia, Latvia, Lithuania, Romania) but also no change (Croatia, Bulgaria, Macedonia, Kosovo) and continuation with 2nd pillar reforms (Czech Republic). That is why it is interesting to analyze the insurance for capital pensions in countries such as Hungary, Poland, Romania, Croatia, Bulgaria and Czech Republic. They initiated reforms in very close time and have much the same structure of pension systems. All of them were influenced by the recommendations from the World Bank and International Monetary Fund.

The six countries started the reforms in different times. Hungary and Poland were first to implement the mandatory capital pension insurance, followed by Bulgaria and Croatia. Romania started the reform a little later and finally the Czech Republic launched it in 2013 but in 2014 is planning to close it. In terms of development of the private pension system three countries (Bulgaria, Croatia and Romania) are on the way to increase their role. In another three (Czech Republic, Hungary and Poland) the conducted reforms are decreasing the impact of private pensions. These processes are analyzed in this paper.

Why countries with relatively similar economies have different politics for capital pensions? Similar factors are exerting great pressure on the financial sustainability of public systems (often referred as PAYG, pay-as-you-go, system). The extension of life expectancy, the ageing of the population and the decreasing share of the active labor force has almost the same influence in each of the six countries.

Part of the reasons can be found in the problems in some countries in other spheres such as public financing, budget deficits, political situation and state supervision. Poland and Hungary have problems with the

Table 1. Development of insurance for capital pensions in selected countries

	Bulgaria	Croatia	Czech Republic	Hungary	Poland	Romania
enactment year of mandatory	2002	2002	2013	1998	1999	2008
enactment year of voluntary	1994	2002	1994	1994	1999	2007
current status/trend in development of capital pensions	↑	↑	↑	↑	↑	↑

Source: OECD Pensions at a glance 2012 and updated by the author.

[1] Price, Will, "Reversal, Reduction and Reform: Lessons from the Financial Crisis in Europe and Central Asia to Improve Outcomes from Second Pillar Pensions", World Bank, IOPS/Pension Europe Conference on Pensions in the CEE region, 2013

Table 2. Some socio-economic indicators in selected countries as of 31 December 2013

	Bulgaria	Croatia	Czech Republic	Hungary	Poland	Romania
assets in % of GDP (mandatory)	7.00%	18.28%	0.49%	0.71%	9.90%	1.78%
government debt % of GDP	18.90%	67.10%	46.04%	79.20%	57%	38.40%
public pension expenditure in % of GDP	9.9%	10.60%	8.30%	9.90%	11.80%	9.80%
life expectancy at age 65 (years)	15.82	16.7	17.6	16.6	17.9	16.1

Source: Countries' official statistical sources.

size of the budget deficit or government debt. In the Czech Republic there is no political will for development of supplementary mandatory capital pension pillar.

In **Poland** the second pillar was mandatory in open pension funds (OFE) for people born in and after 1969. Now the participation in OFE stands voluntary. In December 2013 parliament passed a bill that implemented the automatic transfer of retirement contributions to ZUS (public pension administration authority), instead of OFE, unless a member files a declaration requesting to stay in second pillar. So the scheme has changed from mandatory to voluntary opt-out option. The first time-slot for declaring participation was between 1 April and 31 July 2014. Around 2.5 million people choose to participate in the second pillar out of 14 million members before the changes.

Until 2009 Poland was considered as the flagman and model for second pillar design. The country has the highest funds' asset per GDP ratio among the SEE countries. Also the contribution in the second pillar was the highest - 7.3% of the total pension contribution. In addition, Poland was one of the first countries that adopted the legislation for the pay-out phase. The law on annuities, adopted in 2009, assumes that pension savings will be converted into a single annuity. But the global financial and economic crisis changed the thinking of the politicians. As of 1 May 2011 the contribution was sharply decreased – 2.3% were diverted to the funded scheme. The remaining 5% were placed in a special individual sub-account in ZUS. This amount is valorized by the average annual GDP growth rate of the last five years. The share of contributions allocated in the sub-accounts and in the funded scheme has to change gradually until reaching 3.8% and 3.5% respectively.

The next set of reforms were in conducted in an attempt to reduce government debt (Table 2) and the Polish government confiscated the state bonds held by the private pension funds. At that time there were 14 funds with around 15 million members and more than 70 billion euros in assets. Government bonds constituted 51.5% of the total assets of the pension funds. This action reduced the government debt to 49.9% of the GDP, thus meeting the target of below 50% which enable future debt issuance. After the removal of all government bonds in February 2014 the net assets dropped from 296 billion PLN to PLN 147 billion PLN (around 35 billion euros).

In addition, under the latest reforms assets of the citizens with 10 or fewer years left to retirement have to be transferred to the ZUS. The transfers are expected to be PLN 4.7 billion (EUR 1.1 billion) in 2014 and PLN 3.8 billion in 2015. Another measure was the decrease of the maximum fee OFE can charge from contributions from 3.5% to 1.75%. It is interesting that the pension age is gradually increasing to 67. Minimum 25 and 20 years' contribution are required from men and women, respectively. In most of the countries in SEE the pension age is planned to reach 65 years. In some of them it is still very low – 61 years and 8 months for women and 63 years and 8 months form men in Bulgaria. Table 2 shows that Poland has the highest life expectancy at age of 65 among the six analyzed countries.

The new contributions will sharply decrease after people joining the pension system in the future are not obliged to participate in the second pillar. As a result of the negative government campaign against capital pensions from the new entrants to the workforce only 10% are choosing to join.

Hungary with the second most developed market for capital pension insurance in fact was the first country in the region with de-privatization measures. In the years between 2010 and 2011 all contributions were redirected to the public pension scheme. At that moment the size of the contribution for second pillar was 8%. Members were given the right to decide whether to remain in the scheme or to transfer back to PAYG system. After the reversal only 102,000 decided to remain in the defined-contribution scheme out of 3.1 million members. The defined-contribution private pension scheme has to deliver an annuity on retirement. The annuity must provide at least the same indexation of the pension as the public pension scheme.

The required retirement age is gradually increasing until reaching 65 years for both men and women.

For a long time **Czech Republic** had not built second pillar although the country was among the first ones to create legislation for voluntary insurance in third pillar. Almost 20 years after the start of the third pillar (in 2013) the country adopted the mandatory insurance for capital pension. Evidently it will exist for very short period of time, given that in May 2014 the government formed a working group for dismantling the new scheme. What was envisaged? As of January 2013 every insured person was able voluntarily to opt out into a second pillar insurance. The mandatory private pension scheme is financed by contributions of 5% of gross earnings. It is defined contribution (DC) scheme: payments are based on the accumulated funds which depend mainly on contribution, insurance period, investment results and administrator's charges. The private pension contribution consists of two elements: 3% charged on the public PAYG system and 2% on employee's salary. This decreases the accrual rate to 1.2% annually for the public pension.

Three withdrawal options are available – a lifelong annuity, lifelong annuity with additional three year survivor pension or a temporary 20-year annuity.

Despite the enactment of the second pillar, public expectations were that this would be a temporary measure because of the plans of politicians (the party that was in opposition when the new legislation was drafted and strongly opposed it came to power at the end of 2013) to ban it. Also the architecture of the second pillar does not contain incentives for members to participate. As a result only around 84,000 members elected second pillar insurance for 1 year after the introduction of the second pillar.

It was no surprise that at the end of 2013 the government announced its plans to terminate the second pillar by 2016. The details of the closure have not yet been decided but the most possible solution is the transfer of the accumulated funds into third-pillar voluntary funds.

The package of the latest pension reforms in the Czech Republic contains measures for changes in the voluntary insurance. These measures created uncertainty and distrust among clients. Changes are expected to have a negative impact on the development and to prompt massive consolidation in the sector. "Participation" funds have to replace the existing "transformed" funds. The insured can choose among programs with a range of risk profiles. A conservative fund is compulsory. The non-compulsory funds have a minimum threshold of 1.8 million euros within two years of being licensed. Around 60% of members opted for conservative fund as a result of which eight providers out of 33 had to merge. Voluntary pension insurance existed since 1995. The current tax deduction for employers is up to CZK 30,000 (EURO 1,090) per year. The members in the third pillar are 4.9 millions.

As part of the reforms, the retirement age gradually is increased up to 66 years and eight months for both men and women. The minimum required coverage also is increasing gradually up to 35 years.

In SEE region four countries did not undertake changes in the capital pensions: Bulgaria, Croatia, Macedonia and Kosovo. The size of contribution is 5% in Bulgaria and Croatia, 7.42% in Macedonia and 10% in Kosovo. A voluntary contribution again up to 10% can be added. Macedonia and Kosovo are not included in the analysis because of their small economies, big differences in the market conditions for private pensions and the relatively delayed start of pension reforms compared to the other six countries. Nevertheless their approach and the design of pension system will be included in future analyses. Mandatory insurance in capital pension funds started in 2006 in Macedonia and in 2002 in Kosovo. Insurance in second pillar is mandatory in Macedonia for new entrants in the labour market after 2003 compared to Kosovo where it is mandatory for persons under 55 years of age. Voluntary insurance for capital pension started in 2009 in Macedonia and in 2005 in Kosovo.

In Croatia capital pensions are regulated by two main laws: Act on Compulsory and Voluntary Pension Funds and Act on Pension Insurance Companies and Pensions Based on Individual Capitalized Savings. Both the mandatory and voluntary insurance started in 2002. They are DC schemes. The mandatory capital pension insurance is designed for persons under 40 years at the start of the reform. People between 40 and 50 have a right to choose. In voluntary insurance there are open-end and close-end funds. In order to decrease the costs of administration not only the collection but also the book-keeping is centralized.

The payment of retirement benefits within the framework of mandatory pension insurance based on individual capitalised savings of members of mandatory pension funds is made by pension insurance companies only.

In **Bulgaria** capital pensions enjoy a relatively stable development. On the one hand, the legislation is good, the contribution is set to reach 7% (from the current 5%) in 2017, most of the activities are concentrated in one administrator (pension insurance company), there is a good level of trust among politicians and members, and the tax regime is favorable. On the other, there have been no significant amendments to the legislation since 2007 aimed to respond to the challenges of the market, there are no different risk profiles, the guarantee mechanism is dysfunctional, supervision is not effective, payout phase is not very clear and a lot can be done with regard to cost control, risk management and investment results.

At the moment 9 pension companies are managing the assets of around 7% of GDP and members of the funds are 1.43 times the total insured persons in the country (insured persons for pension security in National Social Security Institute as of 30.09.2014). The investment results are among the worst in the region (Table 3).

It has to be taken into consideration that this (2008 - 2012) is one of the worst periods in the history of asset management.

Table 3. Pension fund nominal and real 5-year geometric annual return over 2008-2012 (%)

country	5-year average return	
	nominal	real
Bulgaria	-0,85	-5,15
Chile	2,7	0,1
Croatia	3,13	0,04
Czech Republic	2,2	-0,1
Hungary	4,1	-0,4
Estonia	-1,8	-5,2
Poland	1	-2,3
Romania	11,41	5,63
Slovenia	2,7	0,6
Slovak Republic	0,4	-2,3

Source: OECD Pensions at a glance 2012 and updated by the author.

Nevertheless some conclusions can be drawn from the information. Firstly, obviously the management of the pension administrators was not prepared to react amid such a crisis. Secondly, investment yield guarantee mechanisms are not sufficient and appropriate in the conditions with minus numbers. Thirdly, the difference among the countries is very broad (around 6% annually for 5-year period, excluding Romania with reason explained below), which exposes a serious problem in asset management capacity and professionalism. This problem needs to be addressed immediately by the supervisory and regulatory bodies.

Romania stands in the best place in terms of asset management results. The reason is that the second pillar was introduced in 2008. It is worth noting that in the other countries the funds registered a high positive return in the 2-3 years prior to the peak of the global financial crisis.

In Romania insurance for capital pension is mandatory for workers below 35 years and is voluntary for those between 35 and 45 years. The administrator of mandatory pension fund can be only a pension company. The administrator of a voluntary insurance fund can be a pension, insurance or investment-management company. Reduction in growth rate path from 2% up to 6% was registered in 2010. The size of contribution froze at 2%. In 2011 it showed a gradual increase by an annual rate of 0.5%. The country faces the lowest replacement rate (38.7%) from public pension and the worst dependency ratio of 1.04 of insured persons to pensioners. For comparison the coefficient is 1.24 and 1.22 in Bulgaria and Croatia. In Romania there are 8 mandatory funds and 11 voluntary ones operating. The average number of the insured in the mandatory fund is the highest

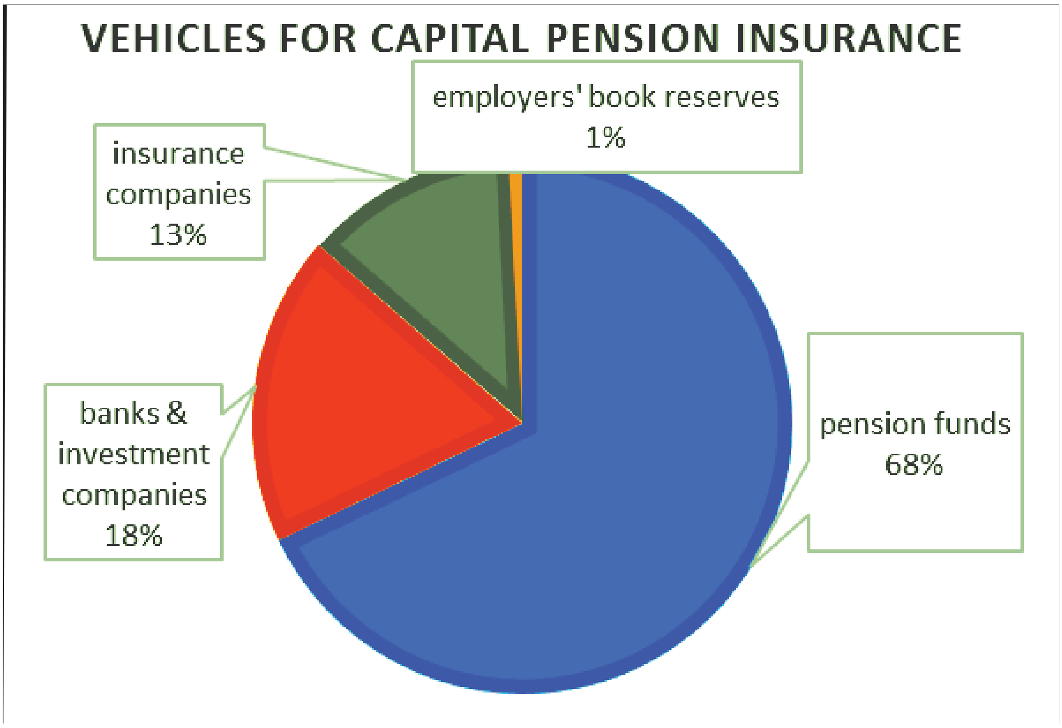

Fig. 1. Role of different vehicles in insurance for capital pensions

Source: Pension Markets in Focus 2013. OECD, p.8

among the six countries – 722,125, compared to 182,857, 425,555 and 370,003 in Poland, Croatia and Bulgaria respectively. This creates an environment of low charges and costs for the administration the capital pensions. At the moment the charges are below those in Bulgaria, Poland and Hungary. Also the capital market in the country is relatively well developed compared to Bulgaria and Croatia, which enables the asset managers to reach good investment results.

2. Future trends

The different role of capital pensions in the region shows that there is no universal solution to the proportion between solidarity and personal pension insurance. The future of the capital pensions is connected with problems of efficiency, customer protection, asset management, financial literacy, good corporate governance and other issues.

These problems can be tackled by applying measures to improve efficiency taking into account the specific environment in every country. It appeared that the schemes in the region are *defined contribution* based. The major form of insurance is a *pension fund*.

In other countries (Western Europe, North America, developed countries in Asia) personal pension plans are often funded through pension insurance contracts or financial vehicles provided by banks and asset managers.

In SEE region the organization of capital pensions is *retail-based*, i.e. the service is directed toward the individual, not to the employer. This fact increases the costs of attracting, servicing, information, marketing, consulting, asset management carried out by the administrator. The retail approach has advantage because it helps improve the financial literacy.

Another conclusion for the future functioning of capital pensions is that the *contribution* has to be at a satisfactory high level – it must be no less than 7%. The size is related to the replacement rate, to the interest of the insured and to the efficiency of the administrator.

The responsibility of the regulator is to keep *charges* low. It is a fact that the size of charges varies significantly[2] among countries. High charges erode the trust of clients and politicians. On the other hand, the administration is carried out by private companies. Part of this strategy is to conduct constant control over the *costs* of the pension administrators. Charges have to be envisaged in the light of the return on investment, competition, risk management, transparency, asset management benchmarks, and options for different risk profile administrative capacity, marketing, servicing and costs. At the same time the regulator and the supervisory body have to stimulate the *asset management capacity* of the administrator.

The topic of charges and costs is directly related to *good corporate governance.* The latter creates trust both in politicians and clients.

In terms of asset management there is need for *diversification* geographically and by asset class. The regulators have to take into account the importance of the *default funds*. *Benchmarks* lead to greater transparency. Most experts accept as an appropriate *investment result* the target of inflation + 3%.

Concentration of most of the activities in single body can help for decreasing charges and low costs. Stimulation of the *competition* keeps alert the pension companies and is a prerequisite for better service for the insured persons.

Detailed *legislation* is another milestone of the capital pension in SEE region. Part of this are investment return guarantee mechanism and clear rules for pay out phase.

Strong *supervision* is a must in countries where there dynamic changes and fast distribution of capital.

Politicians, labour unions, employers' organizations, regulator and supervisory bodies have to follow clear *communication strategy* toward the society. They have to send clear signals to the public about the role of private pensions, the reasons for their development, and the opportunities they offer to the insured, about the risk, the problems and the potential solutions.

Part of the strategy for development is the set of *incentives for insurance*. In our opinion the regulators have to create good environment for employer's plans.

There has to be *pressure from the European Commission* over the local governments. Local authorities are less dependent on IMF and the World Bank.

Another conclusion is that both voluntary and mandatory has to be well developed at the same time. The extreme cases did not lead to good results. Examples are Poland with strong development of mandatory insurance between 1998 and 2008 and Czech Republic with well developed voluntary pillar for the period of 1994 – 2011.

[2] Chłoń-Domińczak, A., "Costs of mandatory pension funds in CEE countries", IOPS/PensionsEurope Seminar: Pension Developments in the CEE Region, 2013

Conclusion

The design of pension systems and their security level vary among countries, also among countries with close economic development and traditions. Based on the analysis of six countries from SEE some conclusions can be drawn. These conclusions suggest the increasing role of insurance for capital pensions, the improvement of the functioning capital system and increase of the overall replacement ratio. As a result of the research *five* spheres as priorities for policies and measures can be formulated, namely: a long-term strategy for the development of capital pension as part of the whole pension system; financial sustainability of the schemes; adequate supervision and legislation; effective asset management and constant cost control.

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