
PENSIONS SYSTEMS AND REFORMS IN NEW EUROPE

Design and Experience

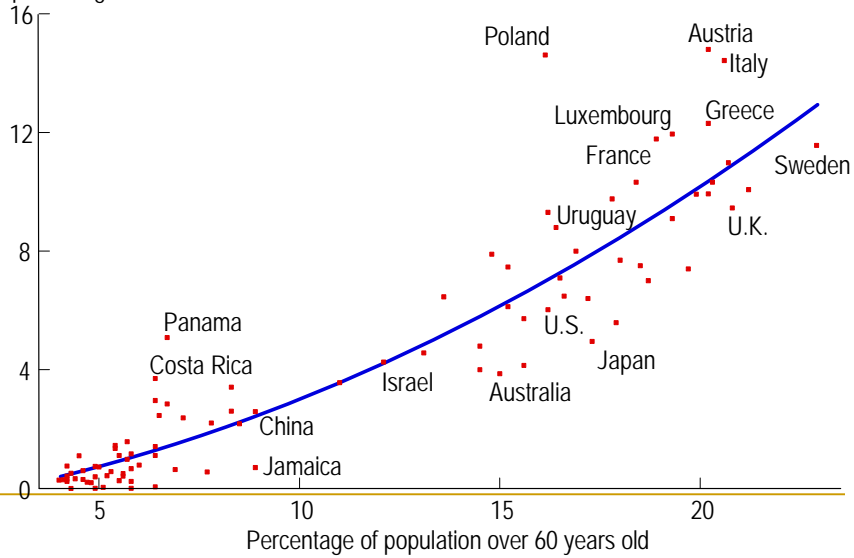
Michal Rutkowski, Director,
Human Development, The World Bank
Segovia, November 14, 2006

Background and Issues

- Population aging is an European and a world-wide phenomenon
 - Aging puts pressure on public programs, in particular pension and health
 - The problems need an open public discussion about issues and reform options followed by policy decisions
 - In the current and enlarged EU the pension reform needs to run parallel to that of establishing fully integrated output and factor markets
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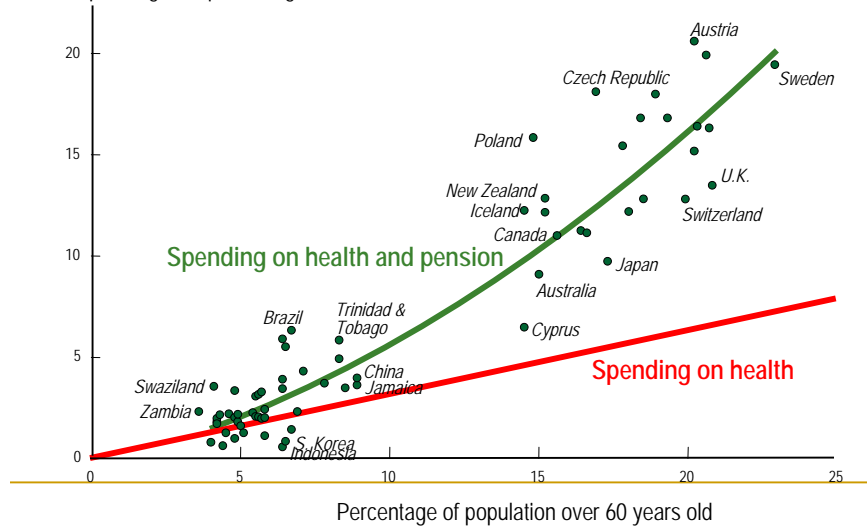
Relationship Between Percentage of the Population over 60 Years Old and Public Pension Spending

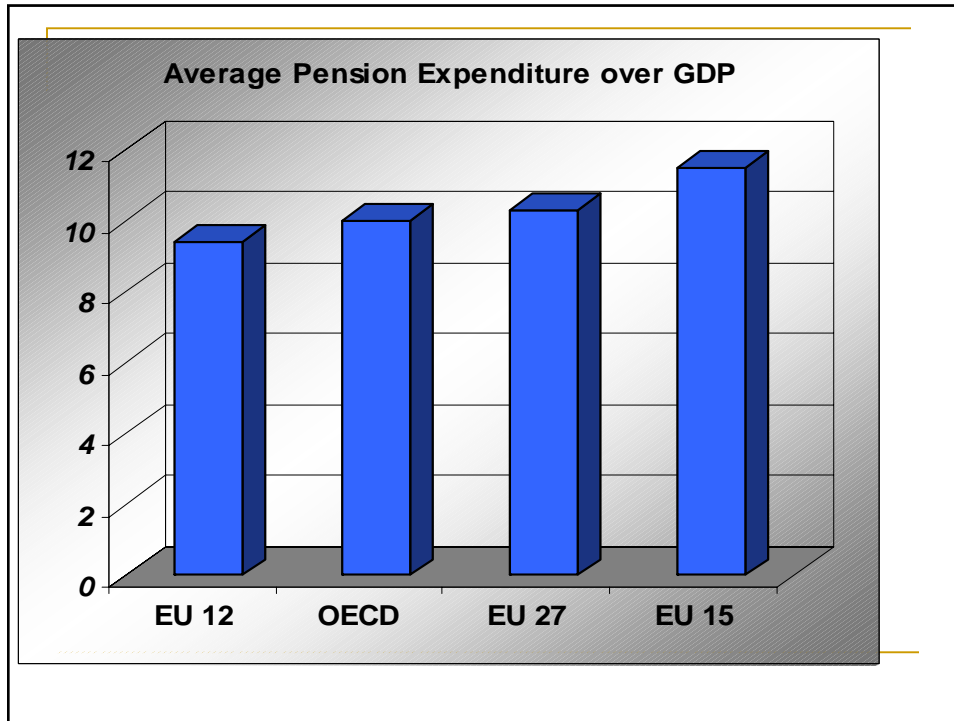
Pension spending as percentage of GDP



Public Health and Pension Spending versus Population Aging

Spending as a percentage of GDP





Increase in pension expenditure from 2000 to 2050

Flat rate system	% of GDP	Earnings related	% of GDP
DK	2.8	A	2.5
IRL	4.4	B	3.3
NL	5.7	FIN	4.6
UK	0	F	3.7
		D	5.0
		I	0.3
		P	3.4
		E	7.9
		S	1.7

Source: EPC

Status of pension reform in an integrated Europe

- Needs and promises
 - Flexibility between education, work and retirement spell over life cycle
 - Incentives for life-long learning
 - Labor mobility between professions and member states
- Reality
 - Pension issues not yet fully on the EU agenda
 - Fragmented and largely unreformed schemes
 - Discussion and tough decisions on harmonization/coordination needs so far avoided

The role of the EU vs. competence of the Member States on pensions

- Social security is mainly in the competence of the Member States
- Yet, a lot of work is going on at EU level
 - directly-binding
 - indirectly-binding
 - non-binding co-operation

A. Directly-binding EU legislation on pensions

- Portability of pension rights under free movement of people (TEC Art 42)
 - Freedom of establishment (TEC Art 43+49)
 - Provisions on capital movements
 - Directive on Institutions for Occupational Retirement Provision (IORP)
 - Taxes: infringement procedure for elimination of tax discrimination, and Commission Communication on other tax distortions
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B. Indirectly-binding EU legislation

- Sound public finances (TEC Art 4)
 - Co-ordination of economic policies (TEC Art 99)
 - Stability and Growth Pact (Stability and Convergence Programmes): assessment of long-term sustainability of public finances
 - Economic Policy Committee projections 2001
-

C (1). Non-binding co-operation between Member States and the Commission in social affairs

- Active discussion since 1999
 - Raising EU's profile in social field
 - Protecting the European model
 - Counterweight to pressure from EMU requirements (cutting excessive deficits)
 - Council unanimity required also after Nice Treaty
-

C (2). Non-binding co-operation under the 'Open method of co-ordination' (OMC)

- Three broad principles endorsed by the Gothenburg European Council (June 2001)
 - **to safeguard the capacity of pension systems to meet their social aims**
 - **to ensure the financial sustainability of pension systems**
 - **to enhance the ability of pension systems to respond to the changing needs of society and individuals**
 - National reports and Joint Report of the Commission and the Council for the Brussels European Council, March 2003
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The root of the pension problem is population ageing, illustrated by the increase in the old age dependency ratio (OADR)

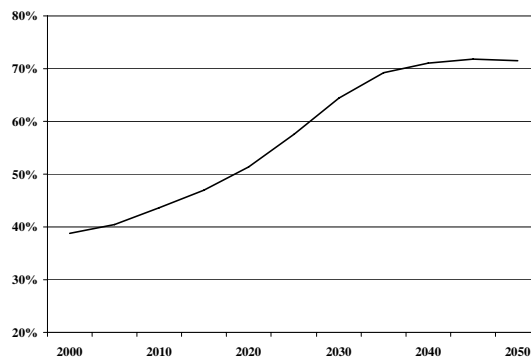
which increases from 40% to 70%

... mainly due to declined fertility and increasing longevity.

Old age dependency ratio* in EU-15, 2000-2050

ratio of population aged over 60 years to those aged 20-59 years.

Source: Eurostat projection



For financial sustainability and intergenerational fairness what is needed, if a reform is parametric, is a combination of:

- *reduced pension rights**
- *increased contributions (now !)**
- * later retirement**

Two Types of Reform Can Meet These Standards

- **Parametric – Change terms of existing system**
- **Paradigmatic – (i.e. One pillar into multipillar or PAYGO Defined Benefit to Notional Defined Contribution)**

Status of pension reform: an example of Europe

- Parametric Reform
 - Attempt to rationalize pension system by seeking more revenues and reducing expenditures while expanding voluntary private pension provision.
 - Austria, Czech Republic, France, Germany, Greece, and Slovenia
- Paradigmatic Reform
 - Fundamental change in pension provision typically through introduction of mandatory funded pensions, drastic reform of PAYG pillar and expanded voluntary retirement saving.
 - Bulgaria, Croatia, Denmark, Hungary, Italy, Latvia, Poland, Slovakia, Sweden, and UK.

Direction of Paradigmatic Changes in Europe

- Actuarial systems
- Funding
- Defined Contribution principle
- Individual choice

Notional Defined Contribution Scheme

- DC systems, but remains unfunded
- Individual accounts, with contributions and notional interests credited
- Pension is calculated by dividing accumulated amount by life expectancy – “G-value”
- Main issues:
 - Choice of notional interest rate
 - Choice of G-value
 - Reserve funds against demographic and economic shocks

NDC Advantages for Europe

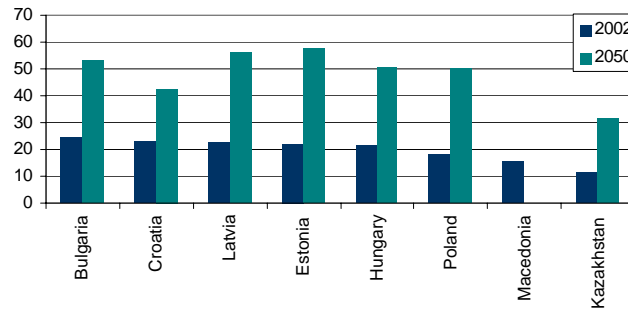
- Breaking reform deadlock in countries
- Harmonizing schemes between professions in countries
- Could be a common denominator in a group of countries (such as EU)
- Labor mobility between member countries
- Easy integration with funded schemes

Countries implementing mandatory funded pension schemes

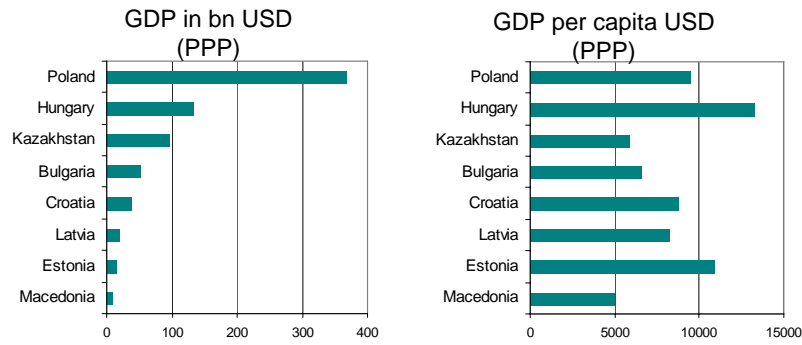


Population ageing

Dependency rate
(65+/15-64), per cent



Economic performance



Both total and relevant size matter

Reasons for the multi-pillar reform

- to make the pension system sustainable in long run
 - to reduce implicit pension debt
 - to diversify risk
- to achieve better balance between collective and individual responsibility in the pension system
- to encourage additional savings
- to develop and strengthen financial markets

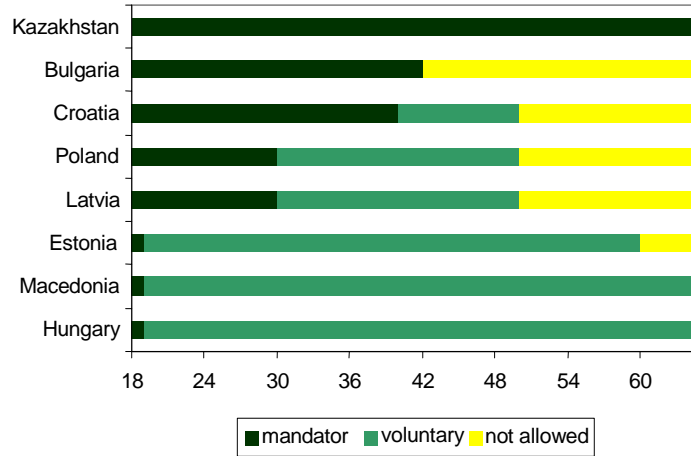
Changes in the PAYG

Strategy	Country examples
Going towards defined contribution	Poland Latvia Croatia
Reducing existing defined benefit	Hungary Bulgaria Estonia Macedonia
Flat rate minimum benefit	Kazakhstan

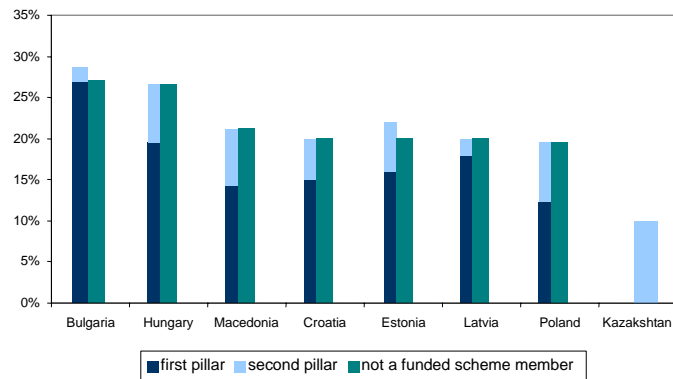
- to balance public pension expenditures
- to create room for financing the transition costs

Design

Participation in the funded pillar



Contributions



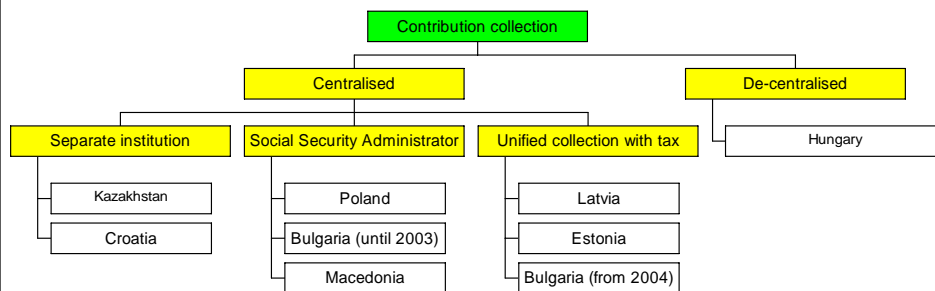
- Tax treatment: usually EET

- Size of contributions to funded component depends on capacity to finance transitions costs

Transition costs

- Size depends on:
 - policy choices
 - contributions
 - members of funded system
 - individual choices
- Examples:
 - Poland: 1.6% of GDP
 - Hungary: 0.6% of GDP
- Financing:
 - current tax revenues
 - savings on pensions
 - future revenues (debt)

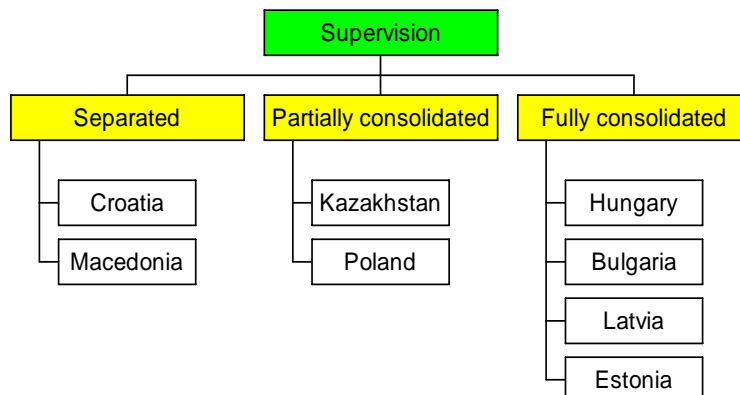
Contribution collection



Charge structure

Strategy	Country examples
Limits on charge structure and partial ceiling	Hungary Poland Latvia Macedonia
Limits on charge structure and full ceiling	Croatia Bulgaria Estonia Kazakhstan

Supervision



Licensing

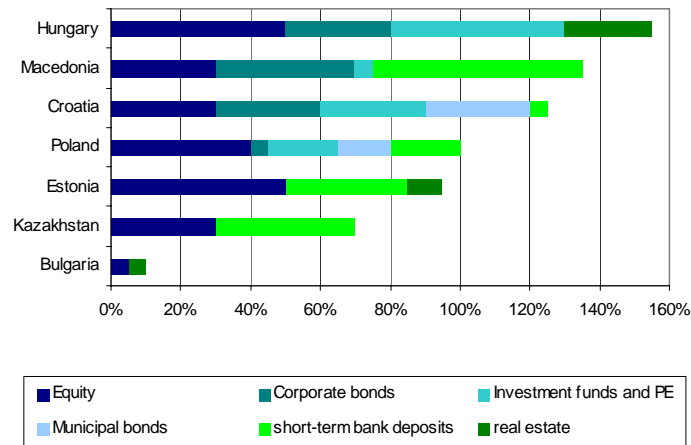
- financial requirements:
 - minimum shareholder capital,
- legal provisions and quality check:
 - presenting draft articles of association for the approval of the supervision
 - business plan
 - information on the quality of the managers

Marketing and sales

examples of policies

- rules of marketing
 - limiting joint sales of several products from the group
 - guidelines for marketing information
 - approval of marketing materials
- rules of sales
 - licensing sales agents
 - professional qualifications
 - limiting sales at workplace

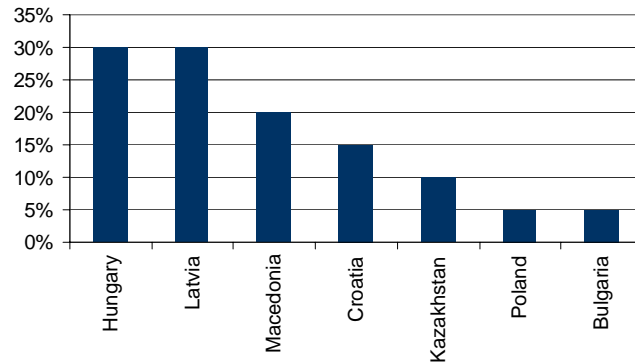
Investment limits



Concentration

- by ownership
 - a ceiling on the proportion of the issue of a company that a given fund can hold - only in Latvia and Macedonia
- by issuer
 - a ceiling on the proportion of assets in a fund's portfolio issued by the same institution - virtually in all countries

Foreign investment



- In Estonia: only investment in specified categories of foreign investment, no quantitative limit

Guarantees

- Rate of return guarantees:
 - Relative to pension sector
 - Kazakhstan
 - Poland
 - Croatia
 - Relative to benchmark:
 - Hungary
- No rate of return guarantee:
 - Latvia
 - Bulgaria
 - Estonia
 - Macedonia
- Financing of guarantees:
 - Mandatory reserves
 - Hungary
 - Kazakhstan
 - Poland
 - Bulgaria
 - Estonia
 - Guarantee funds
 - Hungary
 - Poland
 - Estonia
 - Minimum pension (overall)

Payouts

- Mandatory annuity:
 - Hungary (pension fund or insurance company)
 - Poland (providers not decided yet)
 - Croatia (specialised companies)
 - Bulgaria (licensed companies)
 - Estonia (licensed insurance companies)
- Several options:
 - Latvia (various annuity types - joint, variable, deferrals)
 - Macedonia (annuity or scheduled withdrawal)
 - Kazakhstan (once the system matures - annuities, currently lump-sums are allowed)

Transparency and accountability

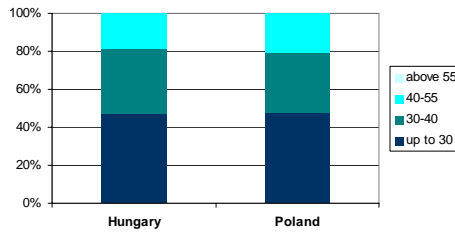
- Annual statements
 - financial statements
 - investment structure
 - shareholders structure
- Valuation of assets
- Information for participants
 - individual accounts (by mail, also by Internet or telephone)
- Web site
- Publishing investment results

Experience

Members

	Funded system	
	participants (ths)	% of all contributors
Kazakhstan	5 141	100%
Poland	10 990	76,4%
Hungary	2 253	49,6%
Bulgaria	1 115	48,40%
Croatia	938	67,50%
Estonia	210	35% (of choice group)
Latvia	325	32%

Members age distribution

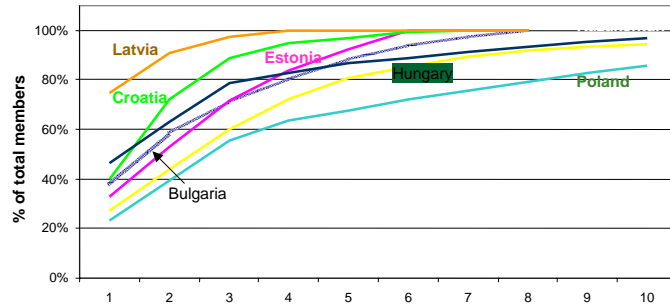


- Similar age pattern in Poland and Hungary, despite different switching policies
- Other countries:
 - in Estonia: 45% in the age group 20-25 and 32-34% in age group 26-60, fairly equal distribution

Number of funds

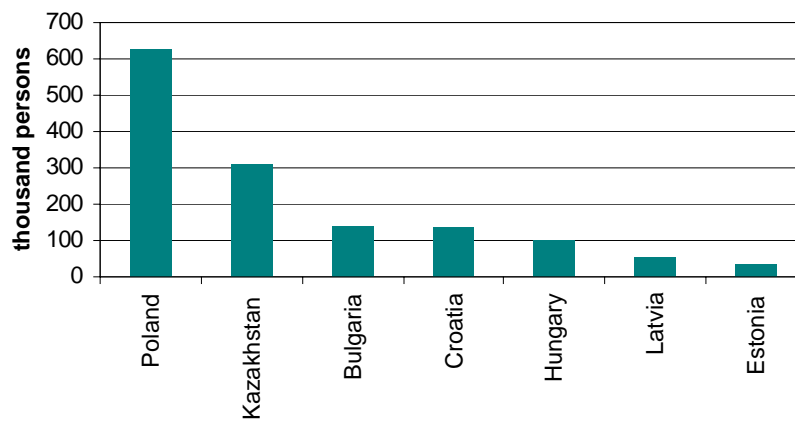
	Initial year	2002
Kazakhstan	10+1	13+1
Hungary	38	18
Poland	21	17
Bulgaria	8	
Croatia	7	
Estonia	6	15 funds
Latvia	6	11 plans

Concentration



- Significant share of state funds in Latvia (76%) and Kazakhstan (46%)

Average size



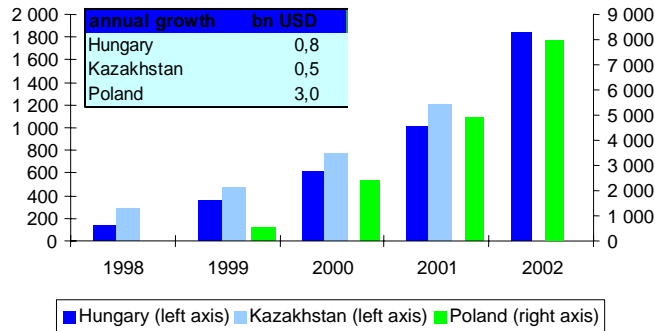
Market structure

TRANSFERS BETWEEN FUNDS

- Fewer transfers among funds than expected:
 - in Hungary around 1% of members changed funds
 - In Poland the number of changes is growing:
 - 1.4% in 2000
 - 1.7% in 2001
 - 3.1% in 2002
 - in Kazakhstan:
 - mostly transfers from state to non-state pension funds
 - share of state pension fund decreased from 82% in 1998 to 46% in 2001
 - smaller movements between private funds
 - in Latvia:
 - in 2003 c. 12% participants changed from state to private pension funds

Assets

(USD MLN)



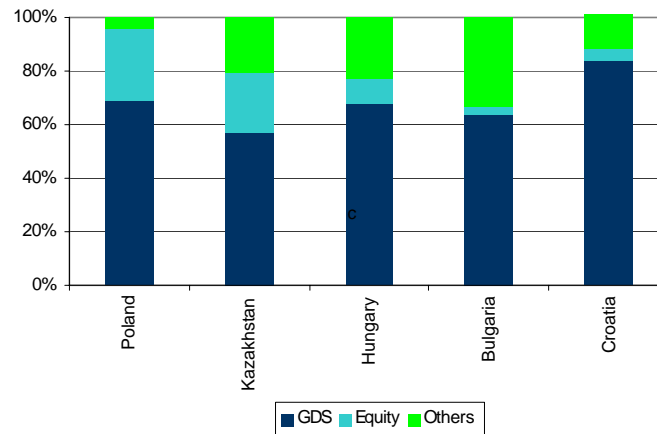
% of GDP	2030	2040
Hungary	30%	45%
Poland	80%	120%

Assets

- Role of pension funds as institutional investors:

	stock market capitalisation	pension funds' equity	% of stock market in pension funds:
Hungary	6,28	0,16	2,6%
Poland	6,19	2,13	34,4%

Investments



Rates of return

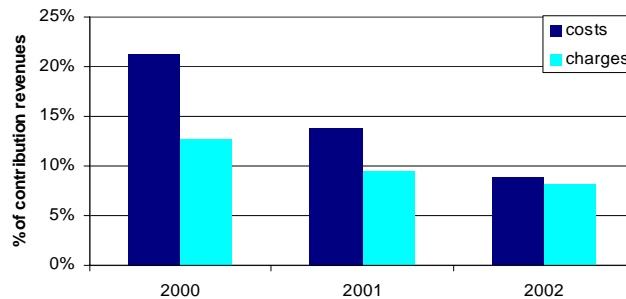
- Kazakhstan:
 - relatively high real returns, little disparity between funds
 - significantly better performance of state fund - different asset allocation
- Poland
 - lower, but still above zero real returns
 - large differences between funds
- Hungary
 - lack of comparable data
 - in 2001 net fund returns at 6.1%

Kazakhstan (real rates):		10/01-10/02
<i>Private funds:</i>		
non-weighted average		6,51
minimum		5,33
maximum		7,07
State Accumulation Fuhnd		9,04

Poland (real rates) *:	2001	2002
weighted average	4,31	8,28
minimum	-0,49	3,39
maximum	7,19	10,38

Costs and charges

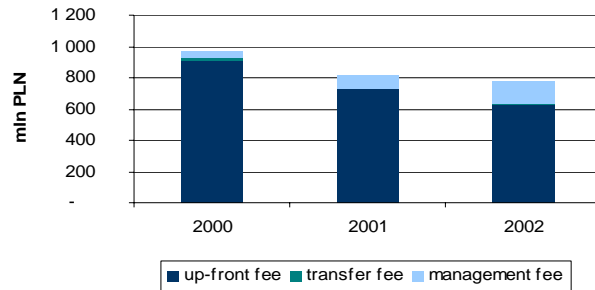
POLAND



- managers running deficits in 1999-2002
- surplus expected in 2002
- breakeven point around 2010

Charges

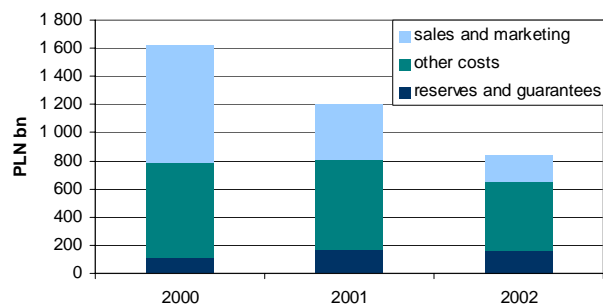
POLAND



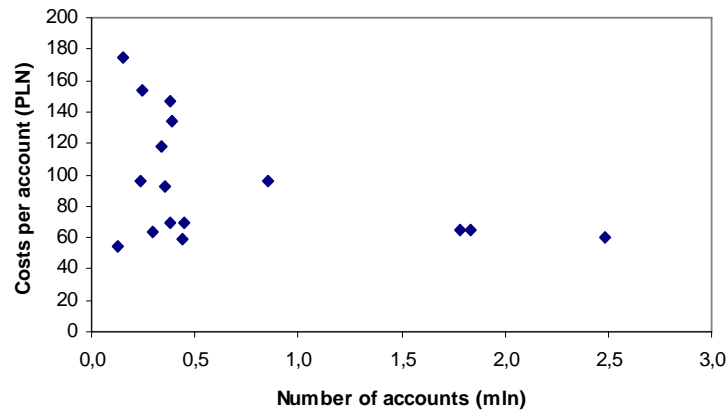
- Decreasing revenues due to digressive up-front fee (after 2 years of participation)
- increasing role of the management fee with rising assets

Administrative costs

POLAND



Size vs costs



Conclusions

MEMBERS AND MARKET STRUCTURE

- **Overswitching or underestimation?**
 - distrust to the public system
 - belief in private savings?
- **Large concentration:**
 - biggest funds: bank or insurance backing
 - more efficient sales?
 - earlier presence on the market?
- **Little changes between funds**
 - design worked?
 - outflow from public managers

Conclusions

ASSETS AND INVESTMENT

- Assets will be growing at a fast pace
- Increased investment in equity would be desirable
 - to diversify risk within pension system, not only within funded pillar
- Necessity to increase foreign investment limits

Conclusions

COSTS AND CHARGES

- Costs still relatively high
- Necessity to work on the cost reduction:
 - eliminating excessive guarantees
 - increasing client's awareness

Conclusions

- Trend towards multi-pillar schemes:
 - Implemented in 8 countries
 - Considered in Slovakia

- Experiences up to now:
 - high participation
 - fast increase of pension savings
 - concerns regarding transition financing

Issues for the future

- Elements of success:
 - prudent supervision
 - prudent investments
 - equity
 - foreign investments
 - transparency and accountability
 - keeping costs low
 - re-thinking guarantees