

# **Pension System Reforms in CEE – example of Poland**

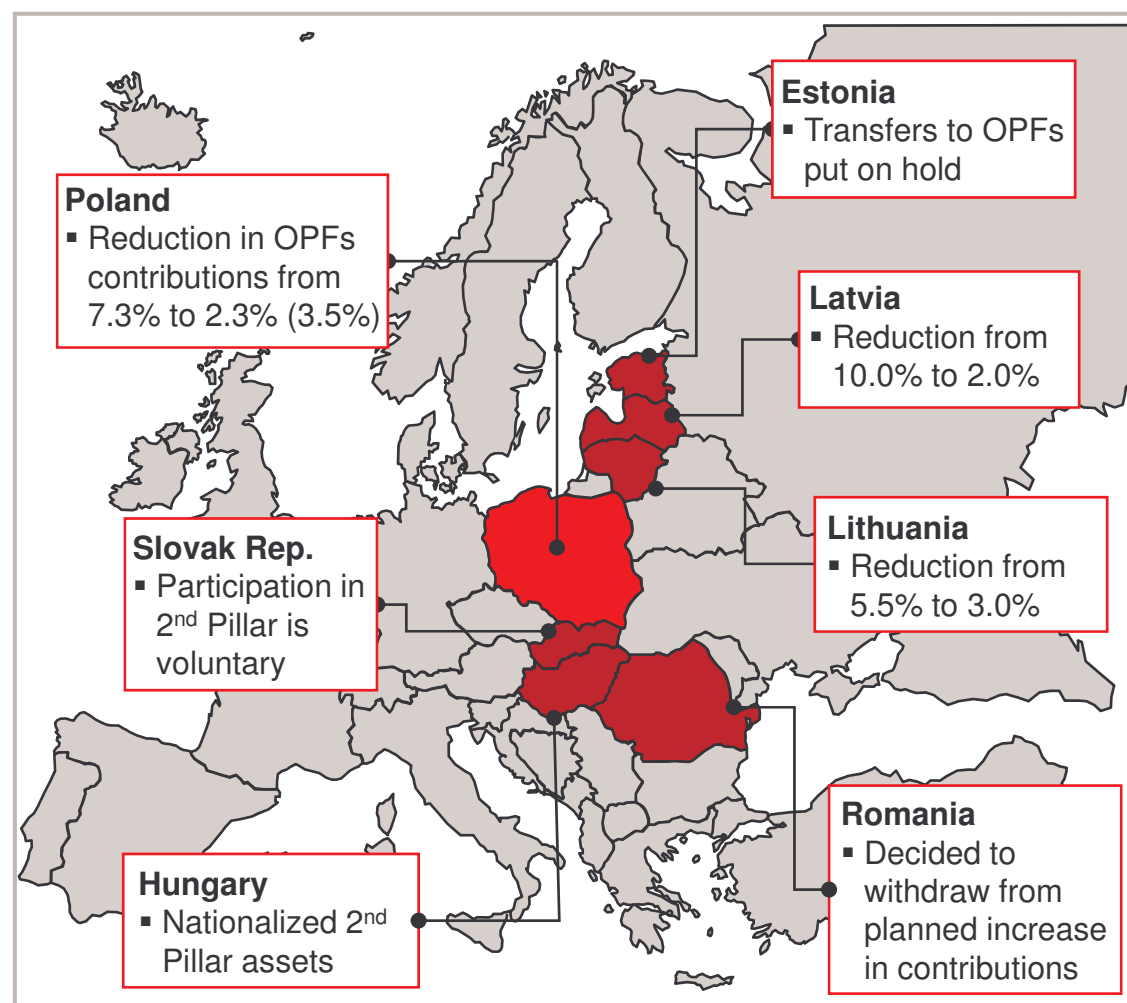
Jan Krzysztof Bielecki

**Office of the Economic Council to the Prime Minister of Poland**

1<sup>st</sup> of April 2011

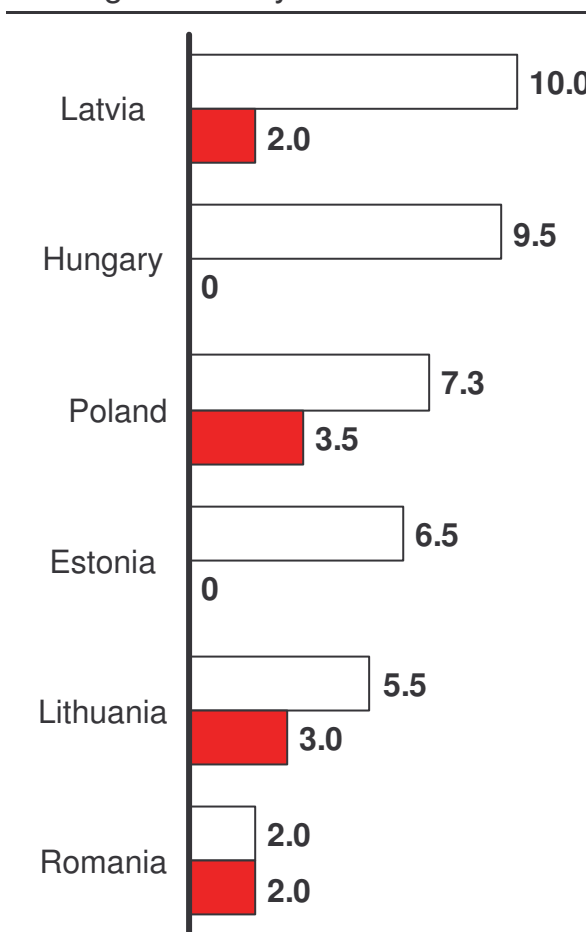


## Recent pension reforms in Eastern Europe resulted in reduction of contributions to Open Pension Funds

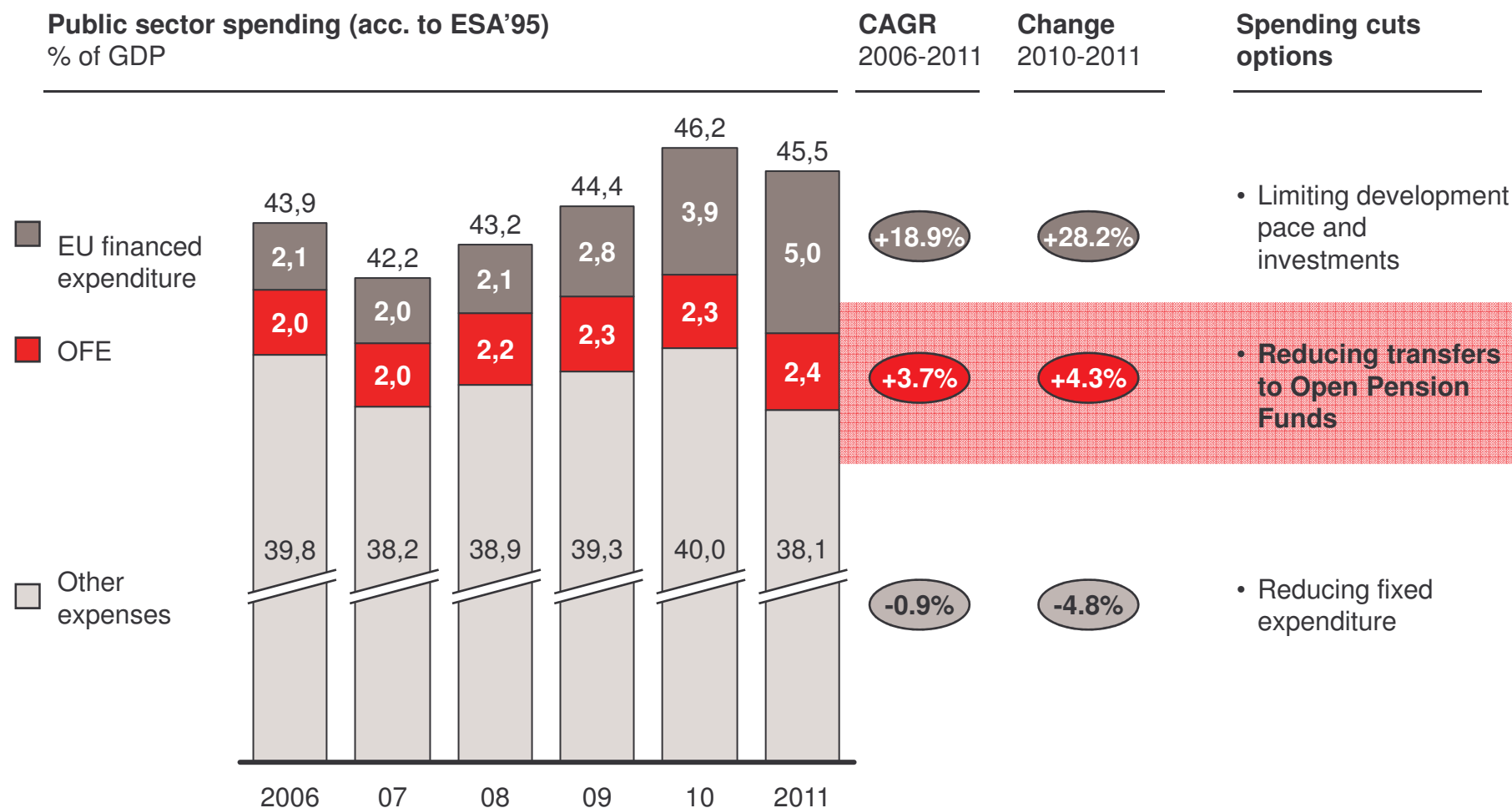


□ Before changes  
■ After reform

**Contributions to OPFs**  
% of gross salary



## The rise in the EU related investments led to high pressure on the government expenditure side



## Example of Poland

**Pension Reform of 1999**

**Challenges associated with 2<sup>nd</sup> pillar**

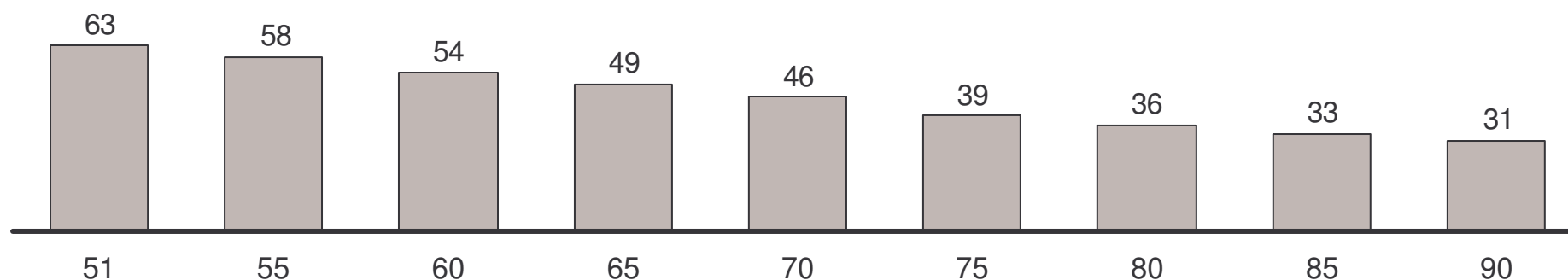
**Current changes to the Polish pension system**

The system has been based on 3 pillars – two mandatory and one voluntary

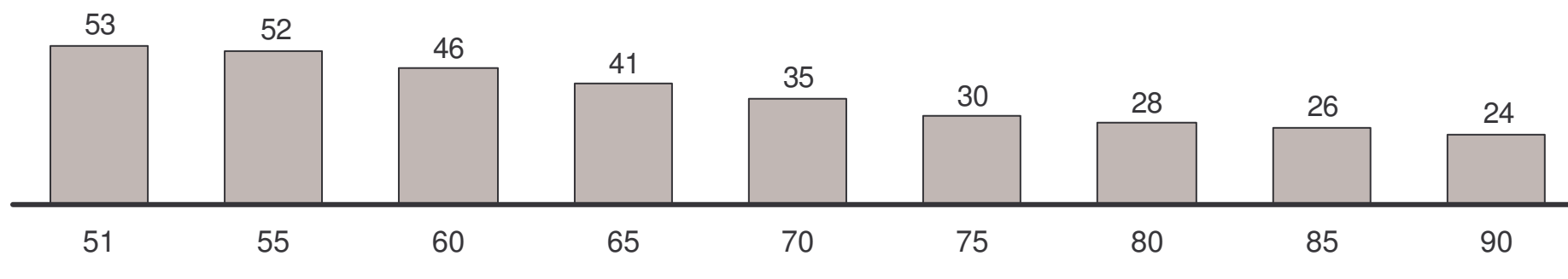
Mandatory System – splits contributions into two parts		Voluntary System
Pillar 1 - NDC	Pillar 2 - DC	Pillar 3
<ul style="list-style-type: none"><li>▪ Notional Defined Contribution system with individual accounts</li><li>▪ Contributions of 12.22% of gross salary</li><li>▪ The system is operated by state owned ZUS that collects the contributions and pays out pensions</li><li>▪ <b>Accounts are indexed according to wages bill changes ensuring immunity to negative demographic trends</b></li></ul>	<ul style="list-style-type: none"><li>▪ Funded part of pension system</li><li>▪ Contributions equal to 7.3% of gross salary</li><li>▪ Assets managed by 14 private Open Pension Funds</li><li>▪ Current asset under management valued at PLN 221 bn (EUR ~54 bn)</li></ul>	<ul style="list-style-type: none"><li>▪ Voluntary part of the system consisting of individual retirement accounts and employer sponsored programs</li><li>▪ Returns on investments are exempt from capital gains tax</li><li>▪ Up to date the number of participants is very low ~775 ths people</li><li>▪ Assets accumulated:<ul style="list-style-type: none"><li>▪ individual accounts - PLN 2.2 bn (EUR 0.5 bn)</li><li>▪ Employer programs – PLN 5.5 bn (EUR 1.3 bn)</li></ul></li></ul>

## The defined contribution system indexing mechanism adjusts to demographic changes through lowering replacement rates

**Estimated gross replacement rates before currently implemented changes - men**  
% last salary



**Estimated gross replacement rates before currently implemented changes - women**  
% last salary



**Year of birth**

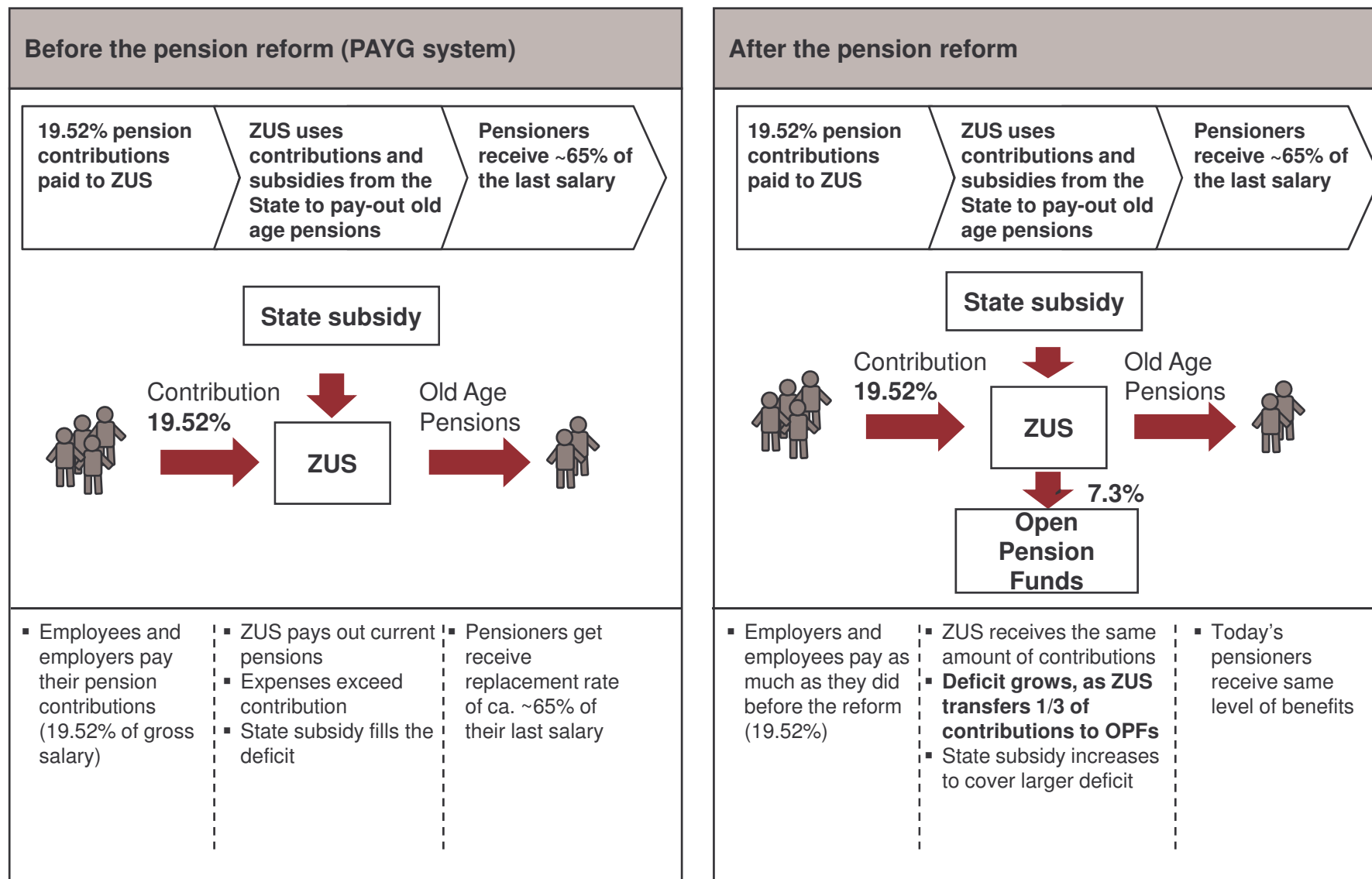
## Agenda

**Pension Reform of 1999**

**Challenges associated with 2<sup>nd</sup> pillar**






**Current changes to the Polish pension system**

## The 1999 pension reform created transition gap associated with transfers to Open Pension Funds



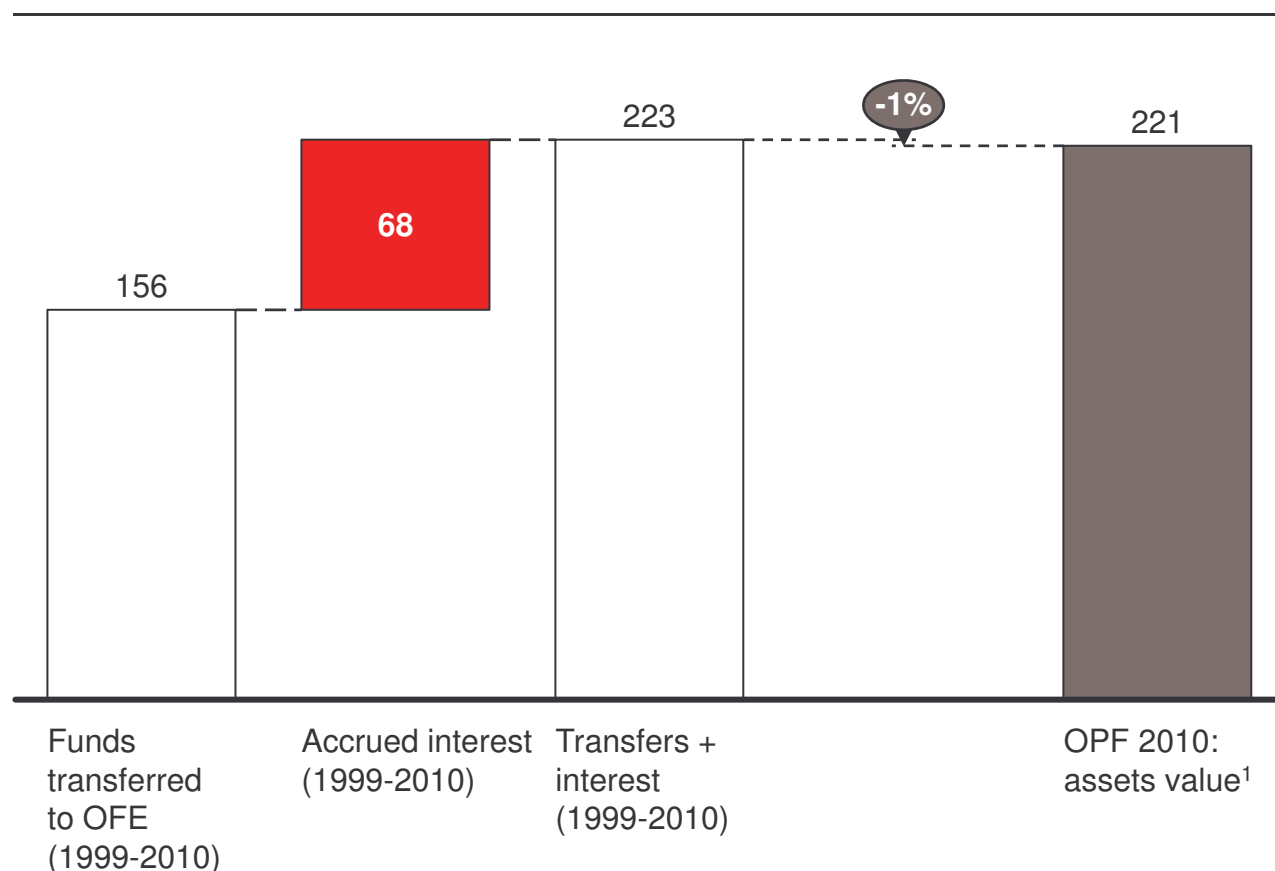


## How to fund the transition gap?

		 <b>Poland</b>
<b>Ways of funding transition period</b>	<b>Increasing taxes</b>	 <ul style="list-style-type: none"> <li>▪ No increase in taxes (e.g. Chile increased taxes by 3%, Czech Rep. considers VAT increase)</li> <li>▪ Introduction of cap on contributions (no contributions over 250% of average salary level)</li> </ul>
	<b>Decreasing public expenditure</b>	 <ul style="list-style-type: none"> <li>▪ Instead of anticipated decrease in expenditure various governments have done the contrary by awarding benefits to strong groups of interest (miners, military, police)</li> </ul>
	<b>Debt financing</b>	 <ul style="list-style-type: none"> <li>▪ The vast majority of transfers has been financed by increasing public debt</li> </ul>
	<b>Other income</b> (eg. budget surplus, privatization)	 <ul style="list-style-type: none"> <li>▪ The initial plan assumed the transition will be funded by income from privatization of state owned companies</li> </ul>

Poland is funding transition period by increasing public debt. The value of the transition related debt with interest is higher than assets accumulated in OPFs

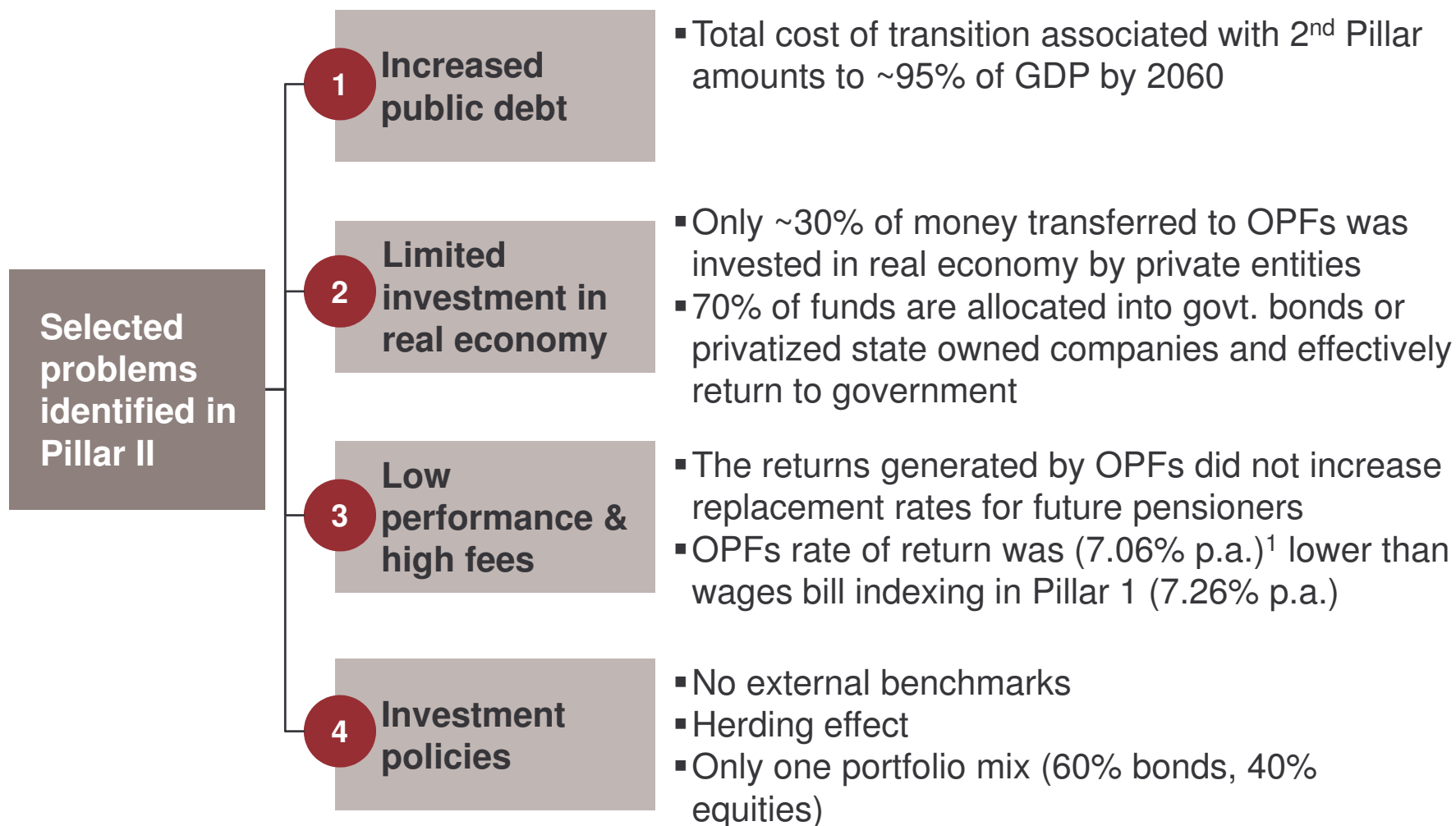
### Cost of transfers between 1999 and 2010 compared to the OPFs assets PLN bn, 2010



- If the State did not transfer funds to OPFs, but instead indexed them with the government bond interest rates, the level of assets would be similar to that in OPFs
- This result is due to strict limits on equity investments imposed on OPFs as well as high fees charged by Pension Funds Managers

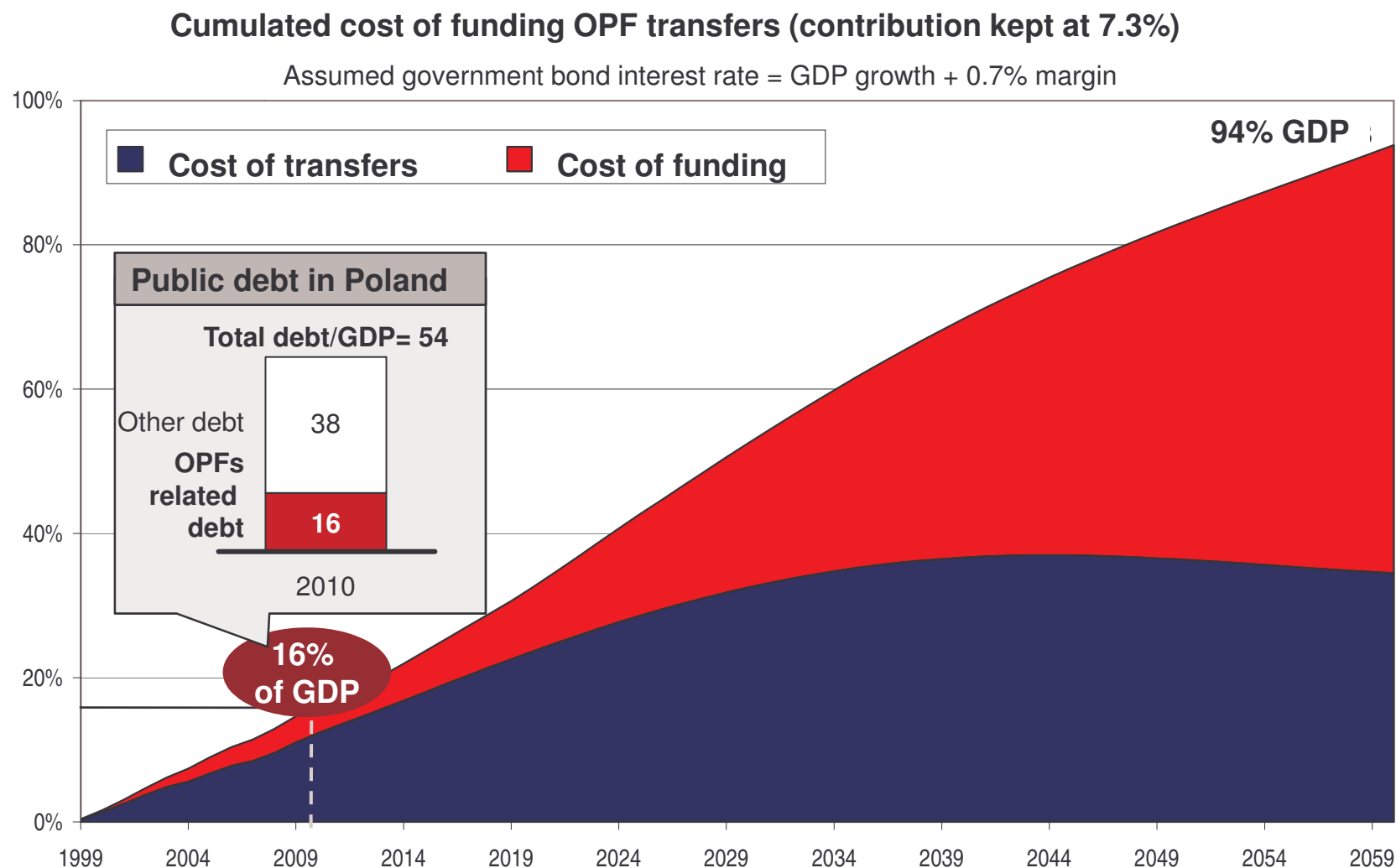
1 data as of December 2010

## Main problems associated with 2<sup>nd</sup> Pillar in Poland



<sup>1</sup> IRR net of fees for years 1999-2010 – both values – Pillar 1 and Pillar 2 calculated by the Chamber of the Open Pension Funds

- 1 Ministry of Finance estimates the cost of transition under previous regulation would exceed ~90% of GDP by 2060

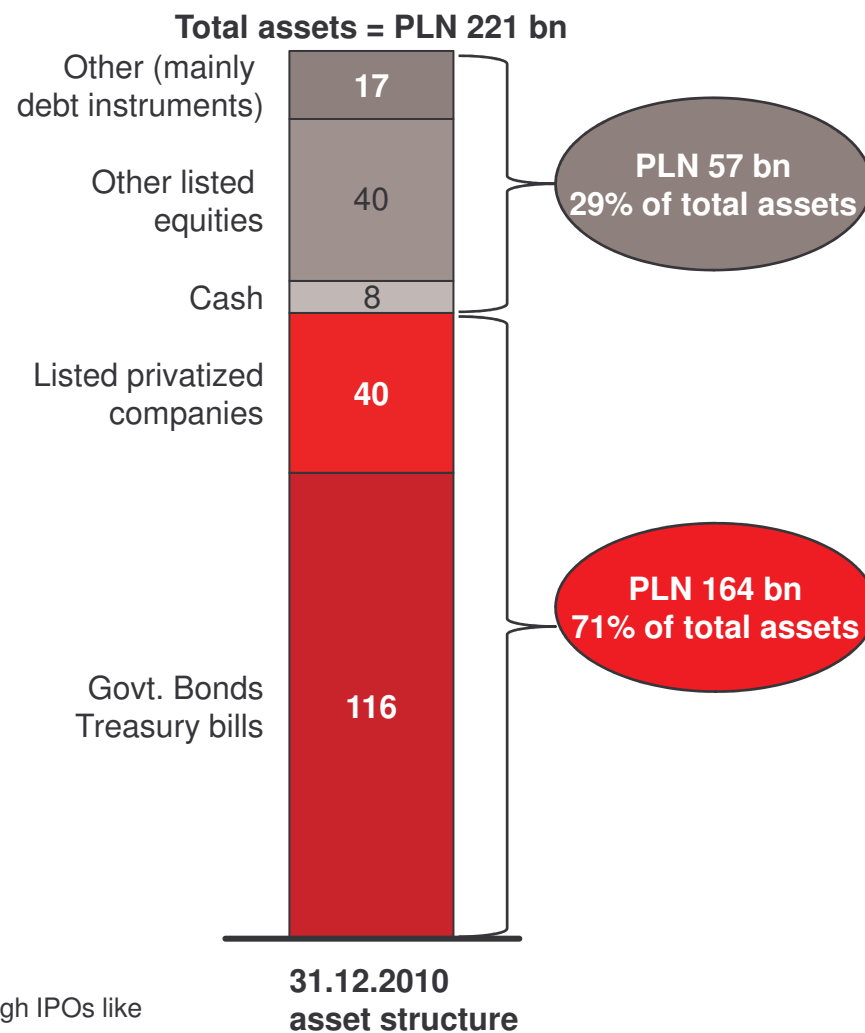
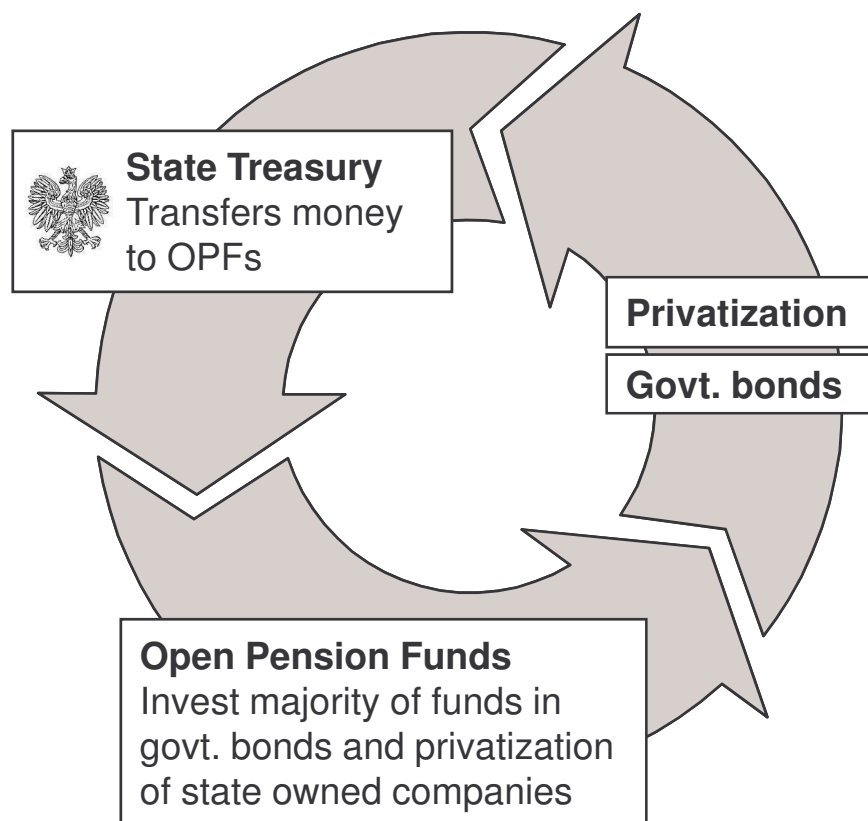


NOTE: this is a base case scenario in the optimistic case the total OPFs related debt reaches 79% of GDP in 2060

Source: Ministry of Finance as of 3/30/2011

2

Over 70% of total OPFs assets are invested either in government bonds or privatized state-owned companies – indicating that majority of money transferred to OPFs have returned to the state treasury



1 Includes only OPFs holdings in largest state owned companies privatized through IPOs like PZU, PKO, PGE, etc. - the actual number might be closer to PLN 50 bn

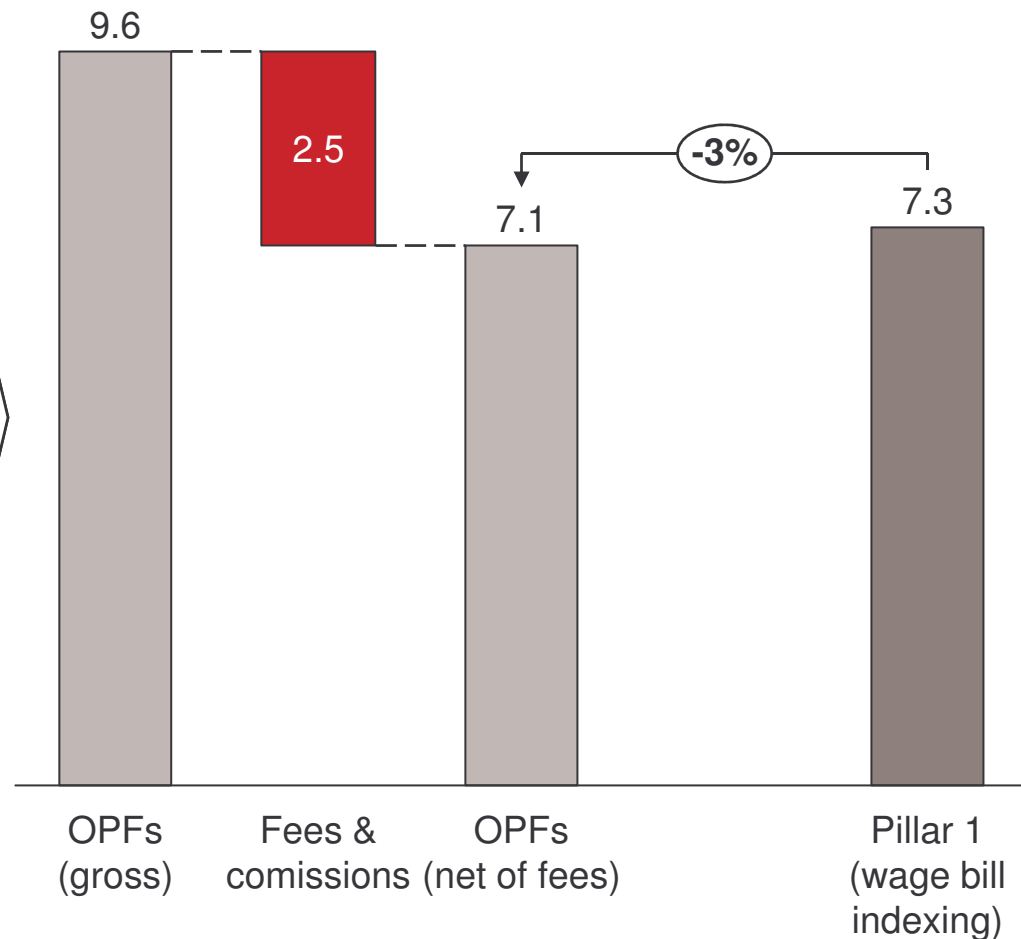
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Performance of Open Pension Funds have not benefited future pensioners mainly due to high fees & commissions

### Key facts

- Open Pension Funds delivered performance below wage bill indexing in Pillar 1
- This was mainly due to the fact that OPFs have been charging very high distribution and management fees
- **Crisis of 2007-2009 did not have material impact on OPFs performance as:**
  - Polish stock market recovered most of the losses (WIG20 is now at the ~80% of its historical peak)
  - OPFs portfolios were historically holding only ~30% of assets in equities

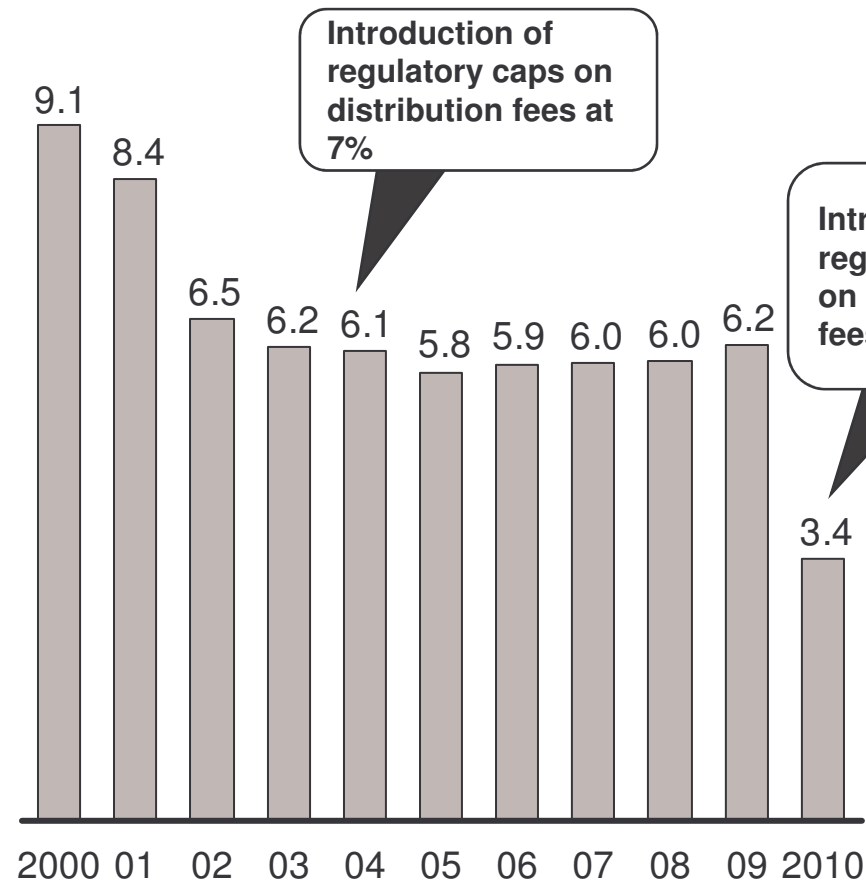
**Internal Rate of Return on Pillar 1 and Pillar 2 (OPFs) accounts**  
IRR 1999-2010, %



### 3 OPFs fee structure

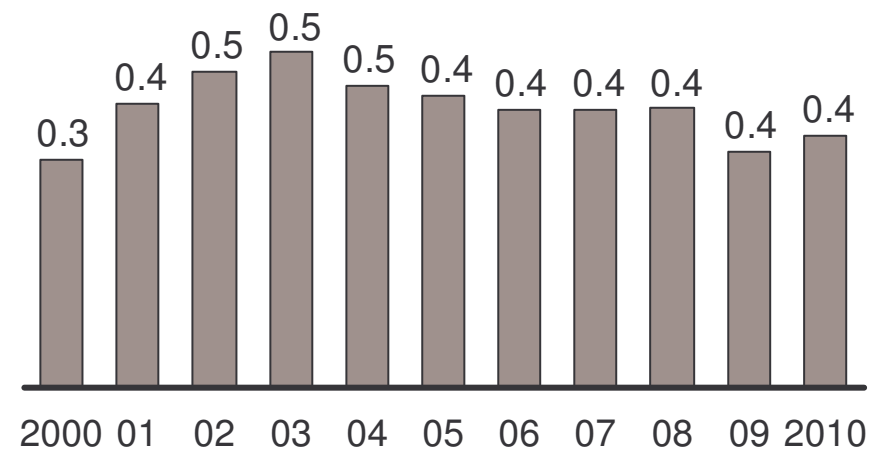
#### Distribution fee

% of monthly contributions, effective charges



#### Assets under management fee

% of AuM, effective charges



## 4 Key Open Pension Funds investment policies

### Consequences

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#### Only one portfolio mix

- Inadequate portfolios - one portfolio strategy for all members of OPFs regardless of their age, ability or willingness to take risk
  - Mostly invested in government bonds - portfolio mix regulations allow maximum 40% equity allocation – historically OPFs have been close to 30% equity and 70% fixed income allocation
- 

#### Internal benchmark

- **Herding effect** - minimal rate of return for OPFs based on internal benchmark (weighted average of rates of returns of all OPFs)
- OPFs usually have very similar portfolios – low level of diversification



## Agenda

**Pension Reform of 1999**

**Challenges associated with 2<sup>nd</sup> pillar**

**Current changes to the Polish pension system**

## Changes to the Polish pension system

**A** Lowering Pillar 2 contributions

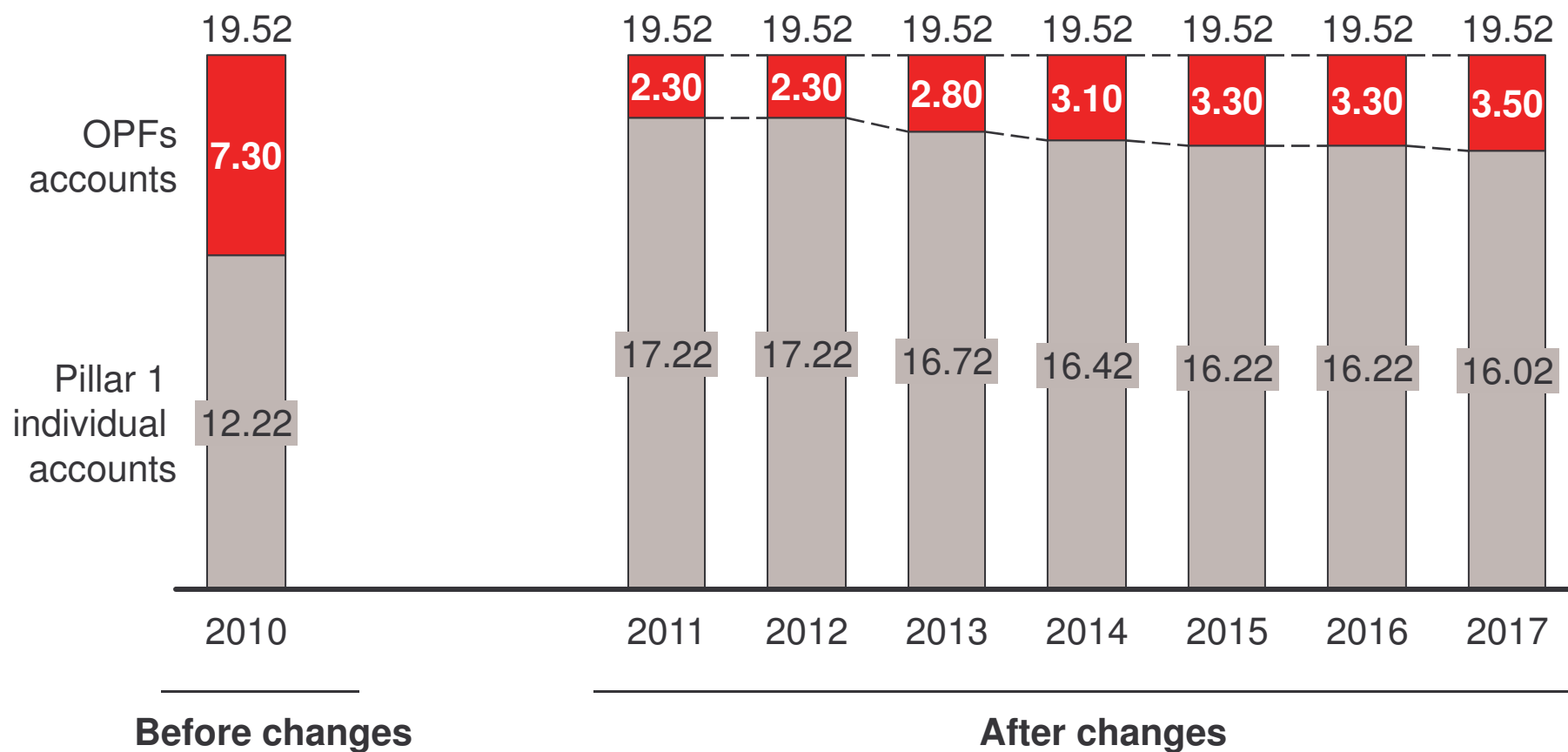
**B** Voluntary savings

**C** Next steps

- A** The government limits the level of contributions to OPFs from 7.3% to 3.5% in the long run

### Pension system contributions

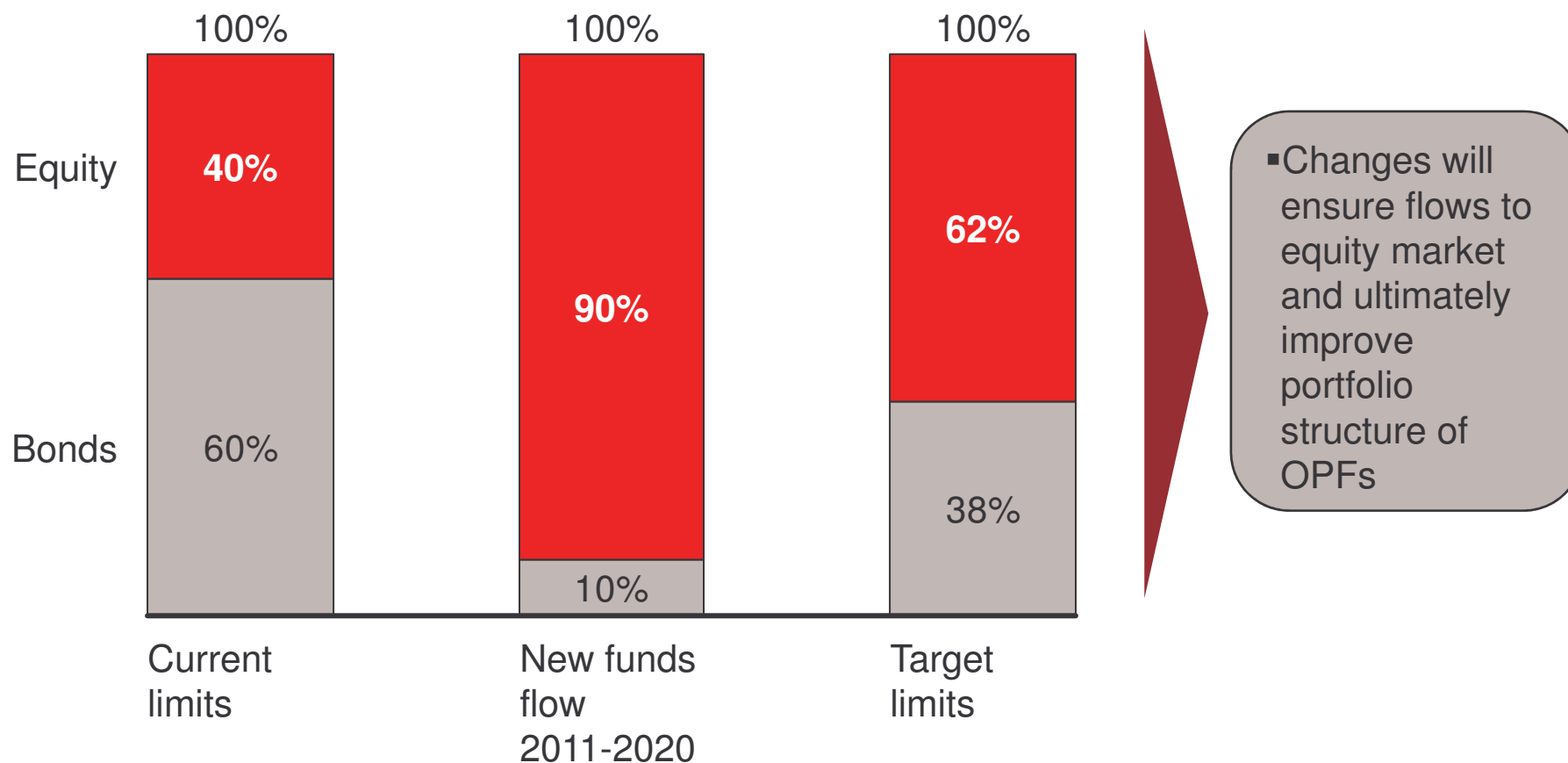
% of gross salary



- A** Equity investment limits will be adjusted to mitigate the risk of negative impact on the Polish equity market. The flow of new funds will be channeled mainly to equity investments

### Changes to bond/equity investment limits in years 2011-2020

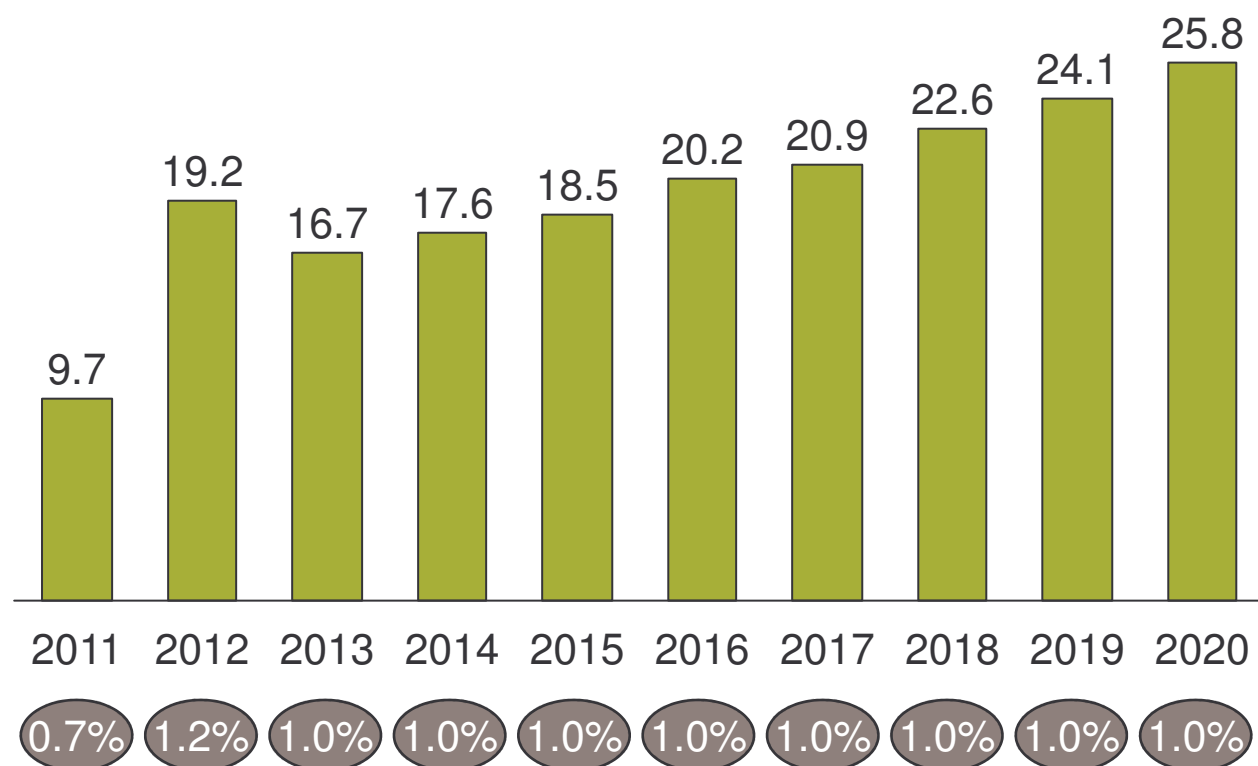
% of assets



**A** The borrowing needs will be reduced by EUR ~50 bn by 2020

**Positive impact on borrowing needs in years 2011-2020**

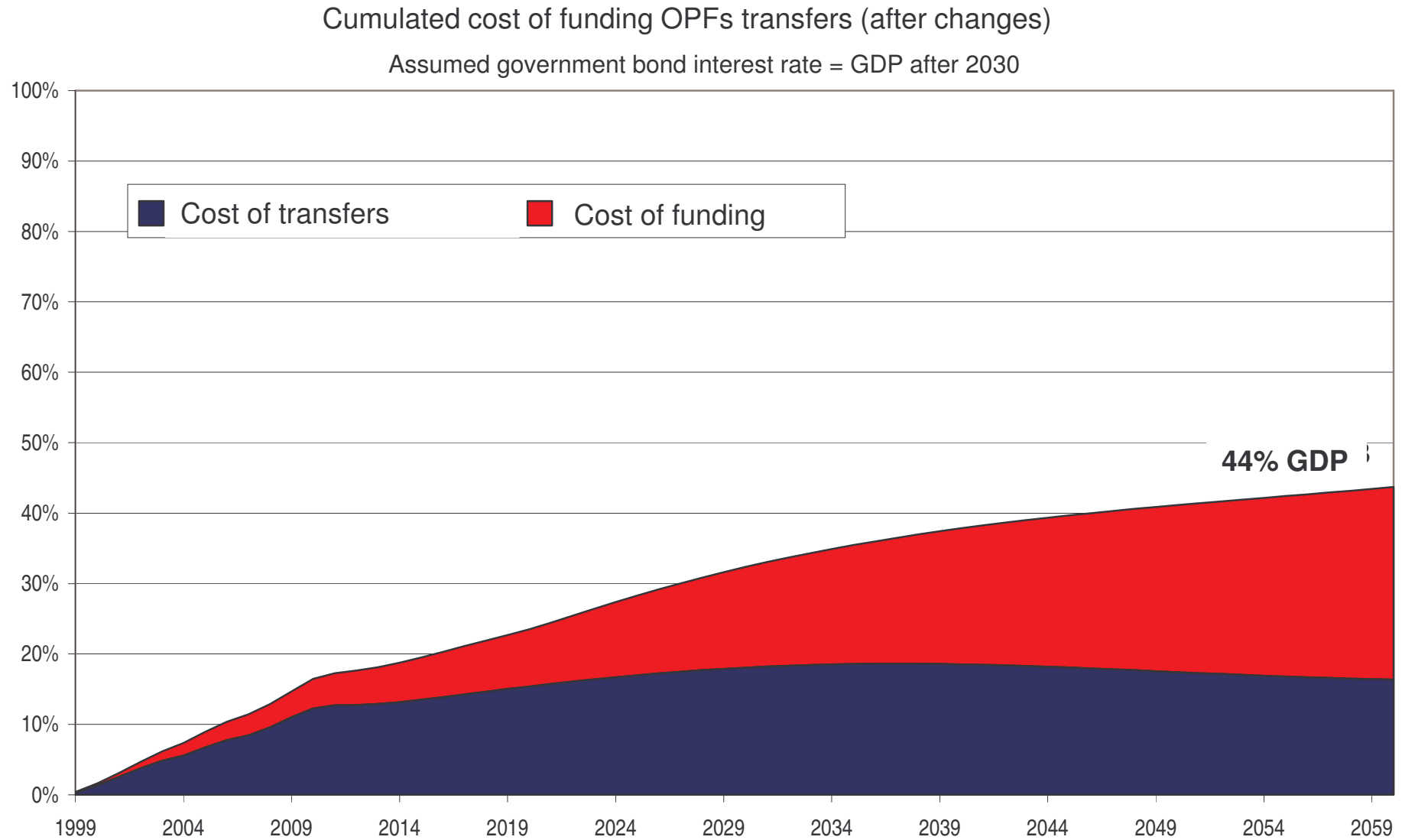
PLN bn



▪ Total impact of **PLN 195 bn** by 2020 in a conservative scenario (assuming 100% participation in voluntary savings tax schemes)

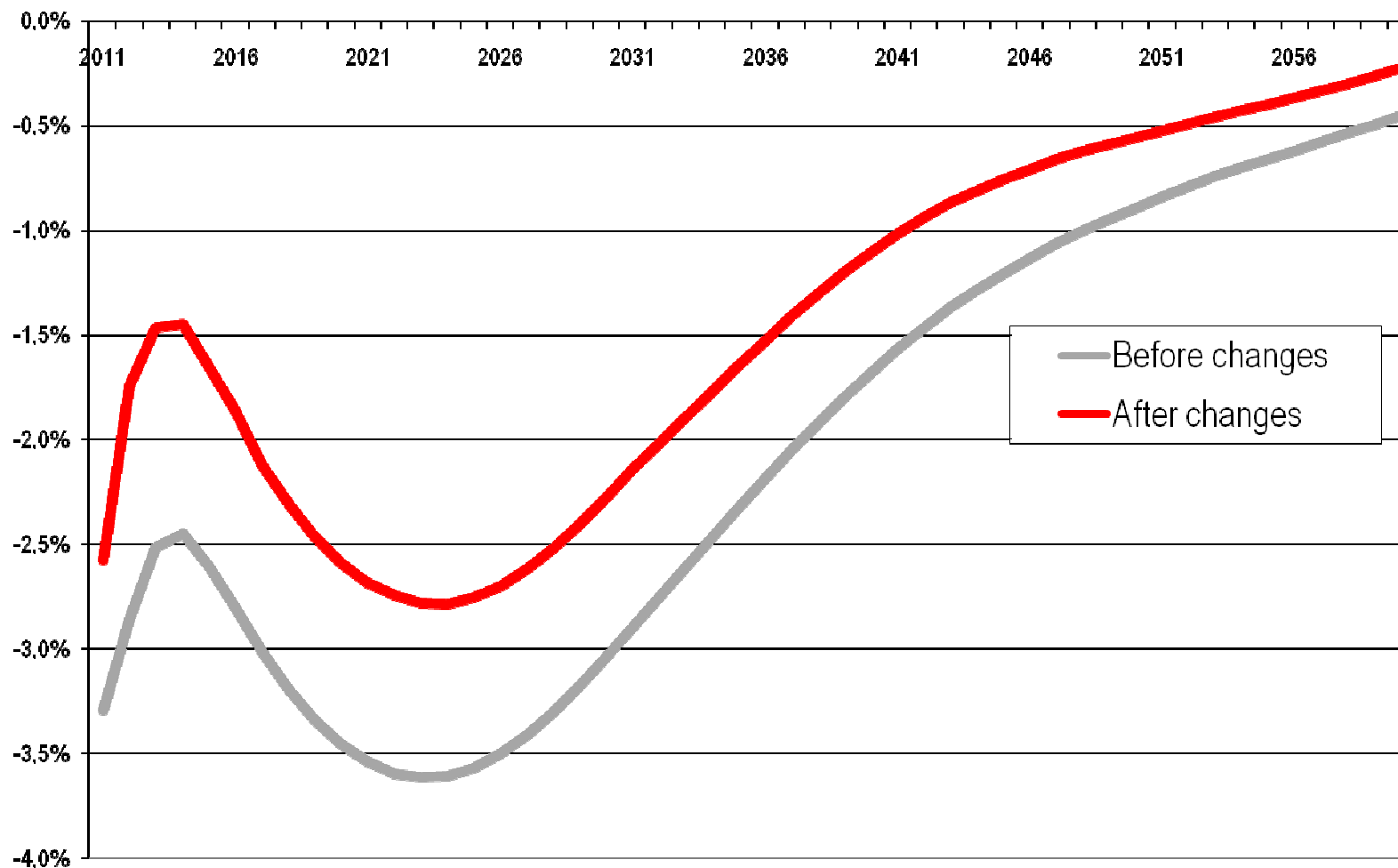
xx % of GDP

**A** The cost of transition period will be limited from ~94% of GDP to ~44% of GDP



**A** ...and pension system deficits will improve in the long run

**Pension system deficits**  
% of GDP

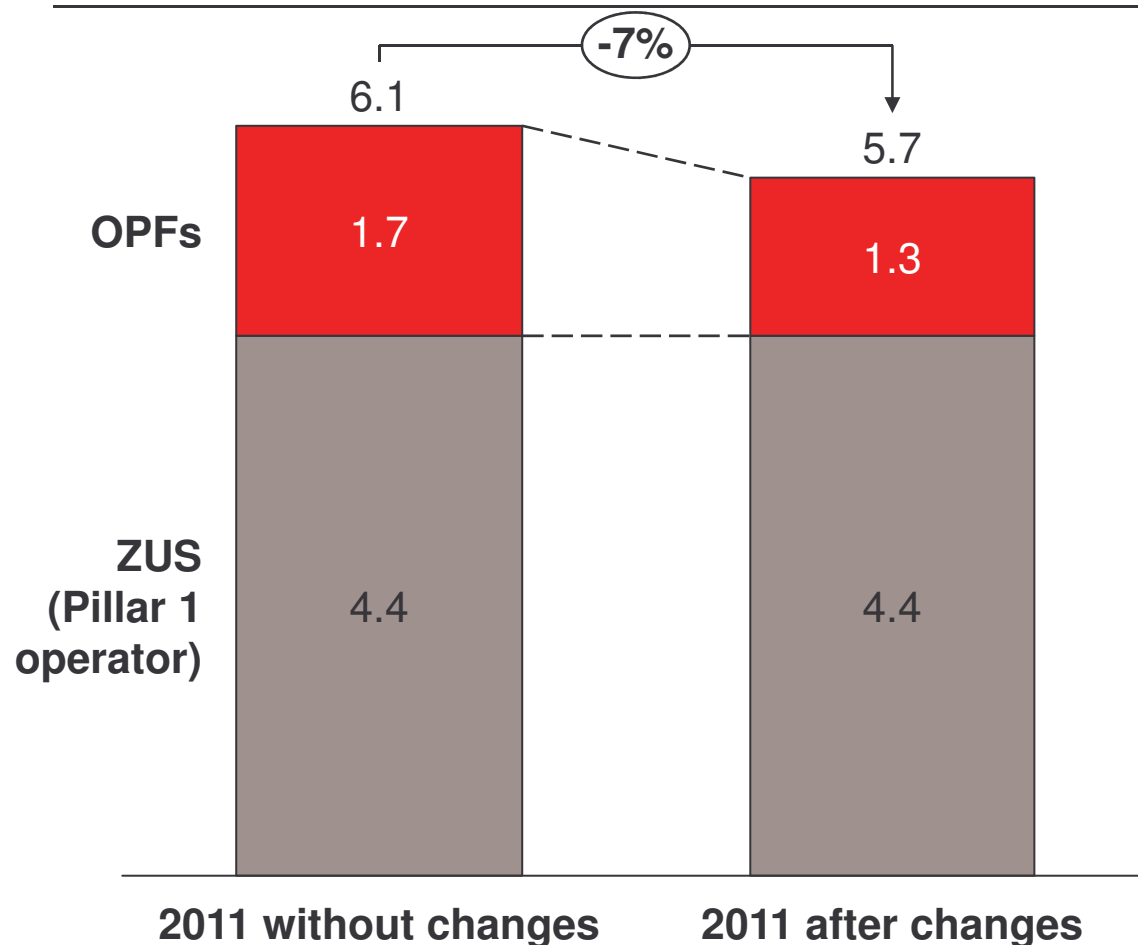


**A** Operating cost of the whole pension system will decrease by 7% in 2011 alone

ESTIMATES

**Operating costs of pension system in Poland**

PLN bn, 2011



**Comments**

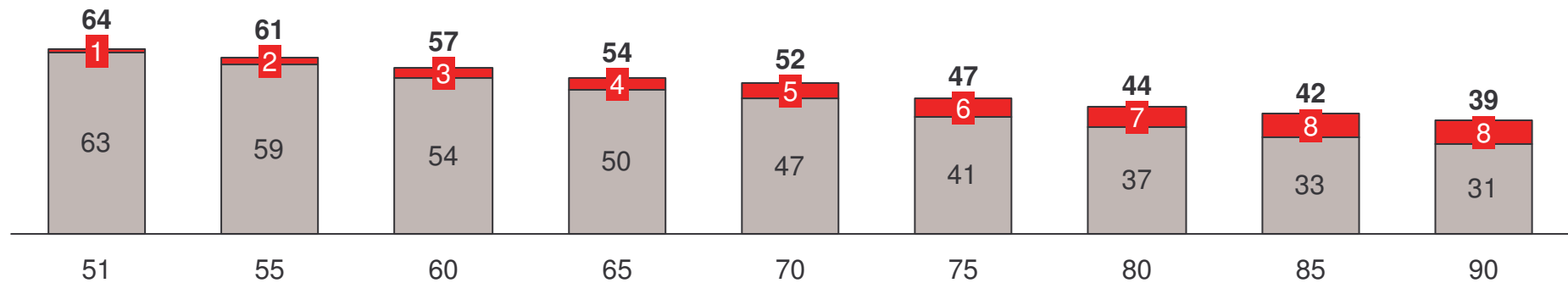
- Open Pension Funds will collect less fees– mainly on distribution charges because of lower transfers
- Costs of ZUS should not increase materially as the change has rather technical character
- ZUS already operates collecting contributions **from all employees in Poland** and manages pensions pay-out



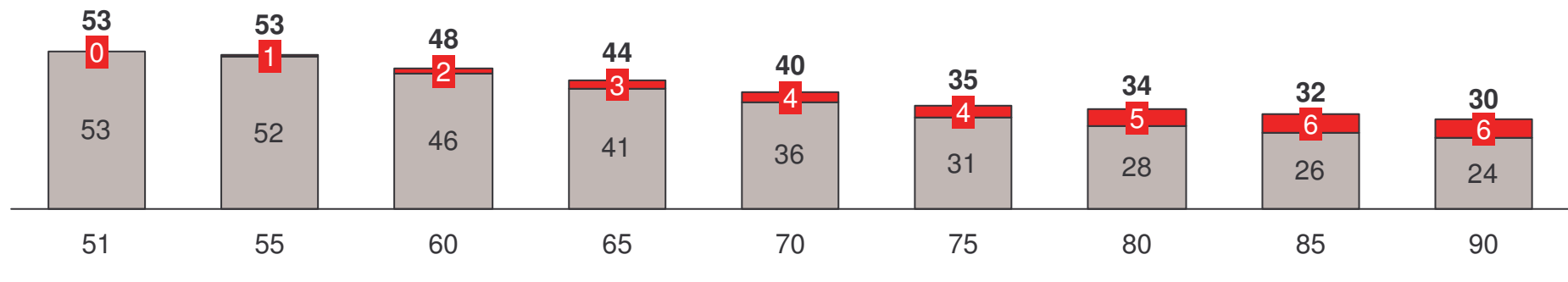
- B** The change should be neutral for replacement rates but the government has introduced a 4% tax incentives for voluntary savings that can help to rise retirement income

**Estimated gross replacement after changes with and without voluntary savings- men**  
% last salary

■ Voluntary savings  
■ Mandatory system



**Estimated gross replacement after changes with and without voluntary savings - women**  
% last salary



Year of birth



## Next steps – planned changes in the pension system

- **Introduction of efficiency changes to Open Pension Funds**
  - Introduction of performance related fees
  - New rules of acquiring customers
  - Introduction of external benchmark
- **Defining pensions pay-out strategy**
- **Monitoring results of changes and their impact on OPFs returns and future pension levels**

## Lessons learned – key points to consider when introducing 2<sup>nd</sup> Pillar

### **1 Transition period funding matters:**

- *Crisis has shown that debt financed transition can be dangerous in turbulent times*
- *Rising taxes on the other hand can slow down the economic growth – a thorough cost benefit analysis is crucial*

### **2 Building an operating model for managing 2<sup>nd</sup> Pillar:**

- *Publicly or Privately owned?*
- *Publicly or Privately managed?*

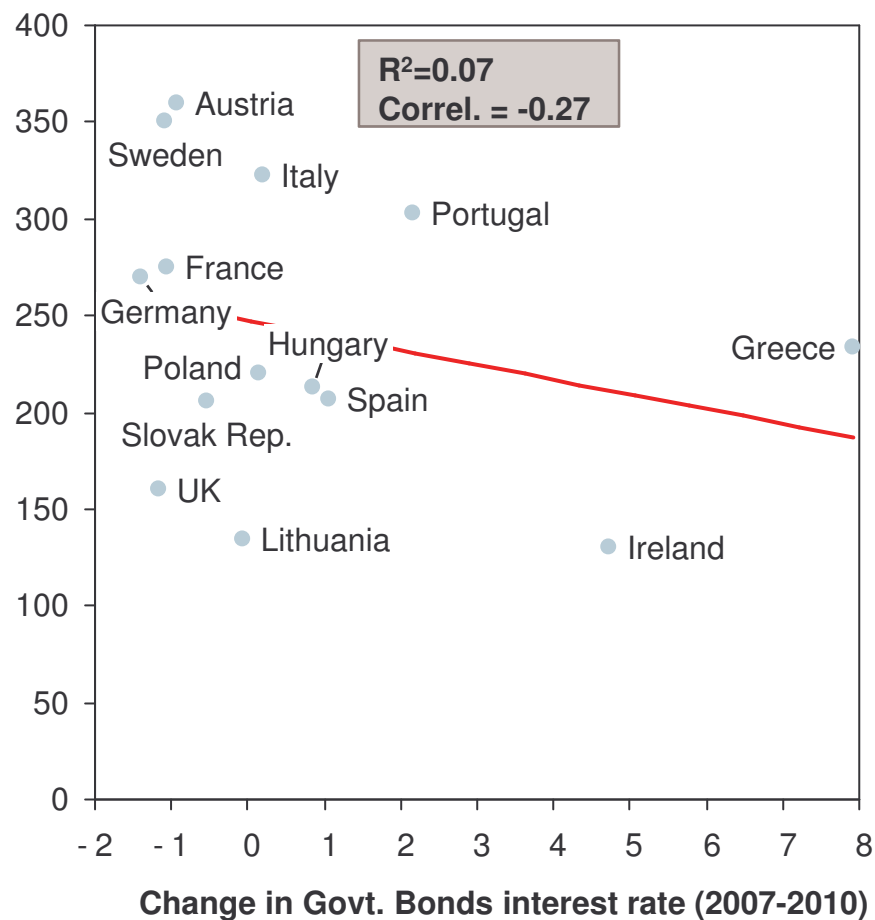
### **3 Efficiency and supervision of the system**

- *Setting the right benchmark for performance*
- *Ensuring low level of fees (they are very important in the long term)*

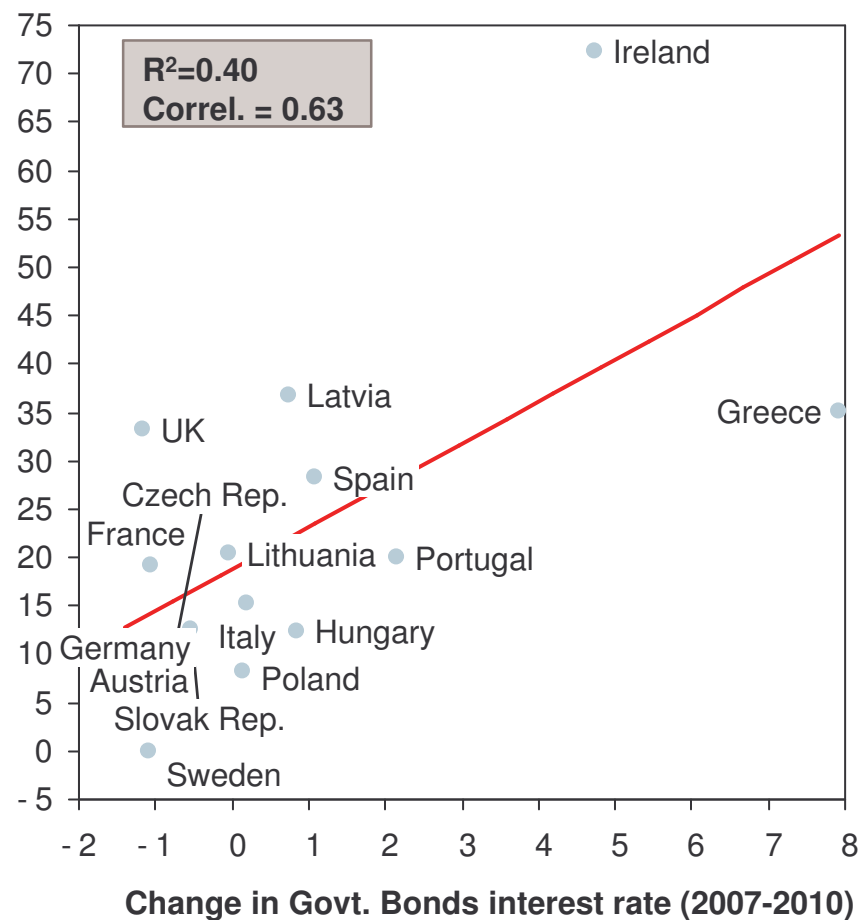
Thank you!

Implicit and explicit debts are not perceived in the same way by the markets. The risk associated with the latter is much higher

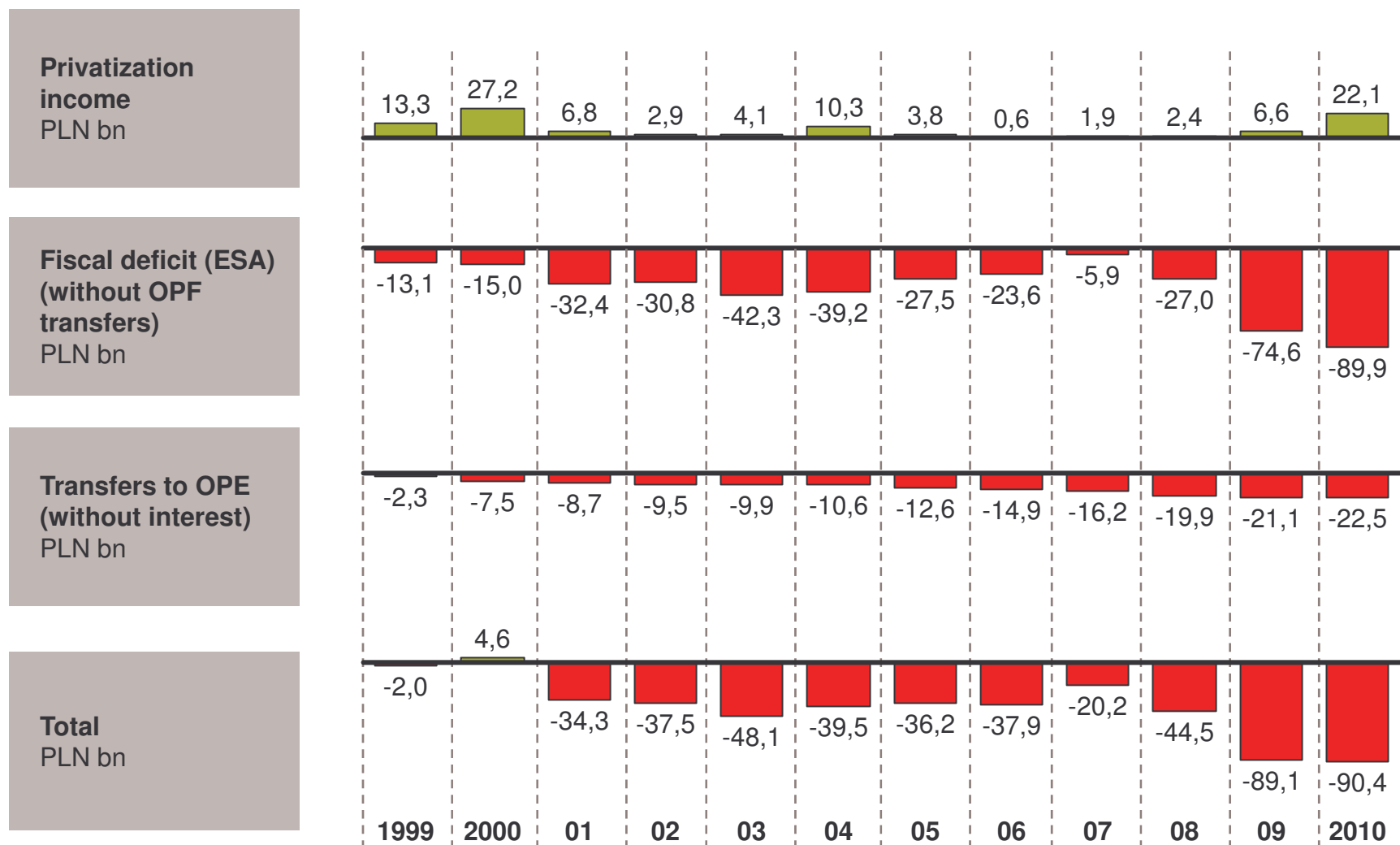
**Implicit debt  
as % of GDP**



**Change in  
explicit debt  
(2007-2010)**



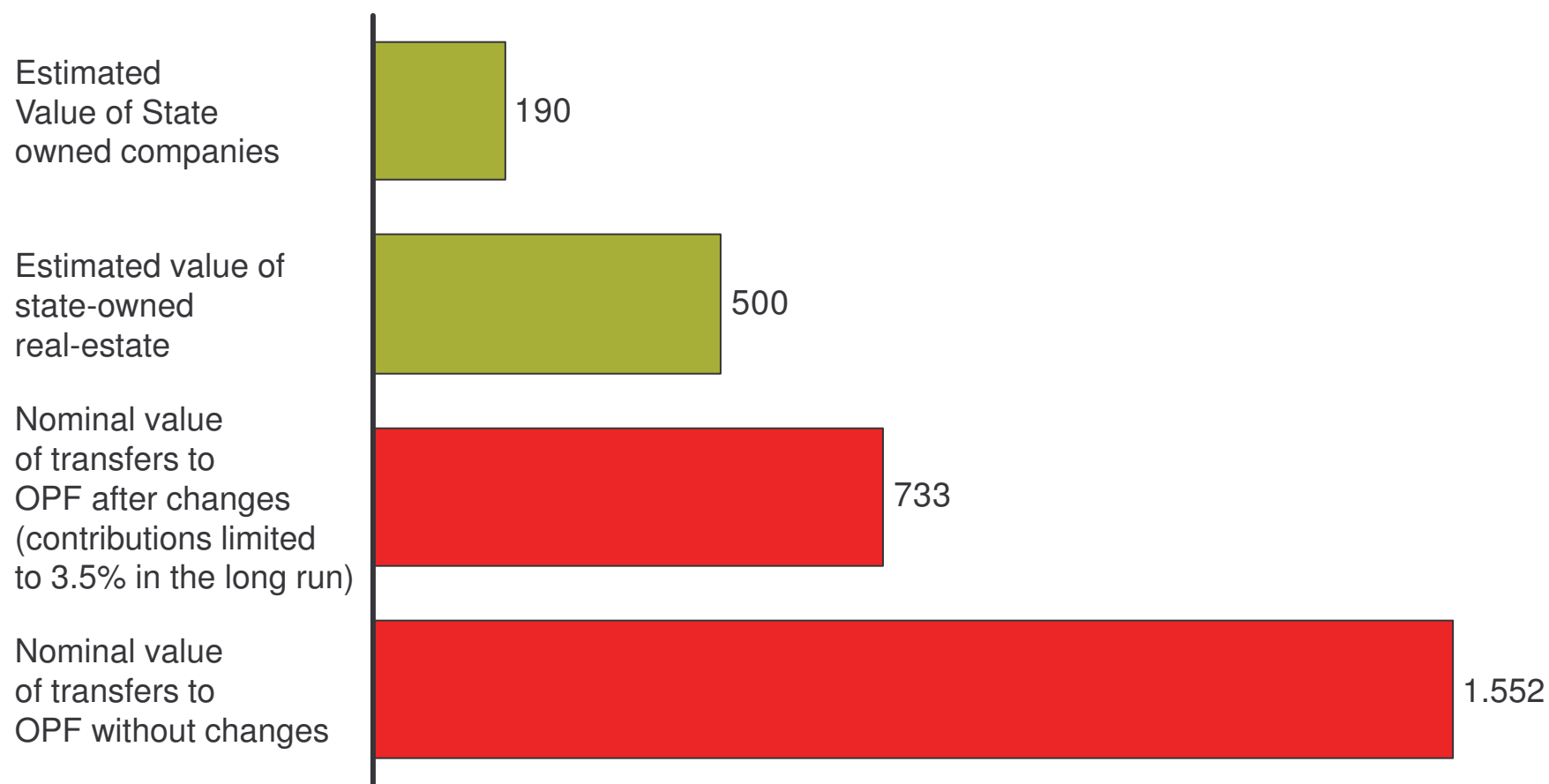
Privatization revenues were not sufficient for covering the ongoing fiscal deficits, not to mention OPF transfers



More-over privatization revenues will not cover the transfers in the future, even after changes to level of transfers to OPFs

### Value of ST assets and OPF transfers

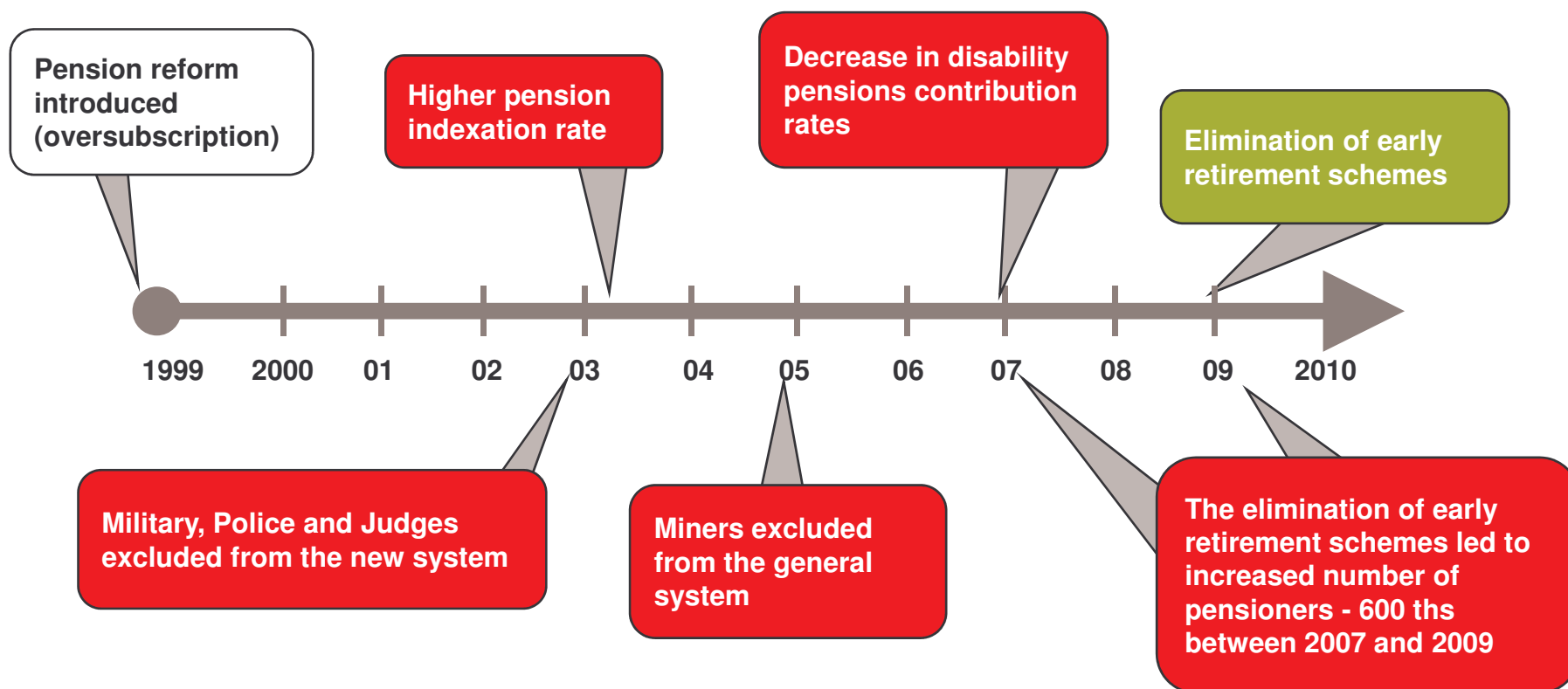
(from 2011 until 2035, without interest payments), PLN bn



NOTE: 2035 is a year when everybody should receive their pension from both Pillars – I and II

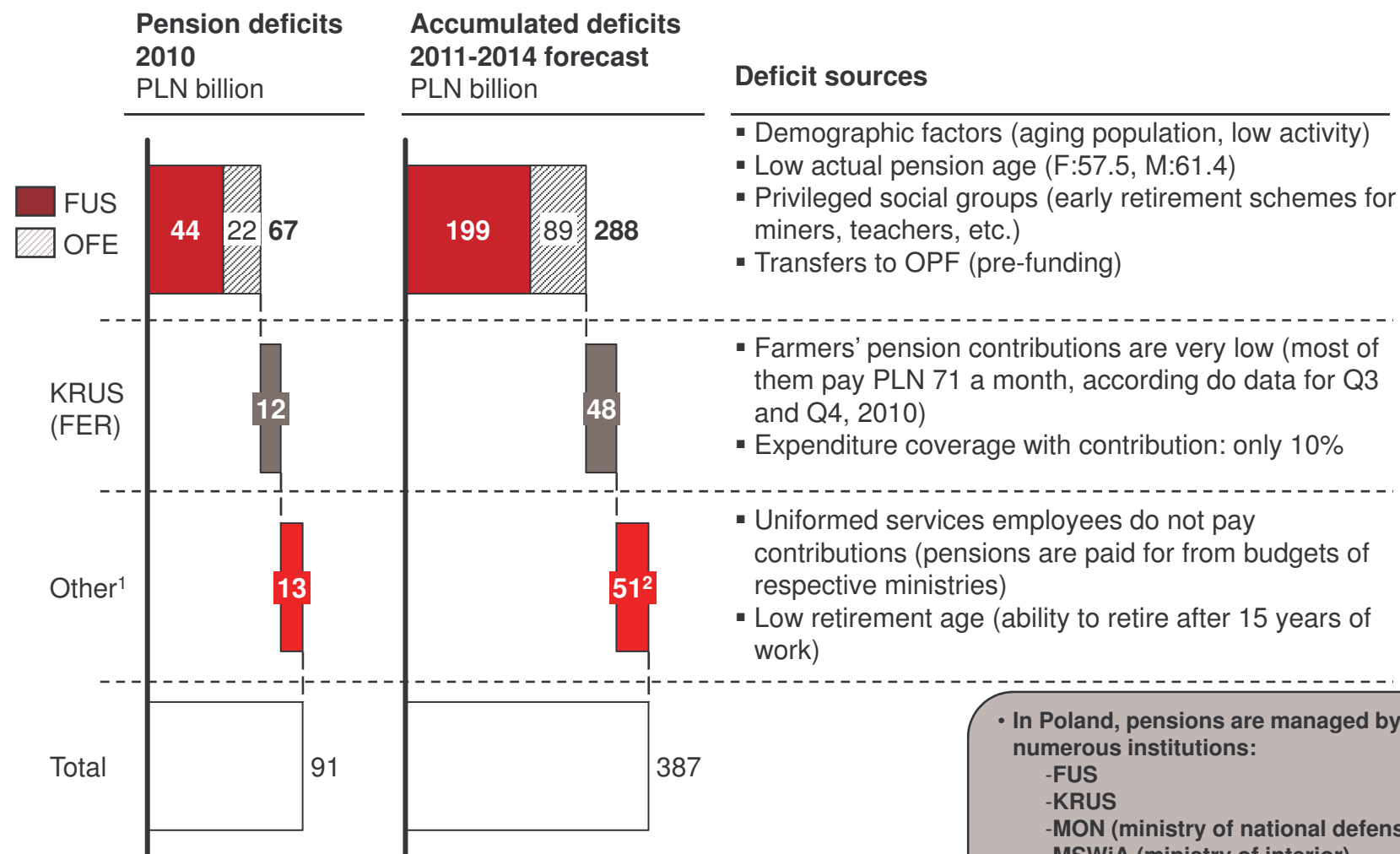
Source: Ministry of Finance; Ministry of State Treasury, ZUS, Deloitte

The expenditures were not reduced – on the contrary they have been increased in the last 11 years





## Deficit sources in the pension system



<sup>1</sup> Includes uniformed services, retired judges, and prosecutors;

<sup>2</sup> No forecasts for pension spending – assumed the same level as in 2010

Values do not take into account interest on debt

• In Poland, pensions are managed by, numerous institutions:

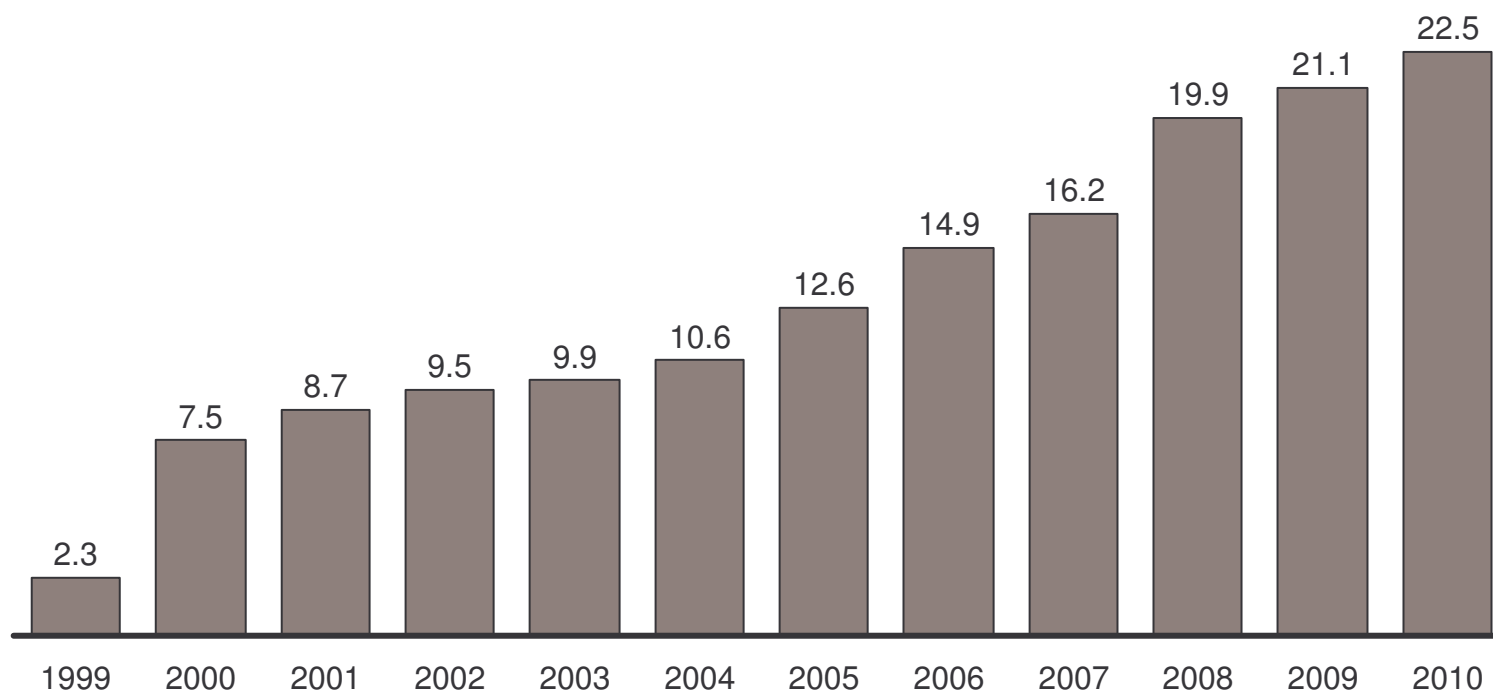
- FUS
- KRUS
- MON (ministry of national defense)
- MSWiA (ministry of interior)
- courts

• So many systems might indicate opportunity for efficiency improvements

The value of transfers to OPFs, grew between 1999 and 2010

**Nominal transfers to OPFs**

PLN bn

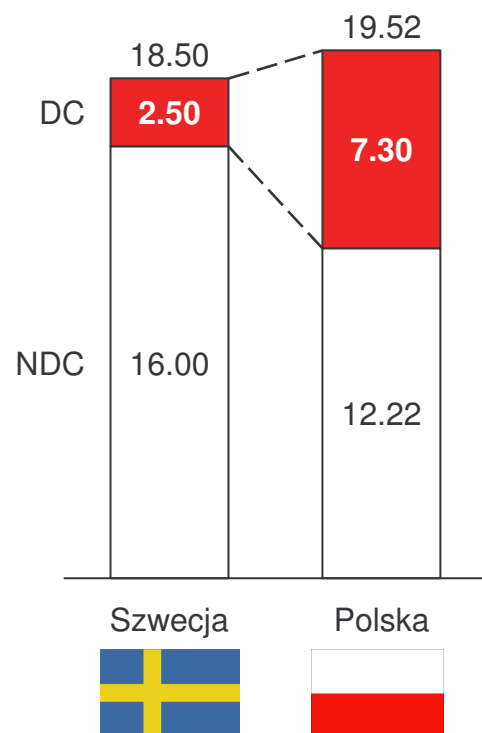


## Case study: Swedish model



1

DC part premium – 2.5%  
%



- In Sweden, there are 500 funds in DC contributions can be invested
- Switching funds is free of charge

2

Buffer fund



- Buffer fund assets represent 25% of the Swedish GDP – SEK 550 bn (PLN 233 bn)



- In 2002, Poland established the Demographic Reserve Fund
- The fund was supposed to receive privatization proceeds
- As of August 2010, it had approx. PLN 13 billion

3

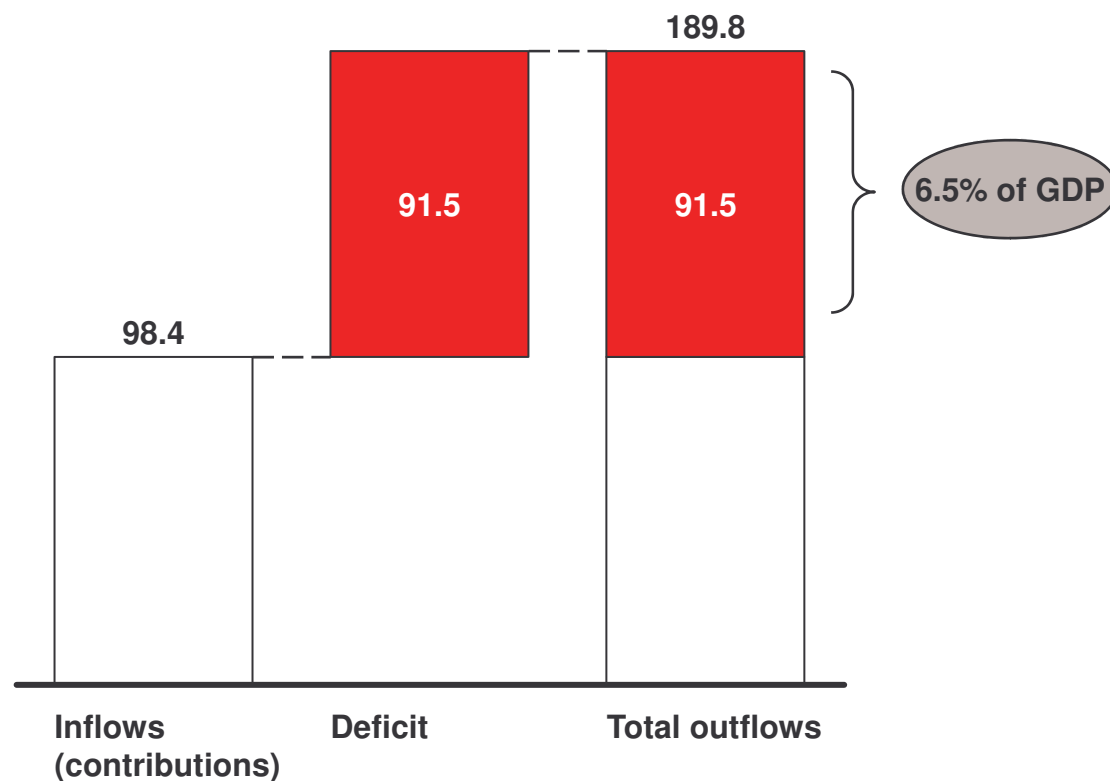
Automatic balancing-  
mechanism

- Pension assets and liabilities must be published every year
- Assets plus buffer fund resources must not exceed liabilities
- If the rule is violated, the automatic balancing mechanism is activated, aimed at bringing the balance back

Current pension and disability insurance deficits (excluding accrued interest) exceed PLN 90 bn a year

### Annual pension system costs in Poland

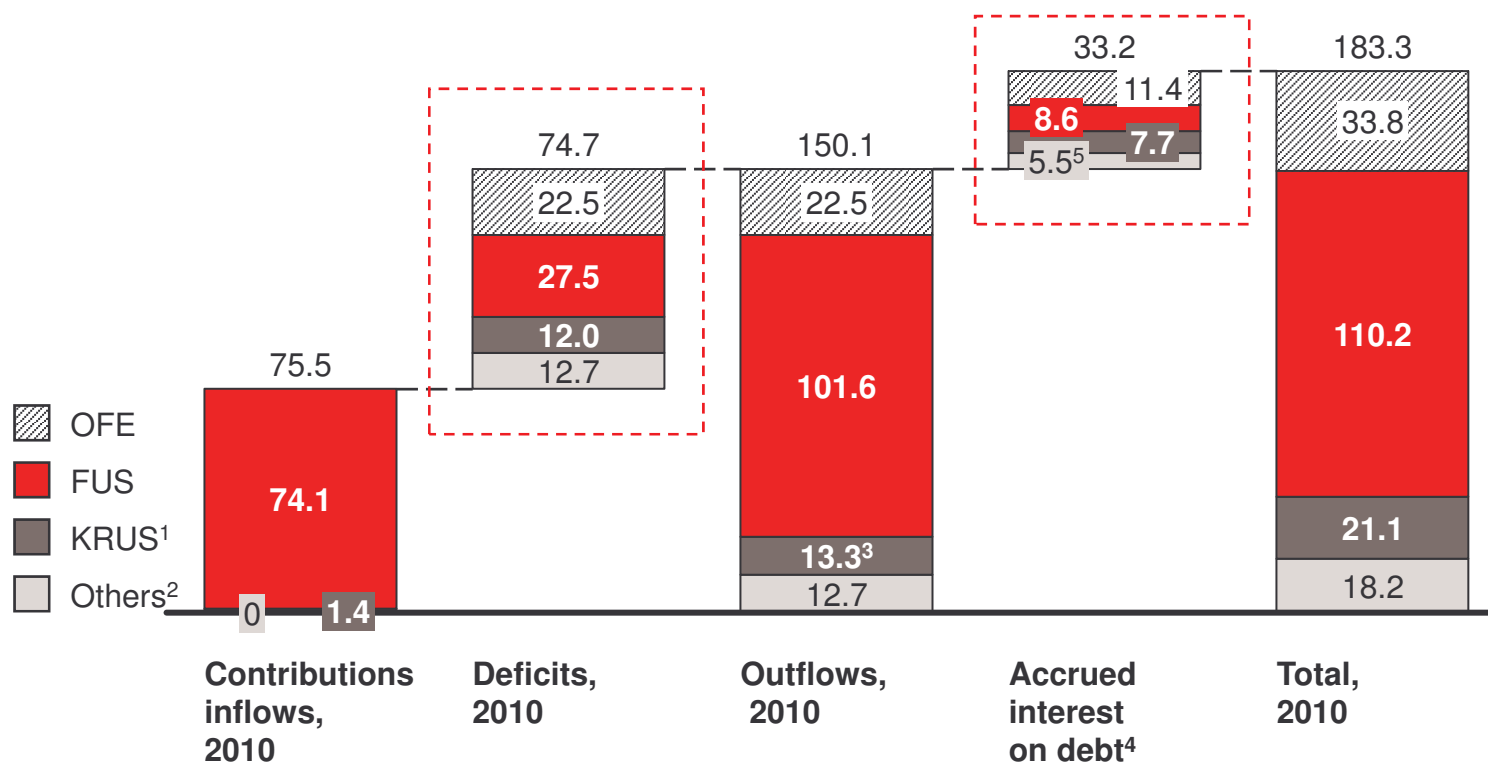
PLN billion, 2010



1 contributions: 19.52%, retirement contributions 6% - disability insurance contributions, KRUS, and others

The annual pensions costs, including transfers to OPFs, exceeded PLN 180 bn in 2010

### Annual pension spending in Poland PLN bn, 2010



1 KRUS includes disability and retirement contributions – it's not possible to exactly separate a pension premium (~80% of contributions are pension related)

2 contributions of uniformed services, judges and prosecutors

3 Old-age pensions constitute ~80% of KRUS expenditure, disability pensions: the other 20%

4 Interest calculated based on cumulated value of deficits from 1999 (no data for previous years)

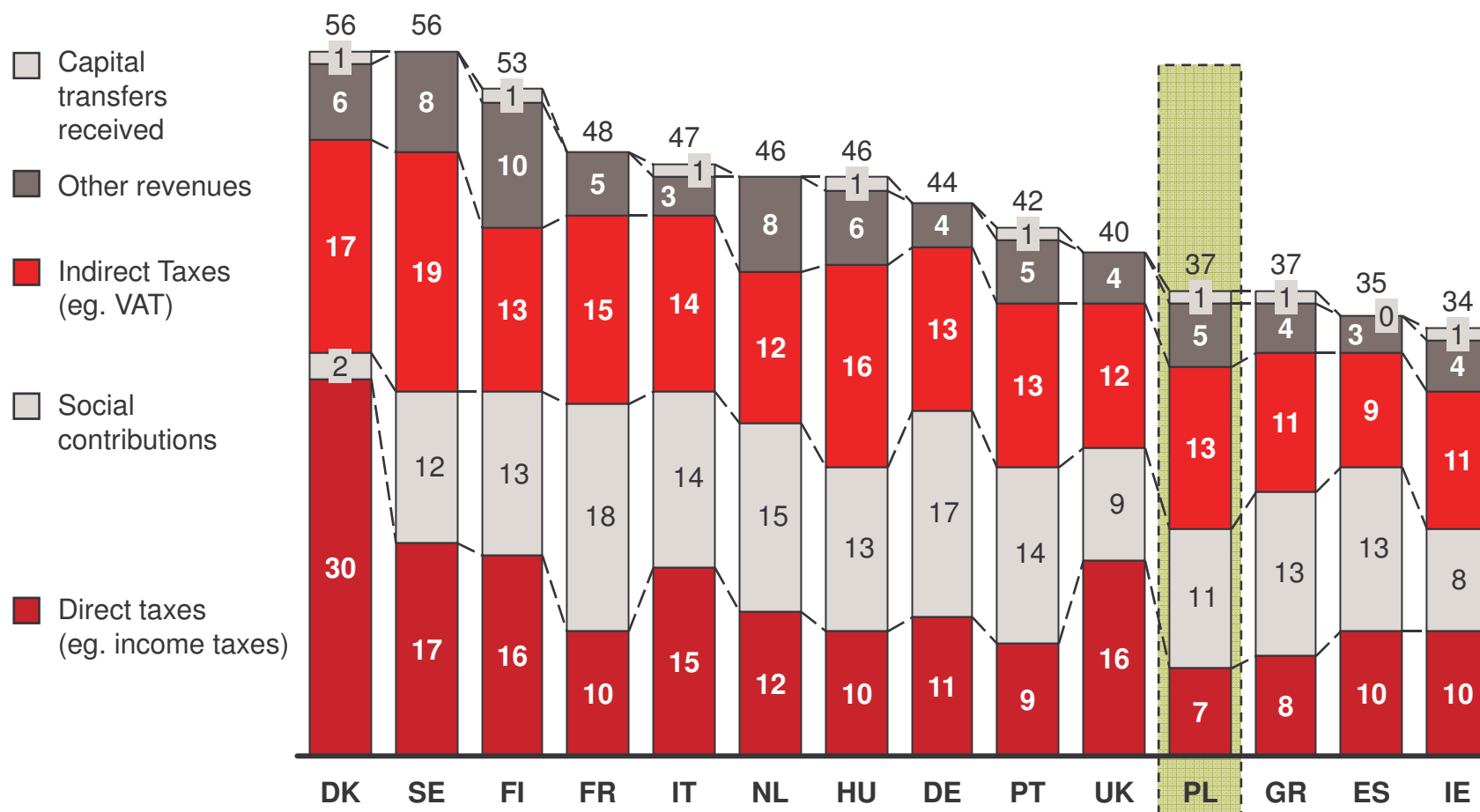
5 Accumulated deficit for the years 2000-2010 – no data for previous periods

## Planned results of the 1999 reform

- 1 Other changes in the pension system will follow the '99 reform, for example: increasing retirement age for women (from 60 to 65), elimination of early retirement schemes
- 2 Estimated negative budget impact of 0.7% GDP in the first year, and 1.5% GDP in the long run
- 3 Privatization revenue will cover the financing gap
- 4 Replacement rates will drop by 10 p.p.

## Poland has low level of taxation when compared to other European countries

**Government revenue, 2009**  
% of GDP



## Poland has relatively low level of government spending comparing to other European countries

**Government expenditure, 2009**  
% of GDP

