

Paying for Retirement



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CHALLENGES FOR PRIVATE PENSION DEVELOPMENT IN EASTERN EUROPE

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The Need for Post-Communist Pension Plans

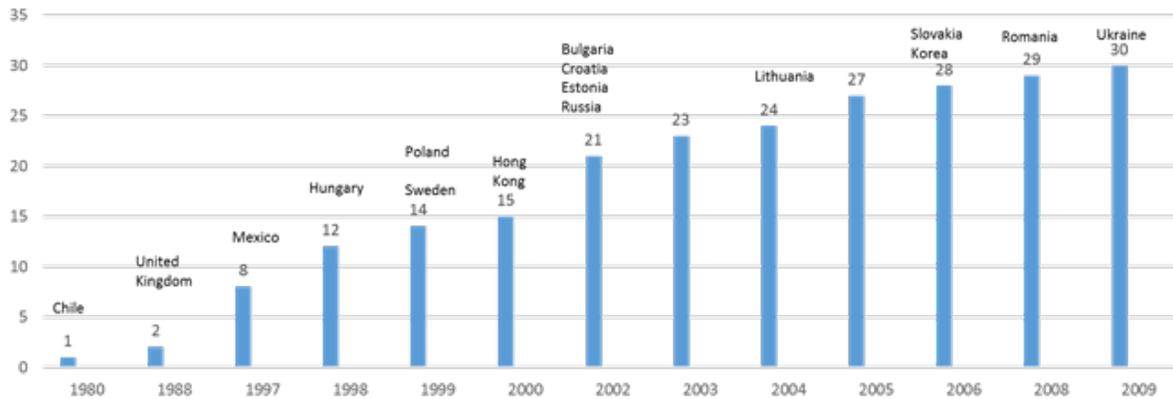
The collapse of communism meant the role of the state in providing pensions was significantly altered on a global basis with the introduction of mandatory private pension systems. Often referred to as second pillar funds (Figure 1), the funds in Eastern Europe were part of privatization programs aimed at moving former command economies towards more economically and politically liberal democracies. The new pension reforms introduced schemes that sought to remove future pension burdens by transferring risks from the state to individual pension members or participants by substituting or adding defined contribution type schemes to traditional state run defined benefit plans.

Eastern European countries were burdened by tremendous pressures on their social safety nets, particularly on the legacy state pension programs which made huge pensions promises that were difficult to keep. Moreover, the countries of Central Europe, unlike those in the Former Soviet Union, were witnessing significant changes to life expectancy that further increased pressures on social safety net programs. The statutory retirement ages were too low and anticipated life expectancies and mortality improvements were too long to manage indefinitely.

Efforts varied in Hungary, Poland and Romania. Each have taken somewhat different approaches to alter or completely reverse their second pillar pension schemes and assess the impacts on capital markets, retirement market development, and present and future savings contributions and contribution rates. These countries represent three distinct stages in the process of reversing second pillar pension reforms.

Hungary represents the option to fully reverse its earlier reform and repatriate second pillar assets back into the government run pay-as-you-go (PAYG) system. Poland is in the process of completely eradicating its mandatory second pillar and finalize

Figure 1: Number of Pension Systems with Second Pillars, 1980-2009



Source: World Bank, Pension Reform in Southeastern Europe, 2009

political directives intended to eliminate the remains of the second pillar are expected in 2018. Romania has decided to lower contribution rates to slow the pace of reform but has not officially reversed the reforms. In both Hungary and Poland, however, the reversals began with efforts to lower or freeze contribution rates.

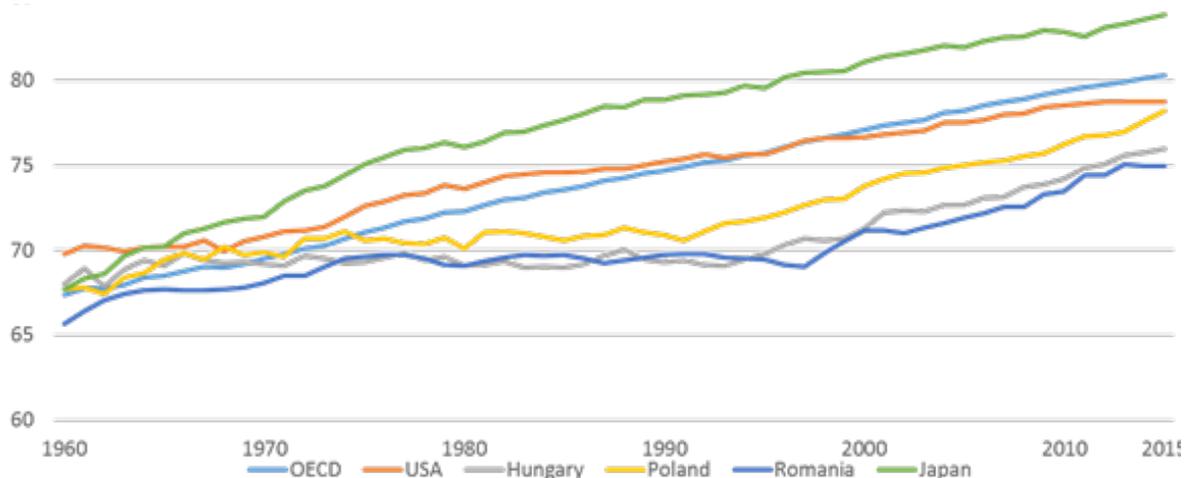
Impact of life expectancy on pensions

Life expectancy in Central Europe, particularly in Hungary, Poland, and Romania, had remained fairly stagnant from 1965 to 1995, just before the second pillar pension reforms were initiated (Figure 2). For example, the average life expectancy in the Organization for Economic Cooperation and Development (OECD) member countries increased

from 68.0 in 1965 to 75.6 years in 1995, for both men and women. In the United States and Japan, life expectancy had risen from 70 and 71 years in 1965 to 78.7 and 83.8 years in 1995, respectively. In contrast, according to U.N. data, Hungary, Poland, and Romania had remained relatively stagnant over the same period. From 1965 to 1995, Hungary increased from 69 to 69.8 years; Poland from 69 to 71.5 years; and Romania from 67 to 69.4 years.

However, projections indicated that life expectancies were to increase significantly through 2015 and beyond. And that is indeed what is occurring. In 2015, life expectancies in these Hungary, Poland, and Romania have converged towards OECD life expectancy (80.3 years), almost catching the United States (78.7 years). Hungary, Poland,

Figure 2: Age Expectancy, 1960-2015 - Selected Countries



Source: UN Database - Life expectancy at birth, total (years)

and Romania in 2015 had life expectancies of 75.9, 78.0 and 75.0 years, respectively. This tremendous increase over a twenty year period meant significant solvency and sustainability issues for state safety nets and for political parties if they could not care for a rapidly aging population which would have fewer workers to financially support more retirees.

Working Within the EU Framework

The financial crisis of 2008 exerted tremendous pressure on many emerging markets and exacerbated financial and capital market imbalances. Central and Eastern European economies were particularly hard hit. As a result, asset values in private portfolios were greatly reduced and politicians faced increasing political pressure to offer both asset security and more implicit return guarantees. Moreover, pension liabilities from mandatory second-pillar funds, secured by government bonds, are counted against public debt burdens under the European Union's Growth and Stability Pact (GSP).

The GSP is an agreement to commit, facilitate, and maintain the continued stability of the European Economic Union (EMU). Created to ensure that fiscal discipline would be maintained within the EMU, the Stability Pact asks governments to commit to reasonable budgetary and debt ceilings. It is essentially a mechanism which all 28 member states of the European Union (EU) agree to comply with in order to preemptively stop spikes, or severe imbalances, in areas of inter-area inflation, public debt, and budgetary deficits. Specifically, the GSP asks that member governments limit their budgetary deficit to 3 percent of their Gross Domestic Product (GDP), and to keep public debt burdens under 60 percent

As a result, a number of countries, facing debt burdens nearing 60 percent, used the GSP as an excuse to alleviate domestic political pressures by eliminating their second pillars, often with controversial actions that lacked sufficient levels of transparency and violating established best practices espoused by global standard setters, such as the OECD. Central and Eastern Europe (CEE) countries engaged in such reforms have included Estonia (2010), Hungary (2010), Slovakia (2013), Poland (2014), and, most recently, Romania (2017).

Reform reversals

The financial crisis and the growing debt burdens were convenient excuses for targeting second pillar funds in Hungary, Poland, Romania, and other countries. Hungary took the most draconian step in 2010, nationalizing the second-pillar by dissolving and moving second pillar assets back to the first pillar.

In 2014, Poland made its mandatory second pillar voluntary and nationalized more than half of the second-pillar assets by appropriating all sovereign bond holdings. More recently, the current government has proposed further steps to move an additional 25 percent of remaining assets into the second pillar and converting the rest into a new pillar consisting of private assets. Although general government debt in Poland fell from 55.7 percent of GDP in 2013 to 50.2 percent in 2014; by 2016 it had increased back to 54.1 percent.¹

The most recent pension policy retreat occurred in Romania, with a cut in the 2018 employee contribution rate from 5.1 percent to 3.75 percent. This has caused alarm from industry participants, such as asset managers and insurance companies as the Hungarian and Polish reforms also began with government decisions to reduce contribution rates.

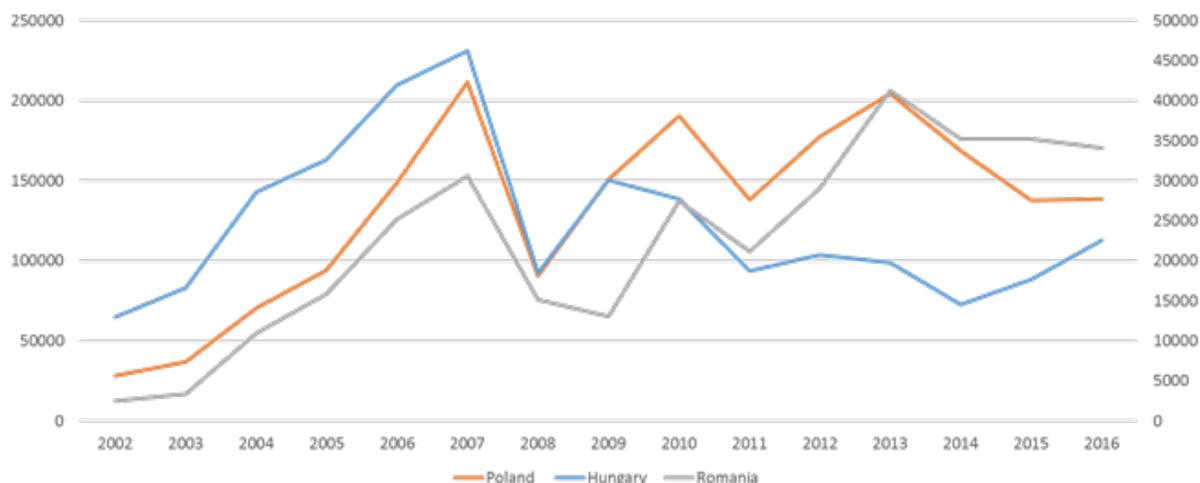
The Current Pension Situation in Hungary, Poland, and Romania

As a result of reversing or slowing pension reforms, some of these countries inflicted huge losses on both domestic and foreign industry market participants, often violating previous reform commitments. Hungary and Poland were the largest countries to scrap their second pillars entirely, with profound impacts on their capital markets and the ability of pensioners to save for retirement. The trend has continued globally to include recent overtures from Romania to impact the competitive nature of their second pillar markets by lowering contribution rates.

Capital Markets

The reversal of second-pillar mandatory pension reforms proved to be quite damaging to market capitalization in both the Hungarian and Polish cases. Losses that occurred

Figure 3: Market Capitalization of Listed Domestic Companies (Current US\$)



Source: OECD, Stat;

during the financial crisis might have spurred politicians to consider changes to the funded pension systems. However, the accumulated real returns were positive in Romania, Hungary and Poland.²

The accumulated return of Hungarian pension funds, even though positive (12 to 38 percent) might not be satisfactory in this longer-term perspective as the average yearly premium over the inflation rate at the end of 2012 was merely 2 percentage points in the case of conservative funds, 1.7 percentage points for balanced funds and only 0.75 percentage points for growth funds.³ The highest returns are observed in Romania and Poland where the annual average real return was close to 6 percentage points.⁴

The removal of assets significantly lowered both the market capitalization of listed domestic companies as a percentage of GDP and the market capitalization of listed domestic companies in terms of value (Figure 3). With regards to the former, Hungary averaged nearly 25 percent in the pre-reversal period from 2002 to 2010; the numbers are skewed by a low of 11.7 percent in 2008 at the height of the global financial crisis. In comparison, during the post-reversal period, 2011 to 2016, the average figure was less than 15 percent of GDP. This amounts to roughly a forty percent decrease in market capitalization as a percentage of GDP since the pension reversal.

In value terms, the average annual market capitalization value pre-reversal was \$28.4 billion, even including a steep retrenchment in 2008 during the global financial crisis; whereas, the average from 2011-2016 was \$19 billion approximately, a figure just above the 2008 financial crisis figure of \$18.5 billion. The information provided in Figure 3 strongly supports the idea that reversal of the mandatory pillar pension have played a prominent factor in the decreasing capitalization of Hungary's equity markets.

In terms of growth, the Hungarian stock market increased at an average of 12.5 percent from 2002 to 2010, even during the 2008 financial crisis. After the reversal, growth slumped to 3.3 percent.

Poland demonstrates similar results. Granted the Polish reversal did not remove mandatory pillar funds from equity markets. Rather it nationalized Polish bonds, forcing remaining assets to be invested in equities, increasing the equity risk for these funds at a time when markets became less liquid. The transfer to all equities also violated non-binding portfolio allocations for equities as dictated by the OECD's Insurance and Private Pension Committee.

As a percent of GDP, Poland's market capitalization has decreased, but not to the degree of Hungary. This would be expected as equities were not nationalized as in Hungary. From 2002 to 2013, annual market capitalization by domestic companies averaged 31.1 percent, including

a high of 49 percent in 2007. Removing the crisis year of 2008, the average is closer to 33.0 percent. In comparison, from 2014 to 2016 the figure was just above 29.7 percent. However, the figure exceeds 30 percent only once, in 2014. From 2002 to 2013, the figure exceeded 30 percent in seven out of 11 years. In terms of value, capitalization on the Polish main stock market grew 39.4 percent on average on an annual basis from 2002 to 2013, with the main stimulus being the second pillar investment. In contrast, since the reform in 2014, the market has decreased at approximately 5.9 percent per annum. Capitalization has decreased from \$204 billion in 2013, the last year before the reversal, to \$138.7 billion just three years after. Thus, capitalization values also have born a huge burden as a result of the 2014 policy reversal.

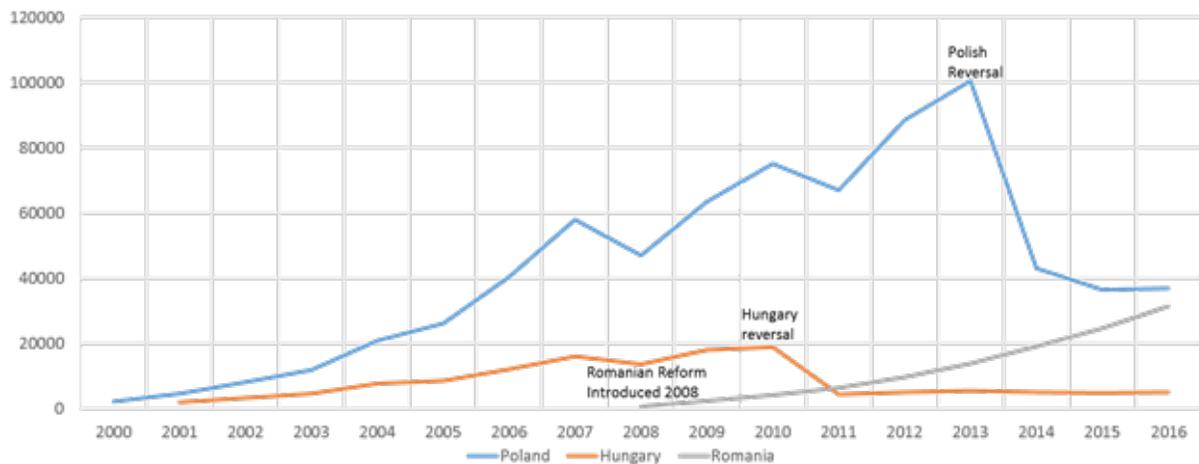
According to the OECD,⁵ Romania experienced one of the best annualized real rates of return between 2006 and 2016 at 6.4 percent. Since 2008, when mandatory funds were introduced, the market capitalization of Romanian listed companies has increased from \$15 billion to approximately \$34 billion. Data for market capitalization as a percent of GDP was unavailable for the full period through 2016. It will be interesting to see how these figures change going forward after the mandated changes to the contribution rate in 2017.

Private Pension Asset Growth

Given that Hungary and Poland both scrapped their mandatory second pillars it is no surprise that private pension assets have decreased since the introduction of reversals. By 2009, Hungary had accumulated private pension assets of nearly \$19 billion according to the OECD Pension Database (Figure 4). This consisted primarily of mandatory second pillar assets and some third pillar funds. After the nationalization of the second pillar in 2010, private pension assets slumped \$4.4 billion in 2010 and have only risen to approximately \$5 billion by 2016. The majority of these funds are held under Hungary's underdeveloped third pillar.

Poland had amassed \$100 billion in private pension assets by 2013. The majority of these funds belonged to the second pillar (OFEs), with the remainder in third pillar accounts. The decision to nationalize Polish government bonds quickly reduced the amount of private pension assets to \$43 billion and this number continued to drop to approximately \$37 billion by 2016. The majority of these funds belong to OFEs, which were supposed to be dismantled in 2018, but plans have not been approved. Once the OFEs are dismantled, the assets will be moved to new individual pension accounts. The funds from current OFEs would be recorded as voluntary pension contributions in the new third pillar

Figure 4: Personal Pensions (millions of US\$) 2000-2016



Source: OECD Pension Statistics Database, 2017

Short-term pain for longer-term gain?

The rollback of pension reforms has the potential to create long-term social and economic issues for the three countries analyzed above. As the economies of CEE have recovered from the negative growth rates during the immediate aftermath of the financial crisis, there are little or no options for individuals to save for retirement. Thus, an opportunity is being wasted to provide retirement security for future years and possibly creating a generation or more with insufficient retirement assets. In addition, given low birthrates in the European Union,⁶ in general, and CEE countries, in particular, dependency ratios are significantly increasing. The dependency ratio is a measure showing the number of dependents, aged zero to 14 and over the age of 65, to the total population, aged 15 to 64. It is also referred to as the “total dependency ratio.”

Recent research⁷ suggests that high dependency ratios may have the following long-term economic consequences on other components of the economy.

Saving rates

As workers get close to retirement, they tend to increase their savings through pension plans, healthcare insurance, catch-up contributions and other vehicles. Also, if younger workers anticipate changes in demographic trends, they could start saving more for the future (by investing more in private pension plans, postponing consumption decisions, or investing in private health insurance). Increased savings could have long-term economic consequences, such as a decrease in long-term interest rates. Eventually, as the elderly start retiring and birth rates start decreasing—as appears to be the recent trend—savings would start decreasing and long-term interest rates would rise. Thus, recent demographic changes could affect saving rates and long-term interest rates.

Investment rates

If savings decrease, there could be fewer funds to finance investment projects, which could decrease investment in physical capital. Decreased investment could reduce long-term economic growth.

Housing markets

A growing labor force would increase house prices. A recent article in *The Economist*⁸ finds that since 1960, house prices in a sample of 10 countries fell by 0.2 percent per year as the age dependency ratio increased. Because the demographic composition of the labor force contributes strongly to the trend in house prices, fewer young people, together with a large increase in the elderly population, would likely result in less investment in the housing market.

Consumption patterns

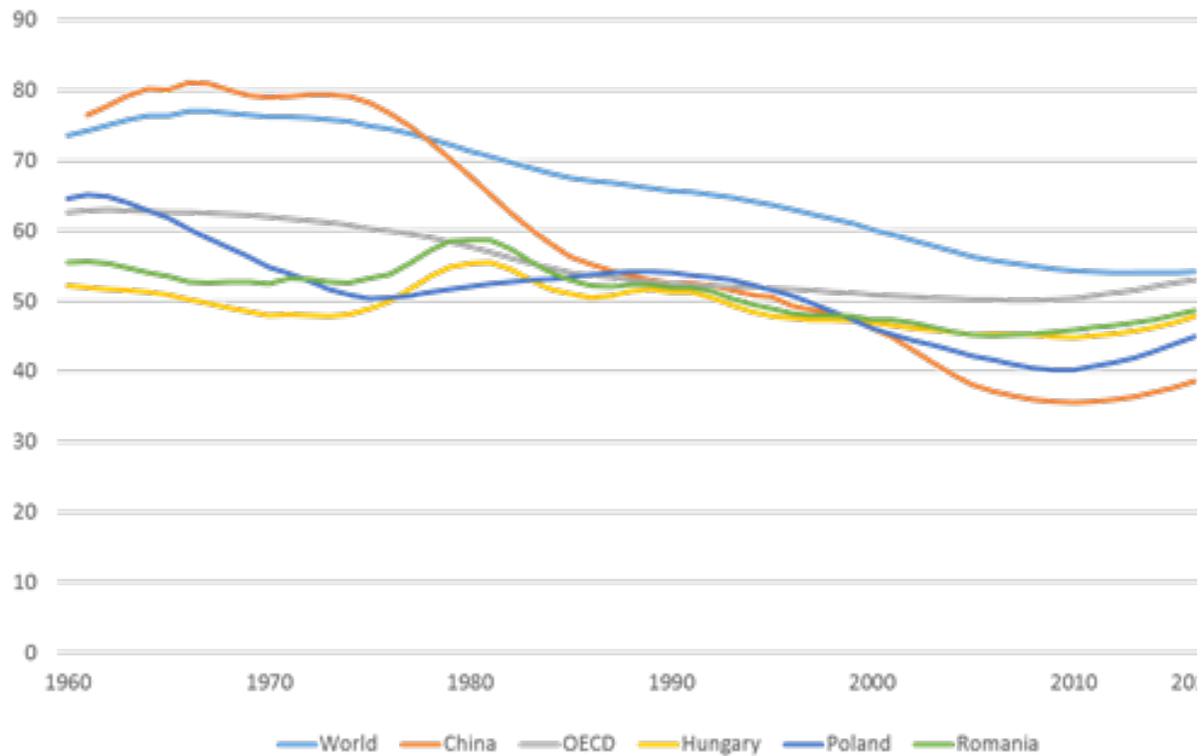
An increase in the elderly population could shift consumption from certain goods toward healthcare services and leisure.

Although increasing old-age dependency ratios are a concern for most countries looking forward to 2050, this could have grave consequences in the CEE region where old-age dependency ratios are expected to lower to one worker for every dependent (Figure 5). First pillar systems are already buckling under the pressure of lower birth rates and increasing old age expectancies. And, the political climate in some CEE countries is not conducive towards reform—in fact, the populist government in Poland has already taken steps to lower the retirement age to 62 for men and women, when it should be increased. The ability of countries to care for the elderly could depend on their ability to construct sound voluntary pension systems. Mandatory systems may not be sufficient and there may be a need to create voluntary third pillar systems to replace or complement mandatory systems. The need to develop third pillar systems could offer tremendous opportunities to countries with strong asset management industries.

Opportunities and challenges for U.S. industry in the Eastern European private pension market

U.S. industry currently manages close to 60 percent of global pension assets or \$26 trillion (of a more than \$40 trillion global market)⁹ and would be poised to manage a sizable portion of global pensions and retirement assets. In addition to being the leader in terms of assets under

Figure 5: Age Dependency Ratios, 1960-2016 Selected Regions and Countries



Source: World Bank, World Development indicators

management, U.S. companies maintain unrivaled expertise and other advantages as the global leader in retirement planning and services.

As such, U.S. pension managers and insurers are in a position to grow this figure significantly over the next decade assuming that governments pursue prudent pension reform and management and avoid heavy-handed policies that empower governments and state owned enterprises at the expense of the private sector and ultimately their own citizens. Opportunities would appear limited currently in three countries analyzed in this study but there are some potential opportunities. To date, Hungary, Poland, and Romania have had limited third pillars that have suffered from a low level of trust stemming from previous reversals and low levels of assets under management.

Currently, Poland is creating a third pillar system which could benefit private sector providers in Poland help manage individual retirement needs and give savers options beyond the third pillar. Poland’s current employee

pension plans (PPEs) were created in 1999 but only cover some 395,000 employees for a total of 11.4 Polish zloty (new).¹⁰

Poland is developing the Employee Capital Plan (PPK) that would seek to use auto-enrollment covering all workers aged 19-55 and putting the responsibility on employees to opt-out. Older workers beyond 55 will be able to opt-in as well. The opt-out model will be used to maximize participation rates. Under the proposed system, for which draft legislation was announced in November 2017, the system will be obligatory for employers but voluntary for employees. PPK aims to have a 75 percent participation rate and cover approximately 11.4 million Polish workers.¹¹

A key impediment for United States and other foreign companies interested in the new plans is that financial management of PPKs has been restricted to Polish investment fund companies (TFIs) with a minimum three years of operation in the Polish market. This could pose a serious market access obstacle to companies not yet

in the Polish market and put them at a disadvantage to Polish companies. Insurance companies are among those companies barred. The current populist government in Poland also wants to reduce the retirement age to 62, further indicating a preference for popularity over preference with regards to sound pension policy.

The decision by the Romanian center-left Social Democrat Party (PSD), elected in the fall of 2016, to reduce contribution rates is a potentially significant jolt to the current pension system. The Secretary General of the Romanian Pension Funds' Association estimates that "the decision is likely to slash future retirement income by at least 20 percent for all plan members as well as providing less capital via the stock exchange."¹² Despite the negative developments regarding contribution rates, Romanian funds in 2017 delivered one of the best annualized real rates of return between 2006 and 2016 at 6.4 percent, according to the OECD.

Hungary's government has made no recent overtures to make any changes to its current system.

Overall, the lack of political will caused the initial reversals in these countries and the uncertainty surrounding political turns to populist parties in Hungary and Poland create additional issues for trust and long-term stability. Romania's center-left PSD party has already experienced political problems.

Conclusion

Domestic politics continues to trump sound pension reform policy in Hungary, Poland, and Romania. In all three countries, patience from governments could have allowed the reforms to take hold, and, with modifications to cost and investment structures, the reforms may have flourished and the retirement situations for their retirees would have been brighter than now exists. These three countries do not deserve all the blame, despite the fact that Hungary and Poland were initial disruptors to second pillar reforms within the region. Rather, these three countries' experiences serve as the rule rather than the exception throughout post-Communist Europe and the Former Soviet Union, including Russia.

The pension reforms, particularly in Poland, could have

been better served by allowing greater amounts of foreign investment in the sector and portfolio investment in overseas assets. The fact that the respective governments created an environment that did not more fully embrace more diverse geographical diversification imposed further restrictions on the potential success of the reforms and their ability to more positively impact the domestic economies in these countries. It does not appear that lessons of restrictiveness have been completely learned as Poland plans restrictions on what types of investment companies can participate in the planned third pillar reforms. Additionally, Hungary, Poland¹³ and Romania's early dependence on local bond investments have undermined the potential benefits from greater diversification by instrument and geographical location.¹⁴ In fact, Poland was found to be in breach of the European Union's free movement of capital principal in 2009.¹⁵

An area of additional concern is the lack of respect for global practices and the trust that the reversals undermined. The actions in the region as a whole, and Poland and Hungary, in particular, have increased the apprehension and uncertainty for financial firms to invest in the region by and large. This places additional burdens upon the region to receive important investment and financing for capital markets that are so crucial for needed infrastructure projects.

Lastly, the pension reversals analyzed in this review raise important political questions beyond pensions when combined with recent political actions in Hungary related to refugee policy and Poland as regards judicial independence. Could these reversals highlight a fundamental difference in values and global outlook for the CEE region and what could it portend for the continuity of EU policy in the future? Does it signify growing rifts within the EU between "old Europe" and the CEE on issues such as budget and trade policy? These will be important issues to monitor going forward in determining whether Europe becomes more united or more divided post Brexit.

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ENDNOTES

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