DC PENSIONS IN CEE

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Dariusz Stańko
IOPS Secretariat

INTERNATIONAL ORGANISATION OF PENSION SUPERVISORS

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Agenda of this presentation

- How do the CEE DC fit in the general pensions context
  - Pension reforms 1998-2008
  - Market structure
  - Pension (reversal) reforms
- How successful they have been so far
  - DC challenges
  - Potential solutions
- Conclusions

NB: The views expressed herein are those of the author and do not necessarily reflect those of the IOPS or the governments of IOPS Members.

Pension reforms in CEE countries

- Mandatory pension funds
  - legal entities
  - no internal governance bodies, members'/stakeholders representation
  - single portfolios in 1990s, life cycle portfolios afterwards
- Managed by private (dedicated) pension fund asset managing companies
- Bank depositary
- Regulated fees and fund members switch overs
- Accumulation phase only
  - decumulation planned to be done later

Pension reforms in CEE countries

- Basically no occupational pension plans or individual retirement accounts at that time – third pillar (almost) non-existent
- Mandatory funded pillar for selected cohorts
- Contributions **curved out** from the existing PAYG systems (Estonia increased the mandatory employees contribution, 2%) → transition costs
- Heavy licencing & high entry costs, economies of scale, legacy of financial institutions present already in the market → **oligopolistic market structure**
- Guarantees plus few players → investment herding

Initial market structure

Country	Year of implementation	Managing companies [portfolios managed]	Participants (million)
Bulgaria (universal funds)	2002*	8 (2004)	1.61 (12.2003)
Estonia	07.2002	15	0.21
Hungary	01.1998	38	1.34
Latvia	01.2003**	5 [10]	0.30
Lithuania	06.2004	10 [26]	0.44
Poland	04.1999***	21	7.0 (12.1999)
Romania	05.2008	14	3.82
Slovakia	01.2005****	6 [18]	n/a

* universal funds, mandatory for most of workers; occupational funds for workers in hazardous conditions were created in 2000, ** assets were managed by the state treasury until 1 January 2003 and invested in state securities and bank deposits, *** medium-aged cohorts could decide on whether to join the system until end-1999; **** persons under 52 could decide to join the system until June 2006.

Source: Modified from Bielawska et al. (2017: Table 2.1).

Pension reforms in CEE countries

	Public pension scheme	Retirement age	Mandatory funded contributions (iniital)	Enactment date	Who participates
Bulgaria	DB	60/55 → 63/60 → 65 + life exp	2% ↗ 5%	2002	Mandatory for all workers <42
Estonia	DB	60/55 → 63 → 65 + life exp	6% (4% +2%)	2002	Mandatory for new entrants
Latvia	Notional accounts	60/55 → 62 → 65	2% ↗ 8%	2001	Mandatory for new and workers < 30, voluntary for 30-50
Lithuania	DB	60/55 → 62.5/60 → 65	2.5% ↗ 5.5%	2004	Voluntary for current and new workers
Hungary	DB	60/55 → 62 → 65	6% ↗ 8%	1998	Mandatory for new entrants
Poland	Notional accounts	65/60 (60/55) → 67/67 → 60/65	7.3%	1999	Mandatory for new and workers < 30, voluntary for 30-50
Romania	DB	62/57 → 65/63 (discussion to equalise)	2% ↗ 3%	2008	Mandatory for new and workers < 35, voluntary for 36-45
Slovakia	Points	60/53-57 → 62/62 + life exp	9%	2005	Mandatory for born after 1983

Source: Schwarz and Arias (2014) with updates

Pension reforms in CEE countries

- The different strategies applied to the contribution level of the funded pillar, the switching rules, and choices made by employees, influenced the level of transition costs.
- **Actual transition costs** before the 2008 financial crisis emerged ranged
  - … from 1.6% of GDP in Poland and Hungary (due to high contribution rates, high participation, the longest period from the introduction of the reform),
  - through 1.3-1.1 % of GDP in Estonia, Latvia, Lithuania and Slovakia, to 0.8% of GDP in Bulgaria (due to relatively low contribution rates and the restriction of participation to specified cohorts) and
  - 0.4% in Romania (due to the lowest contribution rates and the shortest period since reform implementation).

Source: Bielawska et al. (2017), emphasis added.

Pension reforms in CEE countries

- Initial plans for covering transition costs:

Country	Increase of government sector revenues (taxes, social security contributions)	Savings in existing PAYG pillar	Privatisation revenues
Bulgaria	x	x	
Estonia	x	x	
Latvia	x	x	
Lithuania		x	x
Hungary		x	
Poland		x	x
Romania	x	x	
Slovakia	x	x	

Source: Bielawska et al. (2017: Table 1.4), colours added.

Incentives for subsequent pension reforms (aka reversals)

- 2008 financial crisis, socio-economic factors (disillusion), costs (large portion of TB bonds), political discussions
- Eurostat treatment of pension assets (individual, therefore private "+") and transition debt (quite a big public "-")
- Follow-up reforms:
  - Permanent reversal (Hungary)
  - Permanent reduction and partial reversal (Poland)
  - Partial reduction (Lithuania, Latvia)
  - Temporary reduction with offset, subsequently voluntary withdrawals (Estonia)

DC challenges

- Generic problems:
  - Decision-making by members of DC pension systems
  - Uncertainty and perception of investment results by members
  - Short-termism (by pension managers) and agency problems
- CEE-specific problems:
  - Oligopolistic market structure & members inertia, customer acquisition wars
  - Guarantees & investment herding
  - Investment policy (dominant TBs, few non-traditional instruments)
  - Undeveloped decumulation phase
  - Relatively low contribution rates

Source: Stańko (2017) and further update.

Generic DC challenges & potential solutions

- Investing and decision-making by members of DC pension systems
  - → Default options (autoenrollment, contribution rate, asset allocation, life cycle funds)
  - → Financial literacy campaigns
- Uncertainty and perception of investment results by members
  - → Pension communication (benefit statements)
  - → Pension projections: IOPS Good Practices for designing, presenting and supervising pension projections (2022)
- Short-termism and agency problems
  - → Improved benchmarks and fee incentives
  - → A (theoretical) concept of target retirement income (c.f. Stańko, 2015) – connection with decumulation phase (e.g. target replacement rates)

CEE-specific DC challenges & potential solutions

- Oligopolistic market structure & members inertia, customer acquisition wars
  - → Value for money, e.g. The Member outcomes assessment (Australia)?
  - → Changes to agents' remuneration; formal and operational obstacles for frequent switching; ban on customer acquisition (Poland)
- Guarantees & investment herding
  - → Elimination of relative guarantees
  - → Return-based fees
- Investment policy (dominant TBs, few non-traditional instruments)
  - → Life cycle / target date funds
  - → Extending investment universe (including foreign investments, alternatives)

Conclusions

- DC funded pillars in CEE
  - are very important for economy and politicians (reversals but also funds may have a role in economic recovery & ESG)
  - represent an additional, but not yet substantial element of overal retirement income
- **No significant supervisory challenges** (fees and customer acquisition initially, impact of pension funds on local financial markets), more related to pension policy
- **Design of the second pillar has implications** on market structure, investment behaviour by managing companies, members' disengagment and on supervision (fewer and bigger entities to supervise, more large pension funds)
- **CEE funded pillars still need to develop** (increase contribution rate and/or expand occupational pension schemes, better use of autoenrolment and other default features, more diversified investments); decumulation phase may require some decisions.

Sources:

- Bielawska, K., Chłoń-Domińczak, A., Stańko, D. (2017). Retreat from mandatory pension funds in countries of the Eastern and Central Europe in result of financial and fiscal crisis: Causes, effects and recommendations for fiscal rules, Research financed from research grant number UMO-2012/05/B/HS4/04206 from the National Science Centre in Poland, Instytut Zarządzania Ryzykiem Społecznym.
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- OECD (2020), OECD/INFE 2020 International Survey of Adult Financial Literacy
- Stańko, D. (2015). The Concept of Target Retirement Income: Supervisory Challenges, IOPS Working Paper No. 25
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Some additional slides on CEE fees, performance & financial literacy in CEE

Fee structure and levels are regulated and are decreasing over the time

Jurisdiction	Type of funds		Contributions		Assets		Returns	
			Legal cap	Avg.	Legal cap	Avg.	Legal cap	Avg.
Bulgaria	Occupational DC plans		7.00%	3.96%			10.00%	10.00%
	Personal plans L	UPF	3.75%	3.72%	0.75%	0.75%		
		PPF	3.75%	3.68%	0.75%	0.75%		
		VPF	7.00%	2.30%			10.00%	8.90%
Czech Republic	Personal plans – Transformed funds				0.80%		10%	
	Personal plans – Participation funds				1.00 % / 0.40 %		15.00 % / 10.00 %	
Estonia	Second Pillar				No cap but mgmt fee must decline by 10% each time the assets of pfs managed by the same mgmt company exceed the next level of EUR 100 m.			
	Third Pillar							
Hungary	Occupational DC plans							
	Personal plans NL		6%	4.84%	0.80%	0.45%		
Latvia	Occupational DC plans							
	Personal plans L							
	Personal plans NL							
Lithuania	Personal plans NL	Second Pillar			0.20% / 0.65%*	0.20% / 0.65%		
		Third Pillar (data for 2018)		1.00%		3.49%		
Poland	Occupational DC plans				0.60%			
	Personal plans L		1.75%	1.55%	0.54%	0.49%	0.06%	0.03%
	Personal plans NL							
Romania	Mandatory Personal plans		1.00%	1.00%	0,07%[1)]	0.29%[2)]		
	Voluntary Personal plans		5.00%	2.02%	2.40%	1.79%		
Slovak Republic	Second Pillar		1.25%[55)]	1.25%[55)]	0.30%[56)]	0.30%	10%[57)]	8.69%
	Third Pillar				0.65% / 1.30%[59)]	1.23%	10%[57)]	2.34%

Source: Extracted from Han and Stańko, D. (2019).

Fees usually include most of the elements

Jurisdiction	Plan/scheme administration fees	Investment management fees for:		Custodian fees	Investment transaction costs	Guarantee fees	Cluster
		Primary funds only	Underlying funds				
Poland	●	●	●	●	●	●	A
Czech Republic (Transformed funds)	●	●[1)]	●[2)]	●	●	●	
Czech Republic (Participation funds)	●	●[1)]	●[2)]	●	●		
Bulgaria	●	●	●				B
Romania (Second Pillar)	●	●		●	●	●	C
Slovak (Second Pillar)	●	●		●	●		
Latvia[6)] (voluntary pensions)	●	●		●	●		
Hungary	●	●		●			
Romania (Third Pillar)	●	●				●[10)]	D
Slovak (Third Pillar)		●		●	●		E
Latvia[14)] (mandatory pensions)		●		●	●		

* Notes: A cell marked with '●' means that the item is included in the charge ratio calculations.

A **blank** cell means that the item **is not included** in the charge ratio calculations.

A **crossed** cell means that the item **is not applicable** in the jurisdiction.

Source: Extracted from Han and Stańko, D. (2019).

Charge ratios in 2016

Country	Pension Scheme		Projection period			# of fee compo-nents
			40y	30y	20y	
Poland*	Personal plans L		12.7%	9.8%	6.9%	2
Median of Cluster A	**19.6%**	**13.3%**	**10.1%**			
Bulgaria	Occupational DC plans		10.3%	8.6%	6.9%	2
	Personal plans L	UPF	21.5%	17.1%	12.7%	2
		PPF	21.5%	17.0%	12.7%	2
		VPF	8.2%	6.6%	5.1%	2
Median of Cluster B**	**16.6%**	**13.3%**	**10.1%**			
Romania*	Mandatory Personal plans	15.3%	12.0%	8.7%	2	
Slovakia	Second Pillar		12.4%	9.5%	6.6%	3
Hungary	Personal plans NL		15.5%	12.7%	10.0%	2
Median of Cluster C	**21.3%**	**16.3%**	**11.9%**			
Romania*	Voluntary Personal plans		36.3%	28.6%	20.3%	2
Median of Cluster D	**15.2%**	**11.9%**	**8.6%**			
Slovakia	Third Pillar		28.8%	21.9%	14.7%	2
Latvia	Personal plans L		22.6%	17.0%	11.3%	1
Median of Cluster E	**25.7%**	**19.4%**	**13.0%**			

Notes: Figures in (*) are as of 2017 while others are as of 2016. ** Median of cluster B is calculated excluding data from India

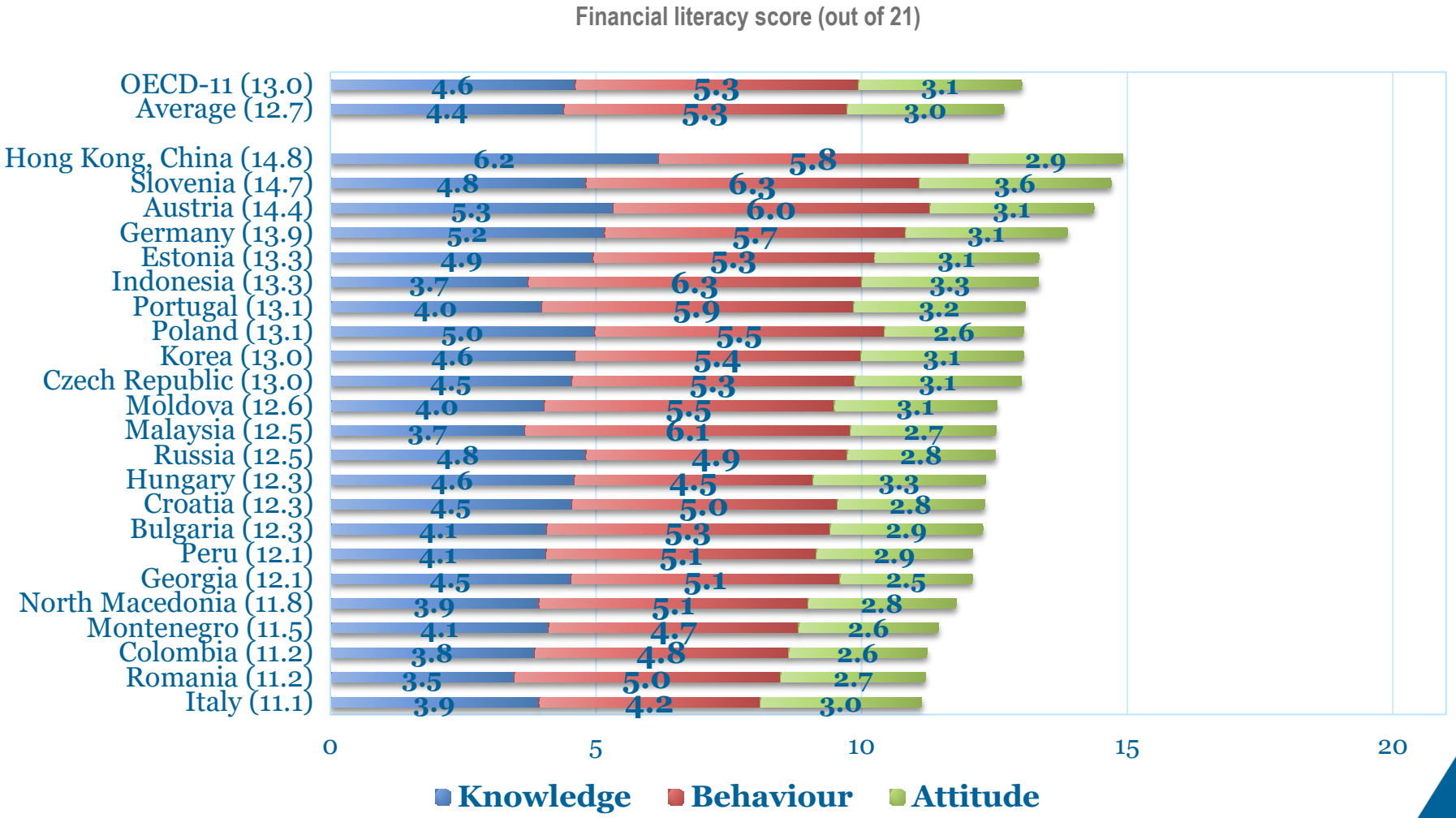
Source: Extracted from Han and Stańko, D. (2019).

Investment returns in CEE funded pension pillars (as of end of 2013)

Country	Type of funds	Calculated since	Real rate of return (%)		Duration (in years)
			accumulated till 2012	average p.a.	
Bulgaria	mandatory pfs	1.07.2004	-17,67	-2,06	9,33
Estonia	all funds	2.07.2002	-1,01	-0,10	10,50
	conservative	2.07.2002	-9,14	-0,91	10,50
	balanced	2.07.2002	-9,62	-0,96	10,50
	progressive	2.07.2002	3,52	0,33	10,50
	aggressive	1.01.2010	4,92	1,61	3,00
Latvia	conservative	7.01.2003	-11,54	-1,22	10,00
	balanced	7.01.2003	-15,29	-1,65	10,00
	aggressive	7.01.2003	-16,22	-1,75	10,00
Lithuania	conservative	15.06.2004	-7,56	-0,84	9,38
	stable	15.06.2004	0,03	0,00	9,38
	balanced	15.06.2004	-1,99	-0,21	9,38
	aggressive	15.06.2004	-7,72	-0,85	9,38
Hungary	classic	1.01.1998	n/appl.	3,39	7,25
	conservative	22.03.2005	35,66	2,05	15,00
	balanced	22.03.2005	28,73	1,70	15,00
	growth	22.03.2005	11,81	0,75	15,00
Poland	mandatory pfs	1.09.1999	110,48	5,74	13,33
Romania	mandatory pfs	21.05.2008	29,80	5,97	4,50
Slovak Rep.	conservative	22.03.2005	-3,21	-0,42	7,75
	balanced	22.03.2005	-10,33	-1,40	7,75
	aggressive	22.03.2005	-11,96	-1,63	7,75
	indexed	2.04.2012	1,31	1,75	0,75

Source: Bielawska et al. (2017: Chapter 2).

A limited financial literacy among adults at a global level



Source: OECD (2020), OECD/INFE 2020 International Survey of Adult Financial Literacy