Department of Social Policy and Intervention

Open Pension Funds in Crisis

Assessing the Merits of Poland's Multi-Pillar System

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March 22nd, 2013

Background

- Studying the political economy of “pension privatization”
- Doctoral thesis has focused on the UK, France and Poland
- Main claims:
  - Apart from international organizations and conservative politicians, another main protagonist of pension privatization is the *financial industry* (esp. insurance companies, mutual funds and stock exchanges)
  - The success of governments’ plans to develop funded pensions hinges on the reaction of *employers’ associations and trade unions*
  - However, there is large *variation in employers’ and workers’ preferences*
  - These are determined by their labour market concerns, by pre-existing pension institutions, but also by their corporate governance concerns

Why care about the Polish pension system?

- In 1999, Poland replaced its main statutory PAYG/DB scheme with a multi-pillar system (i.e. reduced PAYG + *mandatory* private pension funds)
- Representative of World Bank (1994) approach to pension reform
- For a long time, considered a “success story”
- Questioned since the financial crisis
- Currently, political debate about whether the mandatory private pension funds should be suppressed
- If that happens (… Hungary has nationalized its pension funds…), it would deal a serious blow to (or even sound the death knell for?) the World Bank’s pension paradigm

System for younger generations

First pillar
- NDC
- 12.22% contribution rate
- Managed by social security institution

Second pillar
- Funded DC
- 7.3% contribution rate
- Managed by a limited number of for-profit "open pension funds"

Third pillar
- Occupational "Employee pension plans"
- Personal "individual retirement accounts"
- Generally low coverage…

The Polish success story: political legitimacy

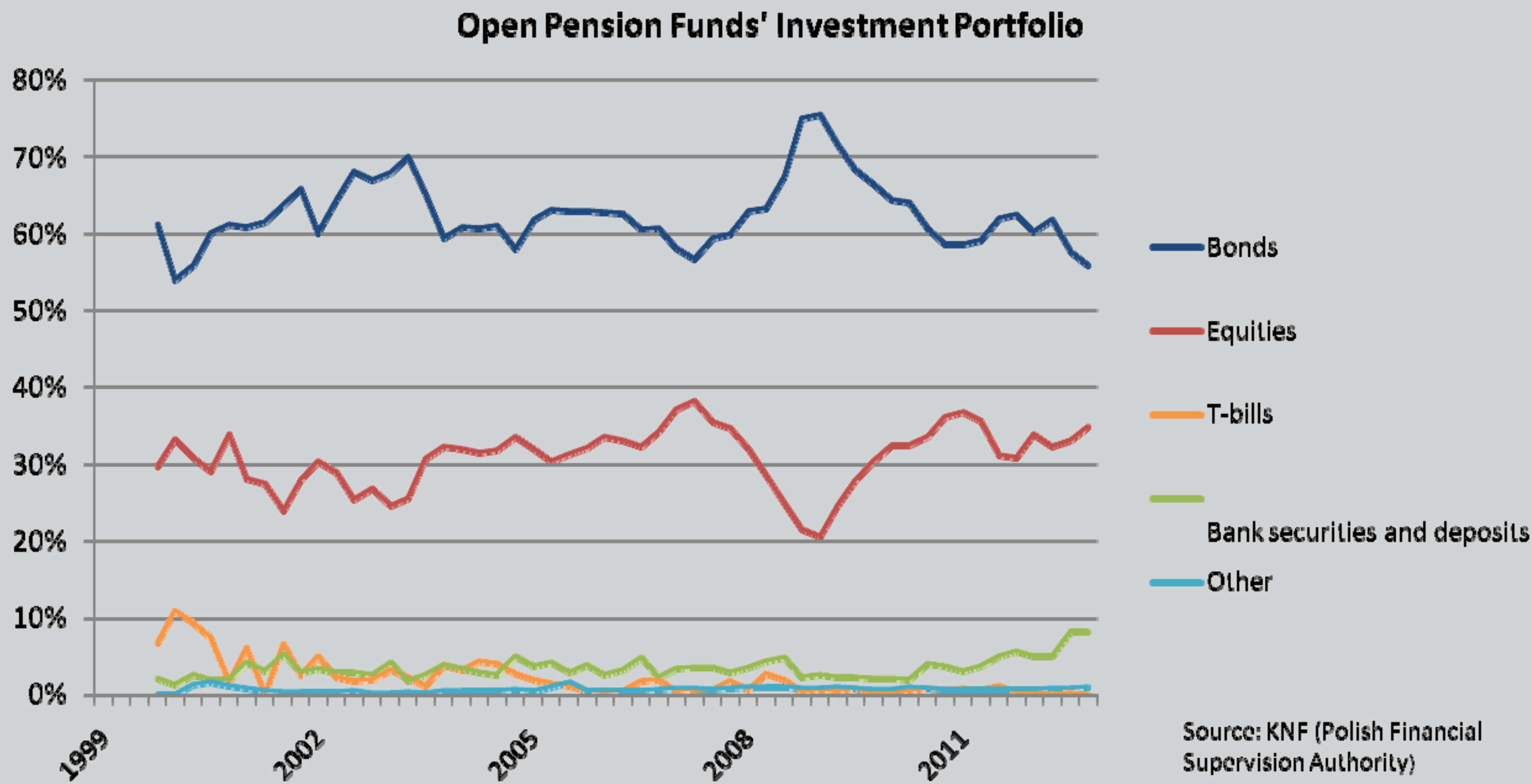
- Large political consensus in 1999:
  - Cross-party consensus
  - Supported by employers and the Solidarity union
  - Popular among public opinion
- Shared belief that new system would:
  - Help cope with demographic ageing (eggs in different baskets)
  - Be fairer (tighter link between benefits and contributions)
  - Even help increase people’s benefits (due to high returns of private pension funds)
- Consensus also due to link with the privatization of state-owned companies

The Polish success story: a boon to the local capital market

- Open pension funds have become a major participant on the Warsaw stock exchange
- “Virtuous circle” between pension priv... ...tion of state-owned companies:
  - In order to finance transition costs, the ... number of companies through IPOs
  - With their growing assets, pension funds acquired large stakes in these privatized companies

Q1/2009: 6.7% of stock market capitalization
Q2/2012: 11.2% of stock market capitalization

The Polish success story: a boon to the local capital market



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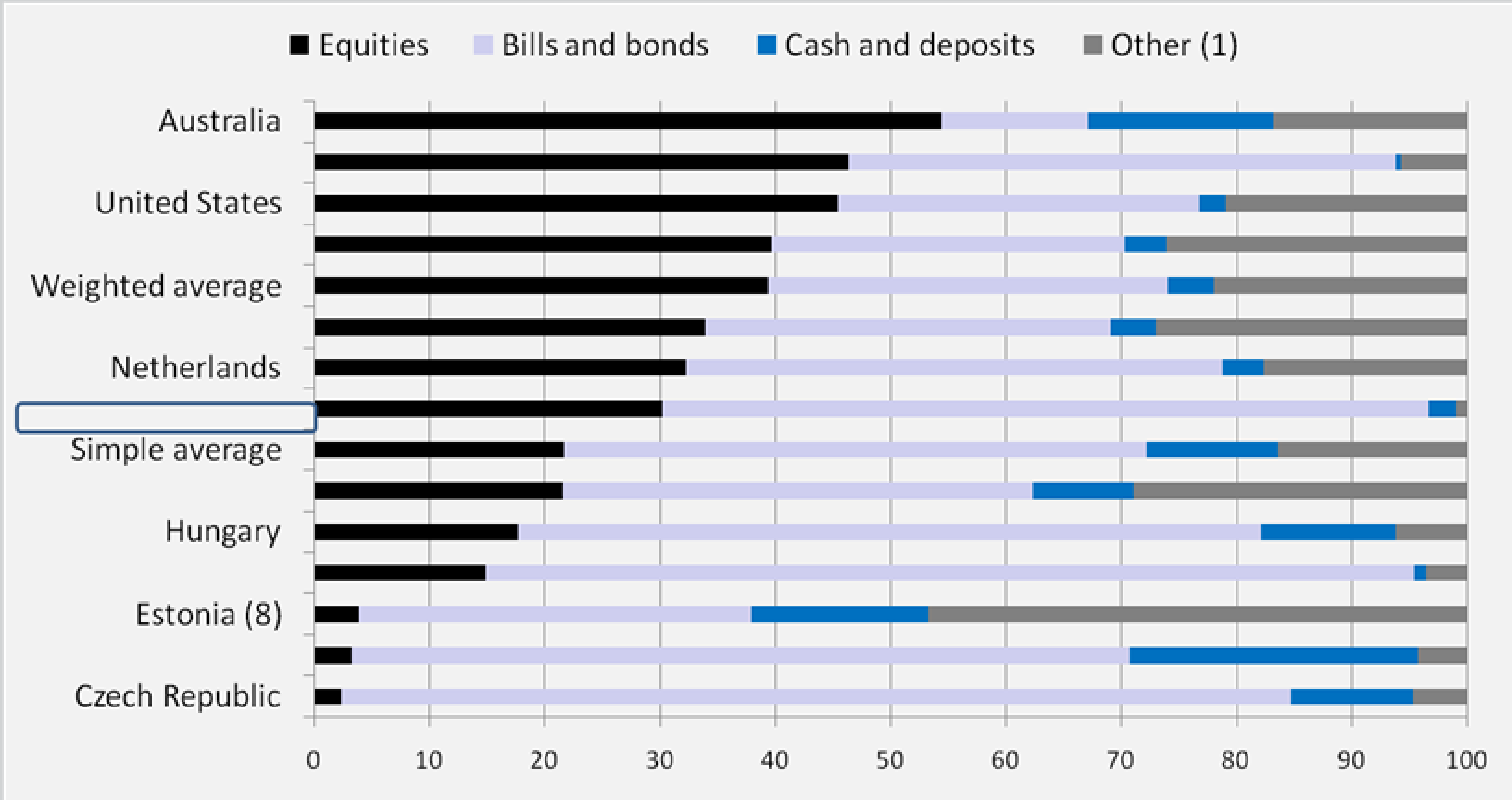


Source: OECD, data for 2009

The Polish success story: a boon to the local capital market

- Open pension funds have become a major participant on the Warsaw stock exchange
- "Virtuous circle" between pension privatization and privatization of state-owned companies:
  - In order to finance transition costs, the state privatized a large number of companies through IPOs
  - With their growing assets, pension funds acquired large stakes in these privatized companies
- 2009: head of the Warsaw stock exchange, Wiesław Rozłucki:
  - "After the creation of the stock exchange in 1990-1991, OPFs have been *the greatest event in the history of the Polish capital market*" (Rzeczpospolita 2009)

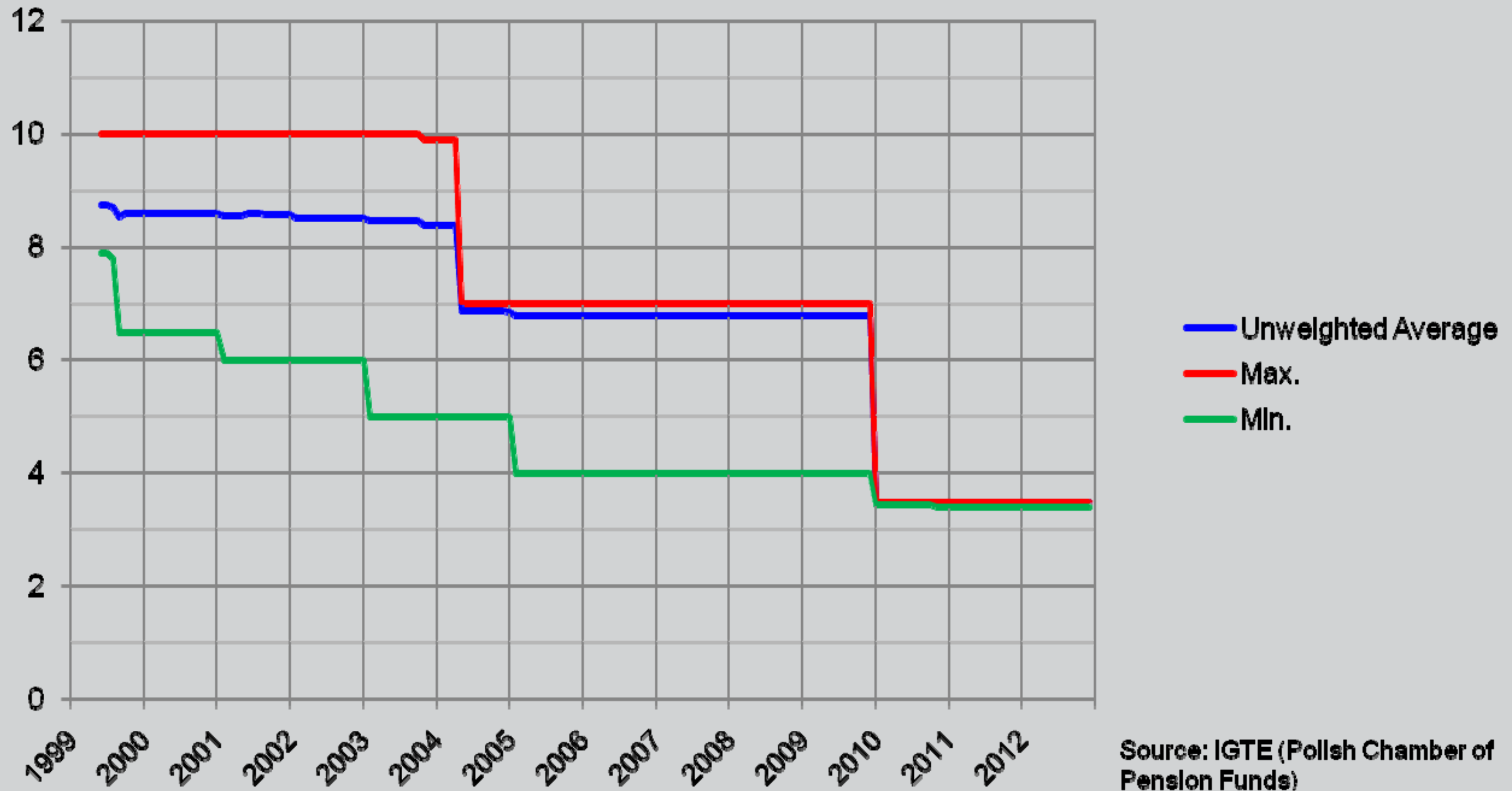
Problems: regulation of the pay-out phase

- No regulation was introduced in 1999
- First large cohort of pensioners to receive 2nd pillar pensions in 2014
- Discussions since the mid-2000s; still no consensus
- Competing projects:
  - Managed by the private sector:
    - insurance companies
    - AND/OR open pension funds
  - Creation of a separate state-run “Fund of lifetime funded pensions”
  - OPF assets to be transferred to Social Insurance Institution 10 years before individual’s retirement

Problems: charges

- Two types of charges:
  - Distribution fee (i.e. charged on contributions)
  - Management fee (i.e. charged on assets)
- Distribution fee:
  - Initially, no limit
  - Capped since 2004 (max. 7%)
  - Further reduced since 2010 (max. 3.5%)

Problems: charges



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- Distribution fee:
  - Initially, no limit
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  - Further reduced since 2010 (max. 3.5%)
- Management fee:
  - Initially, 0.05% per month (or 0.6% per annum)
  - Since 2004, divided into:
    - Fixed component: 0.045% per month (or 0.54% per annum)
    - Variable component: depends on the relative performance of the OPF every semester (each fund pays monthly 0.005% into common pot)

Problems: consequences for public debt

- Introduction of mandatory 2nd pillar creates important transition costs
- Diversion of social security contributions results in loss of revenue for PAYG 1st pillar
- This in turn results in increased state subsidies for social security system
- Which can be financed by:
  - Increased taxation
  - Cuts in current or future public expenditure
  - Sale of state assets (privatization)
  - Increase in public debt

Problems: consequences for public debt

- In Poland, transitions costs were underestimated:
  - 1997 estimates of the agency in charge of the reform:
    - Gap to reach 0.68% of GDP in 2000
    - 1.39% of GDP by 2017
  - In reality:
    - 1.4% of GDP in 2000 (Chłoń-Domińczak 2002: 167)
    - 10 million individuals joined 2nd pillar in 1999 instead of 6-7 mln expected
- Throughout 2000s, attempts to plug the gap through:
  - reform of farmers' pension scheme – never carried out
  - Privatization of state-owned companies
  - Increase in contribution rate for disability pensions

Problems: consequences for public debt

- Much of the transition has been financed through an increase in public debt; became evident following the financial crisis
- Ministry of Finance (Kempa 2010) found that introduction of 2nd pillar in 1999 would on the whole contribute to increase public debt by 93.8% of GDP by 2060
- British-born Minister of Finance, Jacek Rostowski, called the 2nd pillar "a cancer that had grown to gigantic proportions and was destroying the whole pension system"
- Policy implications:
  - In 2011, government has decreased 2nd pillar contribution from 7.3% to 2.3% (and in parallel increased contribution to 1st pillar)
  - 2nd pillar contribution to be increased to 3.5% by 2017
  - But currently debate about whether the 2nd pillar should be maintained

Conclusion: high hopes, mixed results

- A system that proved primarily beneficial to Warsaw as a financial centre
- Problems with the design of private pension funds
  - No regulations on the pay-out phase
  - Problem of charges/costs
  - Captive market
    - Individuals tend to stick to their pension fund
    - Reductions in charges introduced only through political system, not through market competition
- Problems with the design of the multi-pillar system itself:
  - Debt-financed: what is the point of making the implicit debt of the pension system explicit, if it is future generations that end up paying it anyway?
  - Welfare implications of a fully DC system?

Thank you very much for your attention!