Multi-pillar Pension Systems: Lessons from Central Europe

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Overview of the Presentation

• Initial expectations

• The multi-pillar system

• What happened during the crisis

• Key lessons
Pension reforms were often expected to solve pension problems…

- Fundamentally the reforms were designed to deliver good pensions…but also it was also hoped they would:
  - Increase national savings
  - Develop the capital market
  - Have a positive impact on economic growth; and
  - Increases labor force participation
- While it is too early to evaluate the effects of the reform, these outcomes are unlikely to materialize in most of the countries.
  - Misunderstandings?, implementation failures?
FUNDAMENTALS OF MULTI-PILLAR PENSION SYSTEMS
Multiple sources combine to deliver retirement security

**Sources of retirement income**

- **Zero pillar**: non contributory, public, focus on adequacy and coverage. Income and in-kind transfers to support basic consumption
- **First pillar**: mandatory, public, mainly income replacement also redistributive minimum pension guarantee. DB or DC. Sometimes partly backed by assets in public investment funds
- **Second pillar**: mandatory private, income replacement DC (or DB)
- **Third pillar**: voluntary private, income replacement – DC or DB – pure individual personal pensions and employer sponsored
- **Fourth Pillar**:  
  - **Financial Assets**: (bank balance, unit trusts, long-term insurance)  
  - **Family transfers**  
  - **Housing**: Source of consumption and (potentially) investment  
  - **Labour Income**: Boundary blurring between work and retirement
The different sources of retirement income are impacted by a range of risks.

<table>
<thead>
<tr>
<th>Sources of retirement income</th>
<th>Risks affecting size of payout: They differ but are inter-related</th>
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</thead>
<tbody>
<tr>
<td>Zero Pillar</td>
<td>Political</td>
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<tr>
<td>First Pillar</td>
<td>Fiscal</td>
</tr>
<tr>
<td>Second Pillar</td>
<td>Capital Market</td>
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<tr>
<td>Third Pillar</td>
<td>Economic Growth</td>
</tr>
<tr>
<td>Fourth Pillar: Financial assets</td>
<td>Family – size/wealth/relationship</td>
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<tr>
<td>Fourth Pillar: Family transfers</td>
<td>Housing market</td>
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<tr>
<td>Fourth Pillar: Housing</td>
<td>Labor Market</td>
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<tr>
<td>Labor Income</td>
<td>Longevity</td>
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<td>Inflation</td>
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Predicting the size of any of these over 40-80 is very difficult …

Diversifying across sources is the most robust strategy
Recent policy reactions

Permanent Measures

- **Hungary**: nationalization of the 2\textsuperscript{nd} pillar
- **Poland**: Shifting of 5 percentage points (pp) of the contribution rate from the 2\textsuperscript{nd} to the 1\textsuperscript{st} pillar, and gradual increase of 1.3 percentage points until 2017
- **Slovakia**: Shifting of 5 percentage points (pp) of the contribution rate from the 2\textsuperscript{nd} to 1\textsuperscript{st} pillar (announced)

Transitory Measures

- **Estonia**: shifting of 4 pp of the contribution rate from the second to the first pillar, followed by a gradual increase until 2014

Maybe Transitory, Maybe Permanent

- **Latvia**: Shifting of 6 pp of the contribution rate from the second to the first pillar
- **Lithuania**: Shifting of 3.5 pp of the contribution rate from the second to the first pillar
- **Romania**: Reduction in the growth path of the contribution rate
WHAT WENT WRONG?
Fiscal policy inconsistent with sustainable 2nd pillars

Average Fiscal Deficit (% GDP)

- Hungary
- Poland
- Slovakia
- Estonia
- Latvia
- Lithuania
- Romania
- Bulgaria
- Croatia

From 2nd pillar inception (or 2002) to 2007
From 2nd pillar inception (or 2002) to 2010
SGP
It is hard to argue that 2\textsuperscript{nd} pillars were the motivation of the fiscal deficits...
Fiscal policy is at the core of the policy reversals

- While transitional deficits were supposed to be mostly tax financed, they end up being debt financed
  - Poland. Privatization revenues were insufficient to offset the 2nd pillar contribution flows
  - Hungary. While parametric changes were supposed to create fiscal space for the financing of the transition, pension expenditure consumed those savings

- Expansive fiscal policies followed most of the reforms
  - Fiscal policy broke the savings/growth impact of the reform

- Recent reforms
  - Czech Republic: Are VAT increases enough to offset 2nd pillar contribution flows? Careful with simple math on “pension deficit”
  - Armenian reform does not have an explicit mechanism for financing the transitional deficit
Lack of domestic political support combined with the impact of the EU fiscal rule in favoring implicit debt

- While we thought the Stability and Growth Pact (SGP) was a source of strength for 2nd pillars, it ended up backfiring on their stability
  - Countries with 2nd pillars are in disadvantage compared to the rest because ‘hiding’ pension liabilities in implicit debt does not impact SGP (or credit ratings)
- Weak political support at the time of the reform opened room for subsequent reversals
  - Hungary and the Slovak Republic
High fees reduced both support and outcomes for 2nd pillars.
The asset allocation of pension funds is far from optimal.
Initial conservatism is understandable but ultimately conservative strategies are suboptimal

- While some overweight in secure assets in the initial stages of the reform might be necessary, countries need to diversify the asset allocation.
- Excessive investments in government bonds are a direct consequence of unsound fiscal policies.
- Investment regulations in some countries force investments in government securities:
  - Small limits for other securities and underdeveloped capital markets.
  - Restrictions for investments abroad (Poland).
  - Expensive capital rules in DC systems (Kazakhstan).
- Regulations in most of the countries are conductive to short term performance (MRG).
3rd pillars have not performed as expected

Total Assets¹
2nd and 3rd pillars
(\% of GDP)

<table>
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<tr>
<th>Country</th>
<th>2nd Pillar</th>
<th>3rd Pillar</th>
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<tbody>
<tr>
<td>Poland</td>
<td>0.10%</td>
<td>14.76%</td>
</tr>
<tr>
<td>Estonia</td>
<td>0.53%</td>
<td>7.07%</td>
</tr>
<tr>
<td>Latvia</td>
<td>0.83%</td>
<td>5.97%</td>
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</tbody>
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¹ 2011
LESSONS
The crisis emphasizes that all pension pillars are subject to risk

- Reversals and reductions seen in all sources of retirement income
- EU bias: different treatment of implicit and explicit debt.
  - Different perception of implicit versus explicit debt defaults
- Stress testing: is any pension system immune to low growth or unsound fiscal policies?

Pension risk diversification is still the main justification of multi-pillar schemes
‘Pure’ voluntary individual choice might not deliver good enough outcomes

- These systems typically have low contributions and coverage and are likely to be used for higher earners
- Tax relief is regressive and not necessary good value for money
- Matching contributions may be fairer and more effective but the evidence is limited
- Face well known problems of individual decision-making
- Financial literacy is more difficult than envisaged
- Countries need to consider more elaborated options…
Opt-out voluntary systems or auto-enrolment can bring a better outcomes

- Auto-enrolment can make the differences to a second pillar insignificant (Slovakia (current), Nest (UK), Kiwisaver (NZ))
- If properly structured, opt outs can be guide expectations
- As they require sales-force “efforts” opt-ins are more expensive (Czech R., Slovakia (2009), Lithuania)
- In all cases the nature of the default option is critical
  - Vital decisions on (long term) objective;
  - Asset allocation
  - Asset style (passive v active, high or low turnover)
  - Link to the payout phase
  - Who makes these decisions and how is a vital source of future performance
High fees are not endemic to 2nd or 3rd pillars

- High costs are related to the industrial organization of pension fund management companies
  - In the context of bounded rationality, unnecessary emphasis on individual selection
  - It incentives oligopoly structures
    - Overinvestment in sales-force and office space (sales-force)
    - Wasteful competition (switching contributors)

- Range of ways to unlock benefits and improve outcomes
  - Unbundling asset management and account management functions; blind accounts.
  - Auctioning participants among portfolios
  - Large well run employer funds
  - Centralized agencies (PPM, ATP) or Not For Profits (NEST)
Improving asset allocation is a critical part of the story

- Portfolio benchmarks are essential for ensuring that investment portfolios are aligned with an expected replacement rate.
  - Industry-wide portfolio benchmarks
  - Designed exogenously
- Implementation of life cycle investment strategies
- Tracking error deviations against the benchmark
- Use of low cost UCITS and index funds
Conclusion

• Time to achieve a broad agreement on 2nd pillars – and their role are part of a diversified approach to the retirement challenge
• Pre-conditions are essential to starting reform
• The financing of the transition is the most basic element behind the success of the reform
• Reversal – no – reform and realism - yes
• Countries with 2nd pillars are in a better shape to deal with the upcoming effects of the financial crisis in Europe…
• But they need help to ensure they are not punished relative to ‘hiding’ pension problems in implicit debt
Thanks!
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