Facing up to the challenges

EFRP
European Federation for Retirement Provision

CEECC Forum

BUDAPEST CONFERENCE REPORT – 24 MARCH 2009
Contents

Introduction ......................................................................................................................... 1
Foreword .............................................................................................................................. 2

CEEC Forum conference
Facing up to the challenges ................................................................................................. 3
Designing a payout phase ..................................................................................................... 4
The impact of the crisis ......................................................................................................... 8
Investment restrictions ......................................................................................................... 11
Supervising the pension providers ...................................................................................... 14

Country reports
Bulgaria: Third pillar pre-empted reform ......................................................................... 18
Croatia: Retaining tight restrictions ................................................................................... 20
Czech Republic: Expanding the third pillar ...................................................................... 22
Estonia: Minimum investment constraints ......................................................................... 24
Hungary: First with reforms ................................................................................................ 26
Latvia: Contributions on the wane ...................................................................................... 28
Lithuania: A non-mandatory second pillar ....................................................................... 30
Poland: Largest second pillar in the CEE ........................................................................... 32
Romania: Last in the convoy .............................................................................................. 34
Slovakia: Reform under pressure ......................................................................................... 36
Slovenia: Mandatory second pillar refused ......................................................................... 38
Contact .................................................................................................................................. 40

Contributors: Pirkko Juntunen, Krystyna Krzyzak, Thomas Escritt
Edited by: Liam Kennedy and George Coats
Production and design: Adrian Khanna
Introduction

Helping to realise a 50-year-old dream

The central and eastern European countries (CEEC) Forum was established in October 2006 to include the EU enlargement in the EFRP's strategy and overall work. The Forum brings together representatives of private pension institutions – operating both mandatory and voluntary schemes – from those new EU members that over the past decade have introduced multi-pillar pension reforms.

Primarily the CEEC Forum is about gaining a better understanding of the pension reforms in the CEE region. It offers the private pension industry in the CEE region a platform to exchange information and to reflect on the implications of EU membership on the privately managed pension systems.

But the CEEC Forum reaches beyond information exchange among its members. It sends a strong signal that EFRP is open to new forms of private pension provision in the EU without being diverted from its prime objective: to promote secure and affordable pensions for working people across the continent.

A forceful EU pensions industry voice in Brussels is vital to ensure that the European regulatory environment continues to foster the development of private pension provision and continues to respect the diversity of the different European social protection systems and their privately managed supplements. ‘Brussels’ is not necessarily a bad thing. It has brought pension funds the ‘prudent person’ investment rule and the cross-border provision of services by virtue of an innovative IORP-directive, and it did so before such benefits were extended to life insurance companies.

Ageing societies and financial and economic strain are most likely to be drivers for a further streamlining of private pension systems across Europe. The achievement of safe and affordable pension systems for all European citizens has become a core policy objective.

This new report of the EFRP aims to contribute to the better understanding of the specific challenges and issues of the private pension systems in the CEE region and to raise awareness that EU enlargement has brought new and greater diversity in the European private pension landscape.

We have drawn on the excellence of IPE in reporting on pension issues to put together a publication that we hope will be an informative and pleasant read.

Angel Martinez-Aldama, chairman EFRP
Chris Verhaegen, secretary-general EFRP
Although it only held its inaugural meeting in October 2006, the CEEC Forum has already found its feet. And on 24 March 2009 in Budapest, less than three years after its creation, the Forum organised its first public conference. This high-level event was organised with the support of the Hungarian Financial Supervisory Authority (PSzÁF) and featured speakers from that institution as well as from the International Organisation of Pension Supervisors (IOPS) and the European Commission. Consequently, it drew an interesting and impressive audience, with attendees ranging from private pension management companies throughout the CEE region to supervisors from Australia and Chile.

This report reflects the findings of that conference by presenting a summary of its several sessions. It also provides context by featuring CEE country reports highlighting the main characteristics of and issues facing their pensions systems.

Although diverging messages were delivered at the conference, it is possible to distill from them a number of policy recommendations that are valid not only for the region but for all private pension systems in general. And this serves to illustrate that despite some structural differences, the pension systems from the ‘old’ and ‘new’ member states share many common issues.

Among them are that:

■ A multi-pillar pension system is a prerequisite for the delivery of sound and sustainable pensions. Europe needs to promote the development of a balanced three-pillar pension model where state pensions are complemented by private pensions that are accessed through paid work. Whether these systems are voluntary or mandatory is, in our opinion, an issue solely for the member state to decide. In addition to these systems, individuals should have the possibility, or be encouraged through tax incentives, to save individually for retirement.

■ Legislative stability is critical for each pension system. The financial crisis does not provide a licence to scale back the recent pension reforms carried out in the CEE region. Funded pension provision is a long-term commitment between governments and their citizens. It entails trust and confidence in the system from both sides.

■ The financial education of citizens is crucial. To be successful, capital-funded pension systems need the support and commitment of a country’s citizens. It is essential that citizens understand the economics of long-term savings. They need to make an informed choice when allocating their pension savings to a specific pension fund. They have to understand the value of time – the earlier they start retirement savings in their career, the more pension income they get at retirement.

I hope that this report will contribute to a better understanding of the specific challenges and issues that the private pension industry in the CEE region is facing today.

Csaba Nagy, chairman of the CEEC Forum
The inaugural European Federation for Retirement Provision (EFRP) Central & Eastern European Countries (CEEC) Forum Conference in Budapest on 24 March brought pension funds from the region and beyond together with representatives from the European Commission, the OECD, the EFRP, academics, regulators and other experts and was hosted by the Hungarian Financial Supervisory Authority. They examined key issues facing the region’s pension players. The programme was structured around addressing four major themes: the pay-out phase of mandatory pension accounts; the financial crisis and mandatory private pension systems; investment restrictions; and supervision for mandatory pension management companies and providers. In the following pages Pirkko Juntunen reviews the key points made by the conference speakers and during the subsequent question and answer sessions.
In the past decade most countries in central and eastern Europe have undertaken pension reforms and introduced funded second pillar provision. The intention was that an increasing number of people would in the future receive a larger proportion of their pension from mandatory defined contribution (DC) arrangements.

Just as important as it was for a participant to select the right funds for his or her personal circumstances when joining a fund and changing those as circumstances changed, was the choice of an appropriate spending and investment strategy for the accumulated wealth. Therefore, having suitable arrangements in-place for the payout phase was vital.

And this was one of the major themes discussed at the inaugural European Federation for Retirement Provision Central & Eastern European Countries Forum Conference.

Georg Fischer, head of the social protection social services unit at the European Commission’s directorate general for employment, social affairs and equal opportunities, said in his keynote speech that a joint report from the European Commission and Council had pointed to the need to mitigate risk in DC pensions, particularly for those people approaching retirement, and had called for appropriate solutions for the payout phase that were still missing in a number of countries with mandatory schemes.

“According to theoretical replacement rate calculations, Hungarian pensioners in 2046 will be getting a quarter of their overall pension from the statutory DC scheme,” he said. “And a number of other countries – including Poland, Lithuania and Latvia – will have levels above that.”

Creating a viable, flexible and yet safe system for payouts was on the agenda but in many countries there currently seemed to be more questions than answers. These questions typically focused on what payout options should be allowed, what options were available, which entities should be permitted to provide annuity products and which types of products should be authorised. There were also questions about the provision of guarantees and risks associated with annuitisation.

Wojciech Otto, professor at the University of Warsaw, described the Polish pension system and its manifold challenges. First, there was the challenge of how to cope with the risk stemming from the uncertainty of the rate of return on investments combined with increasing longevity. He said the solution would be to share the risk between the annuity provider and the annuity holder. However, another response would be to defer the annuitisation of those eligible for early retirement until they were aged 65 by allowing temporary programmed withdrawals serviced by the country’s open pension funds. He pointed out that the major side-effect of this solution was that it was only a tem-
porary measure, even if it were simple and easy to implement, but it would at least give the policymakers a few more years to design and discuss the details of final solutions.

Another challenge for Poland was how to prevent life annuity providers from focusing excessively on acquisition of new business while ignoring the interests of annuity holders. He proposed that profits not be made at inception but rather be made gradually during the whole duration of a contract. This way the interest of the provider and customer would be aligned.

A further challenge was how to avoid adverse selection and costly acquisition targeted at ‘good risks’ that would arise when a member chooses between competing life annuity providers and when differentiating annuity rates by risk factors other than age was prohibited.

Otto said a solution would be to organise a centralised distribution process with no choice of product in order to avoid signalling that one is a “good risk” through the choices made. Such a signal was given by the choice of programmed withdrawal when a life annuity was an available option or if a fixed annuity in nominal terms was preferred to a well-indexed annuity. However, he pointed out that generally, free choice between products that differed by the degree of protection against longevity risk was expensive.

Otto added that specific solutions were required to reduce the incentives for life assurance providers to seek easy profits by attracting as many males and as few females as possible and attracting persons with a poor medical prognosis.

A solution to this would be to supplement the life annuity with a life insurance. "The solution works better when mandatory, because then incentives for undesirable behaviour disappear on..."
“both sides,” Otto said. “An optional solution makes members more comfortable but it does not remove incentives for the provider to look for seriously ill people and the poorly informed to make the wrong choice, and it will result in annuities without life insurance being expensive.”

In 2008 the Polish government took steps to implement a framework for the payout phase. The Act on Pensions Derived from Second Pillar Savings regulating the temporary phased withdrawals serviced by existing open pension funds for members aged under 65 was passed by parliament and signed by the president.

The legislation also detailed the basic definitions and rules of granting lifelong pensions afterwards. However, the president refused to sign legislation on annuity funds and life annuity companies (LACs), which was necessary for regulating functioning life annuity companies and their financial system.

The arguments against signing the law were a lack of guarantees that lifelong pensions benefits were secured against inflation risk and a lack of guarantees that there would be enough private entities launching LACs to ensure competition. For this reason it was suggested that a state-owned LAC be launched. Otto said that the latest government moves would make the battle for efficient solutions difficult. But he added that some general solutions had been settled by the first law. “This may help focus the debate on system-design and efficiency and away from a number of other issues that prevented move the case forward,” he concluded.

Hungarian Financial Supervisory Authority deputy general director Mihály Erdős said that many countries faced problems and challenges similar to those of Poland.

In Hungary it would not be compulsory to annuitise private pension savings until 31 December 2012, but after that it would be mandatory after a minimum of 15 years of pension fund membership, he said. “Now practically nobody buys annuities,” Erdős said. “Rather they ask for a lump sum. There is some regulation, but it is partial and inconsistent.” Currently, the annuity provider could be the fund itself despite not having solvency capital for this function, or the fund and the client could buy an annuity from an insurance company. A life annuity was compulsory and there were four different types of products, with guarantees differently structured, he added.

However, other parameters were unclear. The maximum technical interest rate was high and changed value annually. The mortality table was compiled by the actuary of the fund.
was no differentiation according to
gender in the premium and the law nei-
ther prohibited nor allowed using other
differentiating factors. The minimum
of the annual indexation was the an-
nual indexation of the Social Security
Pension, and again the law was silent
about the use of the mortality rates.
Erdős argued that it would be possible
to help members choose the best pro-
vider through a quotation system and
to keep costs low through a centralised
annuity exchange. “Without an effective
investment market you cannot expect
an effective annuity market,” he said.
And in a reference to the Beatles, he
concluded that the question is no lon-
ger ‘will you still feed me when I am 64’
but rather 82. Industry professionals ar-
gued that flexibility was key for the fu-
ture of annuities however countries de-
cided the structure of the framework.
Pablo Antolin-Nicolas of the OECD’s
financial affairs division suggested that
countries with compulsory pension ac-
counts where assets accumulated in
DC pensions were the main source
of retirement income, should mandate
that part of their assets be used to buy
a deferred life annuity that would start
paying at old age, for example at 80.
How the rest of the assets would be
paid out should be fully flexible.
He also argued that if there were a
mandated deferred life annuity, the
system should allow any type of annu-
ity product for the remaining balance.
Further, Antolin-Nicolas said the sys-
tem should be open to any provider
as long as it was sufficiently regulated
and fair competition was guaranteed.
Countries with small or non-existent
annuity markets should institute a cen-
tralised annuity fund provider, but also
allow insurance companies and other
providers to enter the market and guar-
antee full equal competition. In this way
a centralised annuity fund could gradu-
ally exit the market. Countries that
decided pension funds could provide
annuities should make sure that ap-
propriate prudential regulation was in
place to protect retirement income.
He also highlighted state involve-
ment: “Governments may need to en-
courage the development of a market
for longevity hedging products by de-
veloping a reliable longevity index. And
in countries with small liabilities from
PAYG, governments should consider
issuing longevity-indexed bonds ahead
of the payout phase.”
Raymond Maurer, professor at
Goethe University in Frankfurt, told the
conference that integrated solutions
that combined the characteristics of
annuities and drawdown plans could
offer higher benefits while having effi-
cient risk controls. “However, the aver-
age retiree will need professional help
to implement payout strategies and the
task for the financial industry is to cre-
ate cost-efficient integrated products
based on and monitored according to
dynamic life-cycle models,” he added.
He also argued that the government or
state should also help in offering infla-
tion-protected annuities.
The economic and financial downturn and the resulting fiscal deficits have seen some governments reduce contributions to the World Bank-model funded second pillars and others nationalise them. Nevertheless, pension funds have remained resilient, despite record low returns for 2008.

“These events are forcing us to look at private pensions again and indeed on pension systems in general,” Georg Fischer head of the social protection social services unit at the European Commission’s directorate general for employment, social affairs and equal opportunities, told the conference. “We cannot exclude that for some people in some countries who are dependent on certain types of private pension there will be serious impacts on their retirement income. And there will be lessons for future provision. However, what we have seen up to now suggests that in Europe the crisis has had a less serious impact on pension funds than on other types of financial institutions and on funded pension systems in some other parts of the world.”

He did not deny that there was a decline in confidence in funded pension schemes as a result of the market turmoil. He cited a recent survey of Dutch pension fund members that found only 44% of respondents had confidence in pension funds, down from 64%
just three years ago. “We can expect similar drops in confidence elsewhere, including in statutory funded pension schemes set up in many central and eastern European countries over the last 10 years,” Fischer said. “Poor performance in pension fund investments will inevitably have at least a psychological impact on contributors to such funds, even if they are not due to access their pension for many years.”

Iceland would serve, perhaps, as a case study in a loss of confidence in financial institutions. Not only did the country’s financial industry fail but its economy came close to crumbling under the onslaught of the financial and economic crises. Iceland’s three major banks – Kaupthing, Landsbanki and Glitnir – collapsed in the same week in October 2008.

After they had been privatised early this century, the banks embarked on rapid expansion, with the primary focus being the opening local branches outside Iceland and acquisition of overseas financial companies.

According to Thorgeir Eyjólfsson, managing director of Lifeyrisjodur Verzlunarmanna, Iceland’s Pension Fund of Commerce, the rapid growth was facilitated by Iceland’s membership of the European Economic Area (EEA) and the basing of its financial system’s regulatory framework on EU directives. The Icelandic Financial Supervisory Authority (FME) also based its operations on European law, regulations and procedures.

The ‘freezing order’ imposed on Landsbanki by the UK authorities under Britain’s Anti-Terrorism, Crime and Security Act – an order that was extended originally to the Icelandic government, Central Bank and FME among others – exacerbated the situation. After the collapse of the three banks, which represented about 85% of the country’s total banking assets, the FME took over their operations on the basis of newly adopted legislation and this action was viewed as a success, despite the actions of the UK authorities, Eyjólfsson said.

Iceland’s over-stretched and over-leveraged banking system was ill-positioned to cope with the global financial turmoil. Its banking sector’s dramatic expansion had been funded by cheap foreign financing, which allowed it to boost its assets from 100% of GDP to almost 900% between 2004 and end-2007, making it one of the largest in the world in relation to GDP. “It is obvious that the banks had become too large in relation to the Icelandic economy,” Eyjólfsson told the conference. “But the European regulatory framework made this possible.”

Before the collapse of the banks the assets of the Icelandic pension system totalled 133% of GDP, one of the highest ratios in the world. Among the factors that contributed to this favourable position were mandatory contributions to the pension funds and the exceptionally good returns on the domestic stock market arising from the privatisation of the Icelandic banks. In addition, the pension funds reaped the benefits of high real interest rates on the domestic bond market for over 20 years and a fertility rate that is among the highest in the world. Iceland was younger than most western nations and enjoyed the added bonus of having a relatively high retirement age of 67, Eyjólfsson said.

In October 2008, as a result of the crises and collapse of the Icelandic stock market, a considerable part of previous pension fund gains were wiped out. The pension funds also had to write off a significant part of their domestic bond portfolio.

The Pension Fund of Commerce saw its assets decline by 14.4% in October 2008 alone, said Eyjólfsson. Its year-end result showed a fall of 11.8%. “An important factor in these results, that seem not so bad taking into account the disaster the country had just been through, stems from the huge devaluation of the Icelandic krona, which lost 45% of its value over the year 2008,” he added.

“According to the OECD estimates the financial crisis reduced global pension assets by more than 20%”
According to OECD estimates the financial crisis reduced global pension assets by more than 20%, or $5.4trn, at the end of 2008. An increased equity exposure or lack of portfolio rebalancing between 2001 and 2007 explained the large losses in some countries.

Nevertheless, long-term pension fund performance was still very positive, according to Ross Jones, president of the International Organisation of Pension Supervision (IOPS) and deputy chairman of the Australian Prudential Regulation Authority (APRA). He told the conference that IOPS members had responded to the crises by intensifying reporting and stress testing, avoiding pro-cyclical behaviour by submitting recovery plans, and returning to minimum funding levels. Other responses included lengthening and increasing the flexibility on timing of annuity purchases, intensifying communication with supervisory organisations in other financial sectors and liaising with the industry.

In Australia the main impact on pension funds involved liquidity issues such as exposure to unlisted illiquid assets and frozen underlying investment options. In addition, voluntary contribution flows declined for some funds. In response the APRA targeted liquidity practices and the status of illiquid investments in superannuation funds, providing relief from the 30-day rule for portability requests where investments were in frozen assets. There were also specialist risk areas where the APRA was increasing its focus on liquidity management, Jones added. The crises had also hit DB fund solvency levels, which had deteriorated to the point where some funds were in technical insolvency situations, he said.

In addition, the valuation of unlisted assets had had an impact on funds with significant holdings in those assets. The APRA was closely monitoring solvency levels and was reminding trustees of their responsibilities to ensure reliable valuations, he noted. Many central and eastern European countries were in much worse shape than Australia, although not quite at the level of the Icelandic scenario. As a result governments, such as those of Romania, Latvia and Lithuania, had passed laws to reduce contributions in second pillar funds to help shore up the state budget.

More recently, the Lithuanian government had discussed allowing participants to opt out of second pillar funds and considered further reducing second pillar contributions from 3% of a salary to 2% for two years. The proposals were part of an economic crisis plan intended to save LTL5.3bn (€1.53bn) to offset a 2009 budget deficit of LTL1bn, or 4% of GDP. The package included raising taxes and cutting budget expenditure to support the budget as revenues fell.

Critics, such as the IMF, had claimed that the move indicated a breach of contract with society and that such changes could become permanent.

Saulius Racevicius, head of Lithuania’s Investment Management Companies Association, said that another issue of concern in addition to the problems of second pillar financing and the sustainability of fiscal policies, was that the EU did not seem to recognise the differences in the new member countries, further adding to the burden on the pension funds.

Argentina had gone even further than the CEE countries, with the government that took power in 2000 increasing pressure on pension funds and then nationalising them last year.

David Tuesta, chief economist of global trends unit in the economic research department of multinational Spanish banking group BBVA, said the reason for the Argentinian changes were political rather than the current global crisis. “Even assuming a relatively favourable macroeconomic and institutional scenario, expenses will increase in the following decades as a result of the ageing process,” he said.

“The system will register a shortfall in 2014 and wipe out all funds transferred to pension funds in 2026.”

He noted that at present values the imbalance by 2050 would reach 29 points of the current GDP and he warned that other emerging countries should take into account this fiscal burden if they considered following the Argentinian example.
No central and eastern European countries were members of the EU when they embarked on their journey towards pension reform a decade ago. However, most were eyeing accession and many have since joined.

When designing their new pension systems most opted for the World Bank three-pillar model, adding a mandatory second pillar and voluntary third pillar to a reformed first, or state, pillar. And initially most introduced fairly prescriptive, quantitative investment regulations as opposed to the prudent man rules advocated both by the EU and IOPS. However, with a few exceptions these restrictions have gradually been relaxed.

While in general Anglo-Saxon jurisdictions have adopted prudent person rules with varying content and some limitations, and most other OECD countries also use the prudent person rule, although many with some limits, non-OECD and developing countries tend to have more restrictions. Even the relatively mature systems of Latin America retain significant limitations on investments and fund choice.

The approach varied from country to country because of differing local factors, such as financial crises, pre-existing legal framework, trust in financial institutions and the financial sophistication of the population and policymakers.

According to EU rules, the free movement of capital includes direct and portfolio investments. However, while exceptions were not explicitly stipulated they have been established by case law.

Klaus Ossman, an economic analyst at the European Commission’s internal market directorate general, told the conference that economic reasons were not sufficient to warrant exceptions and the measures and procedures referred to in the exceptions should not constitute a means of arbitrary or disguised restriction on the free movement of capital and payments, as defined in Article 56 of the EU Treaty. He further explained that the treaty
freedoms should fulfil four conditions: be applied in a non-discriminatory manner; be justified by prudential supervision or imperative requirements in the general interest, not economic reasons; be suitable for attaining the objective pursued; and not go beyond what was necessary in order to attain it.

The European Commission was the ‘Guardian of the Treaty’ and in case of infringement of the treaty it could launch infringement procedures against member states, leading to a ruling by the European Court of Justice, Ossman noted.

He added that there were also European Commission secondary laws, such as the EU insurance directives, IORP directive and Solvency II. IORP investment rules stipulated the use of the prudent person principle, which required investment in the best interest of members and beneficiaries to ensure the security, quality, liquidity and profitability of the portfolio. Despite some prescriptive measures, such as those on diversification, the IORP directive did not advocate quantitative investment restriction, nor did the life assurance directive.

In general, pension funds fell under the IORP directive. But many schemes in the new member states were defined as being part of the social security system and therefore not part of the IORP directive. Ossman said that the less the state was a stakeholder in the scheme the more likely it was that EU treaty freedoms would apply. “In our view, even DC schemes that are part of social security fall under the treaty if there is economic activity with private operators and the beneficiaries own the funds, and where state guarantees are only exceptionally relevant,” he said. “The state is not a sponsor it only provides a framework, and therefore treaty rules apply.”

In a recent study, the Commission found that there were numerous cross-border investment restrictions within government reserve funds and funded statutory DC schemes. Restrictions included requirements to invest in certain assets such as government bonds, obligations to invest in certain countries, and other discriminatory provisions and regulations such as higher fees for foreign assets.

Croatia, which is not yet an EU member, introduced its new pension system in 2002 and the pension funds in the second pillar are treated as part of the social security system. As such they were subject to many quantitative investment limits and a strong home-country bias. And the country’s third pillar voluntary funds are also subject to limits, according to Petar Vlaic, head of the Croatian Association of Pension Funds Management Companies and Pension Insurance Companies. He said that within set limits the prudent person rule applies but some of the current limits are causing problems.

“Croatian pension funds have a strict limit on the market cap of companies they can invest in, both domestically and abroad, and because of the financial crisis many companies have fallen below the limit,” he said. “[This] would have resulted in forced selling by pension funds, which again would have exacerbated the financial trouble, had the regulator not relaxed the rules. However, the fear of forced selling remains and may result in further price slumps.” He added the hope was that after Croatia joined the EU the investment limits between Croatia and EU countries would be equalised.

But there are two sides to the story and there are also perfectly logical reasons why investment restrictions apply. Darren McShane, head of the Manda-
tory Provident Fund Schemes Authority in Hong Kong, pointed out that restrictions were a reaction to a general fear of loss. Governments had a desire to minimise or eliminate non-investment risks, such as counterparty, credit or liquidity risks, and governments also wanted to manage the development of financial markets and ensure at least a minimum size of the pool of retirement savings.

“Limiting investment risk may constrain investment returns in the long run but the risk for a government is a high dispersion of individual returns, for example if DC schemes perform badly more people have to rely on the state funds” he said. “Therefore, speculative risk taking can be left for the third pillar savings.”

An MPF scheme had both a general prudence requirement and numerous specific restrictions but there were no rules regarding the types or number of funds to offer, except capital preservation funds, default fund choice or the approach to investment risk.

McShane said that a problem with the Hong Kong approach was that it was rules-based and therefore sometimes hard to interpret, as in the case of hedge funds or structured products. And using the comparison of fitting square pegs into round holes, he noted that the rules focused on legal form that did not correspond to investment outcomes. The rules were also unclear on the interaction between rules and general duty requirements, and there were inconsistent policy rationales for different requirements in addition to frequent amendments in order to keep up with market developments. Offering a market participant view on investment restrictions, Istvan Hamecz, head of OTP Fund Management, the largest fund management company in Hungary, said adverse restrictions hindered pension fund performance and consequently it was a problem to have limits.

In recent years the Hungarian authorities have made two significant regulatory changes. First, they cut management fees to 0.8% from 1.2-1.5%. In addition, funds were required to offer diversified portfolios with conservative, balanced and growth strategies. Hamecz said 80% of mandatory fund participants selected growth options that could not invest any less than 40% in equities. Other restrictions in the Hungarian system included a prohibition of the use of derivatives or exchange traded funds.

Ossman noted that rules were not intended to give an optimal asset allocation, just a framework for it because someone has to make the ultimate asset allocation decision. He added that even within the prudent man rule there were restrictions.

Raymond Maurer, a professor at the Goethe University in Frankfurt, said that Hungary’s practice of having a minimum requirement on equity investments was unusual because most countries have caps. He added that once there was a private pension system in place such funds should be allowed to invest in real assets rather than be forced to adopt a specific asset allocation or invest in specified assets.

“In a recent study, the Commission found that there were numerous cross border investment restrictions within government reserve funds and and funded statutory DC schemes”
Supervising the pension providers

Like the funds they monitor, CEE regulators are starting from scratch. Pirkko Juntunen outlines the advice they were given.

In years to come an increasing proportion of pension assets will come from DC funds. As more countries move to DC pension systems, the burden on supervisory authorities will increase. In funds where the investor bears the investment risk there is an increasing need for information and education, not only for fund selection but also on how to manage the assets in the payout phase.

Supervision of DC pensions took several forms but many of the challenges are the same, the conference was told.

John Ashcroft, an independent consultant and the former president of the IOPS, said that supervisors’ objectives should be clear and they should know what they wish to achieve, identify and focus on the most important risks, choose the right instrument to mitigate the risk proportionately and take the supervised industry on board. “Otherwise a lot of energy will be spent with little outcome,” he said.

National laws should assign clear and explicit objectives to pension supervisory authorities as they were needed to enable focus on what is most important. Directional objectives were also needed and they were unlikely to be in legislation. “You cannot keep changing these if circumstances change,” Ashcroft said. The ultimate objective for supervisory authorities was to change or reinforce behaviour, which implied that approaches that were flexible and purposive rather than prescriptive would work best.

“The regulator does not give anyone a pension; the industry does that and regulators can only regulate behaviour,” Ashcroft noted. Supervisors should also seek to mitigate the greatest risks to the pension system and had to decide what these were and
where to focus resources. In addition, supervisors should ensure that investigatory and enforcement requirements were proportionate to the risks being mitigated, which should be natural if the supervisor had clear objectives and evidence-based risk orientation.

This related to using resources in areas where there was a substantial probability of a high impact, as in cases where members chose the wrong funds for their circumstances, were getting poor value for money or in the area of annuities. In such instances supervisors needed to focus on intervention. However, in incidents with low impact and low probability, such as inadvertent breaches of legislation, the supervisor should rely on the supervised entities themselves, Ashcroft said.

He also stressed that transparency was key because pension funds and their advisers would only change if they knew what was expected of them. “It is vital to put a huge effort into communication because this is as important as inspection,” he said. Because the supervisory authorities had to win over hearts and minds they also needed to explain what behaviour was expected of supervised entities, where they saw the problems, how they intended to respond and how they had taken the industry’s views into account, because the industry often knew better than the supervisors what were the main issues.

Solange Berstein, the superintendent of pension funds administrators in Chile, said: “Of all the IOPS principles on pension fund supervision, the most important is risk orientation when it comes to DC funds.” She agreed with Ashcroft that pension supervision should seek to mitigate the greatest potential risks to the pension system and therefore the objectives of the supervision should be risk-based. “In the case of DC it is harder to quantify risk, whereas with DB the focus is on funding, and the focus has to be on the process not returns as well as risk management and governance,” she said.

Berstein explained that Chile was

“The ultimate objective for supervisory authorities was to change or reinforce behaviour, which implied that approaches that were flexible and purposive rather than prescriptive would work best”
currently moving from compliance-based to risk-based supervision. There was a need for preventive measures and improved resource allocation as well as a comprehensive and consistent view of entities’ performance.

Risk-based supervision started with gaining knowledge through information gathering and analysis, on-site visits and integrated information systems. The next step was the assessment level where supervisors analysed owners and corporate governance, management, fiduciary duty, compliance, internal controls and risk management. The last phase was follow-ups, with on-site inspections and action plans as well as periodic meetings with executive board directors, but also included intervention in specific cases of insolvency.

Berstein said that the process was effective because of its comprehensiveness, preventive aspect and because it was oriented to the quality of the process, which was continuous and also conducted jointly with the supervised entities, making follow-ups of compliance with agreements easier. In addition, there was accountability because of responsible corporate governance.

The process was also efficient because there was a focus on supervisory resources with categorisation of risks where larger resources were assigned where bigger risks and impacts were detected.

Some central and eastern European countries faced second pillar funding challenges as a result of governments changing existing rules in the wake of the global financial and economic crises. In recent months several governments had reduced contributions in an attempt to cut budget deficits. This in turn increased pressure on supervisors because as a result it seemed that the interests of the state and of the pension fund members were not in balance.

Romania had very strict legislation and clear restrictions regarding what investment categories pension funds could use, what investment limits were on specific asset classes, how contributions were converted into pension fund units and the valuation of these units, the conference heard. The legislation also applied to the maintaining of investments within not only the legal limits, but also within limits imposed by the pension fund prospectuses.
In addition, legislation was strict on the guarantees offered in the second pillar, the so-called nominal capital preservation guarantees, as well as market-relative guarantees for both second and third pillar pension funds.

Romanian Pension Fund Association secretary general Mihai Bobocea said that the most recent challenge for the pension fund industry had been the government’s decision to freeze second pillar contributions this year, instead of increasing the level to 2.5% of a salary as initially intended when the system became operational in 2007.

Bobocea said the measure was intended to shave €1.1bn from the pension funds until 2017, and he added he was concerned that other populist measures would be imposed. Trade unions had previously attempted to introduce an annual inflation guarantee on second pillar fund performance, but this had been rejected by parliament.

In the event, on the advice of the IMF and the European Commission the government moderated its initiative, imposing the cut but agreeing to return to the initial contribution calendar so that contributions would reach 6% in 2017 as planned but with smaller-than-planned increases in 2009 and 2010 and a recovery in 2011. This would keep losses at around €180m.

Similar moves had also been made by the Latvian and Lithuanian governments and may be expected in other countries as the financial downturn continued.

Changes imposed by governments were going against the original ideas and principles of the reforms. The IMF and the World Bank had criticised them as a breach of contract made with society. And in the case of Romania and other EU members it would seem that it also is also contrary to EU legislation, although Bobocea said they were still waiting for a clarification from the EU on the matter.

Berstein, said that it was precisely the problem with supervising a mandatory system because while members’ interests needed to be safeguarded so too did the interests of the state because of the potential impact on fiscal and budgetary policies. She said that flexibility was needed as systems evolved to ensure that both sets of interests could be satisfied without too heavy a burden for either.
Bulgaria introduced a new pension law in 2000, reforming its first pillar and launching the second pillar of the pension system made up of two types of supplementary mandatory funds – universal pension funds (UPFs) and professional pension funds (PPFs). Statutorily, the third pillar of the system was set up in 1999 with the passing of a new Law on Supplementary Voluntary Retirement Provision. Pillar three consists of supplementary voluntary pension funds. However, private voluntary pension funds predated the reform and have existed since 1994, making Bulgaria a frontrunner in offering this type of product. All second and third pillar pension funds are administered by joint stock retirement provision companies. Each company is allowed to manage one of each type of supplementary funds.

Since the start of the new system the retirement age under the public state pension scheme has been gradually increased, and from the beginning of 2009 stands at 63 for men and 60 for women.

Professional pension funds (PPFs), which are targeted at individuals working in specified hazardous environments, were launched in 2000. Participation in these funds enables the workers to take early retirement. PPFs make payments until participants reach normal retirement age. PPFs are fully funded DC schemes with individual capitalisation accounts into which only employers contribute between 7% (category II workers) and 12% (category I workers) of a salary depending on the occupation.

Until the end of 2009, slightly more favourable retirement conditions will apply to those with long service periods and individuals may choose to receive benefits from the public social security pension fund or from an occupational pension fund. After 1 January 2010 benefits will be paid by occupational pension funds only. Contributions to occupational funds and investment income are tax-exempt.

At the end of 2008 there were nine PPFs with some 221,000 participants and assets of BGN367m (€187.6m). The largest players are Doverie, with 37.5% of assets under management and 34% of members, Allianz Bulgaria, 20% and 16.4%, and Saglasie, 17.8% and 16.3%.

UPFs are also fully funded DC schemes with individual capitalisation accounts. They became operational in 2002. The funds provide retirement benefits to all employees regardless of job category, including the self-employed. Participation is compulsory for all workers born in and after 31 December 1959.

Since the beginning of 2007 the UPF contribution level has been 5% of a salary, whereas the system started in 2002 with a 2% contribution rate. The UPF contribution is divided between employers/sponsors and employees.

Bulgaria has a separate early retirement pension fund arrangement for workers in specified hazardous environments, says Pirkko Juntunen.
whereas in 2000-2001 it was 80:20. In 2009, the aggregate first and second pillar contribution rate is 18% of a salary and the UPF contributions are collected with the state scheme social security payments and then redirected to an employee’s chosen private pension fund management company.

The self-employed must pay the entire 5% contribution themselves. Additional voluntary contributions to these funds are not permitted. UPFs provide only supplementary life-long pensions. Early retirement is allowed from five years before the ordinary retirement age provided the participant has accrued an amount of pension benefits equal or superior to the minimum old age pension provided by the first pillar. Taxation for UPFs is the same as for the PPFs.

The regulator is the Financial Supervision Commission (KFN) (www.fsc.bg). The trade association is the Bulgarian Association of Supplementary Pension Security Companies (BASPSC) (www.assoc.pension.bg).

Both types of Pillar II funds are administered by licensed pension fund managing companies, which are subject to a minimum capital requirement of €2.5m and to certain investment restrictions. In addition, the funds must achieve a minimum investment return set quarterly by the KFN for the respective preceding a 24-month period. Currently it is -6.98% for UPFs and -8.51% for PPFs.

In the third quarter of 2008 a fund managed by the second smallest pension fund company, Future, became the first Bulgarian pension fund to fail to generate the KFN-set minimum rate of return since inception of the three-pillar system. In line with the legal requirements, the company was obliged to make up the difference from its own assets.

Since 2005, UPFs and PPFs must have a board of trustees, which represents the interests of members and employers and acts as an advisory board. The fund and the managing company are separate entities. There were 10 UPFs offering mandatory pensions to 2.8m participants with assets of BGN1.5bn at the end of 2008. Doverie was again the largest player with 604,000 participants with assets totalling BGN482m. Allianz Bulgaria held more than 50% of the market in terms of assets and 42% of members.

On 1 January 2007, in compliance with the EU directives, Bulgaria introduced Voluntary Pension Funds Under Occupational Schemes (VPFOS) in Pillar III of the pension system, participation in which is governed by collective bargaining agreements or collective contracts between a sponsoring undertaking and a member.

They provide company-based pensions to participants at age 60 in accordance with the rules stipulated in a collective bargaining agreement or a collective employment contract. Benefits are taxed identically to the other types of voluntary pension funds. No minimum investment return rate has been set for the VPFs or VPFOS.

### The third pillar

Voluntary pension funds (VPFs), introduced as early as 1994, are also fully funded DC schemes with individual capitalisation accounts. Participation in them is based on a contract between an individual and a pension fund managing company that administers the respective pension fund and is a separate legal entity. Members can choose their managing company, but they still have no individual portfolio choice.

Participation is open to all those aged 16 and over. Contribution levels are determined in a contract between the pension fund managing company and the contributor and there are no legal limits.

Both workers and employers or other sponsors may contribute to these funds. A person may participate in more than one voluntary fund. VPF participants are allowed to transfer their balances to another fund of the same type not more than once within a calendar year. Upon retirement, voluntary pension fund participants are entitled to a personal old age retirement benefit (life-long or limited-period), disability benefit, survivor’s pension for the dependents, lump-sum or programmed withdrawal of the accumulated individual account balance. Employers and members enjoy the statutory preferential taxation; the retire-

| Timeline | 1994 | Voluntary Pensions Schemes (VPS) introduced. |
| 2000 | New pension law comes into force. |
| 2001-2002 | Two-types of mandatory second pillar funds becomes operational: universal pension funds (UPFs) and professional pension funds (PPFs). |
| 2005 | Boards of trustees are appointed for UPFs and PPFs. |
| 2007 | Voluntary pension funds under occupational schemes (VPFOS) are introduced. |
| 2009 | The retirement age reached 63 for men and 60 for women. Introduction of a multifunds system and lifestyling is planned for third pillar funds. |

Source: Financial Supervision Commission

Looking ahead

Last year the government agreed to implement KFN proposals to allow different risk levels (multifunds system) in third pillar funds and ease to a certain extent the investment restrictions for second pillar funds. The implementation of these changes is planned for 2010. VPFs will offer three types of investment portfolios with different risk profile – aggressive, balanced and conservative. The high-risk option will be able to invest up to 80% of assets in equities, while the equity cap for the balanced portfolio is 50% and for the conservative portfolio 15%. The plans also suggest changes to the investment laws for mandatory pension schemes, proposing an increase in the cap on equity investments from 20-25% and on corporate bond investments from 25-40%.
Croatia began its reform process in 1995 by instituting changes to the first pillar PAYG system that was financed by contributions and state budget revenues. In 1998 it was transformed into a defined benefit system based on points and in 2002 a mandatory second pillar and voluntary third pillar were introduced.

The low retirement ages of 60 for men and 55 for women were partly responsible for fiscal imbalances in the pension system, and a process of raising the retirement age by six months a year started in 2000 to reach 65 for men and 60 for women in 2008.

First-pillar contributions are exempt from taxation, while benefits are taxed. Similarly, second and third pillar contributions and investment income are exempt from taxation but benefits are taxed.

The second pillar is mandatory for individuals aged under 40 at the time the reform was implemented in 2004, those aged between 40 and 50 could choose either the first or second pillar while those over 50 remained in the first pillar. Contributions into the first and second pillars are a combined 20% of gross salary. Of this 5% of a second pillar participant’s gross salary is paid into an individual account.

At the end of March 2009 the compulsory pension funds had 1.49m members and combined with the third-pillar funds there were 1.64m participants in the system. Total assets of the mandatory funds stood at HRK23.6bn (€3.2bn) at the end of March.

The second-pillar mandatory funds are seen as part of the social security system and so operate under several quantitative limits. The Croatian Financial Services Supervisory Agency (Hanfa) (www.hanfa.hr) was established as a new regulatory and supervisory institution for the pension system in 2005. Similarly, the Central Registry of Affiliates (Regos) (www.regos.hr) was established in 1999 to administer affiliation, switching, reporting, collection and account services for second pillar members.

The government is reassessing the reform for budgetary reasons, says Pirkko Juntunen.

Funds must invest a minimum of 50% of their assets in Croatian government securities and a ceiling of 30% is put on foreign investments, which must be listed on an official EU or OECD country exchange with a credit rating the same or above Croatia and have a market cap of over €300m. Up to 30% of assets can be invested in domestic and foreign shares, with a maximum of 10% in a single Croatian company. A holding of 5% in a local company must not be above 15% of a pension fund’s total assets.

Pension funds cannot invest in Croatian companies with a market cap below €100m, although a post-trade fall to €87m is acceptable but the holding must be liquidated if the market cap goes below €80m. This restriction has been temporarily waived to avoid further damage to companies in the current market conditions.

Up to 10% of assets can be held in term deposits with Croatian and EU banks, but no more than 2.5% with a

Croatian mandatory pension fund asset allocation (domestic assets as %)

<table>
<thead>
<tr>
<th>Year</th>
<th>Government bonds</th>
<th>Shares and GDRs</th>
<th>Corporate bonds</th>
<th>Open end funds</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>78.5</td>
<td>15.4</td>
<td>3.3</td>
<td>7.9</td>
<td>1.3</td>
</tr>
<tr>
<td>2007</td>
<td>66.5</td>
<td>15.4</td>
<td>3.3</td>
<td>7.9</td>
<td>1.3</td>
</tr>
<tr>
<td>2008</td>
<td>78.1</td>
<td>15.4</td>
<td>3.3</td>
<td>7.9</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Total domestic assets in thousands (HRK)

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>14,588,033</td>
<td>20,297,532</td>
<td>20,920,792</td>
</tr>
</tbody>
</table>

Source: Hanfa
single bank, or in short-term certificates of deposits of up to one year. Up to 30% of assets can be invested in corporate bonds, municipal bonds and bonds issued by the local authorities. The secondary market is totally illiquid as was the case even before the crisis when bid/ask spreads were very wide, with the only traders in the secondary market being the underwriters. A ceiling of 30% has been put on investments in open-ended investment funds and in shares of closed investment funds listed in Croatia, EU and OECD members. Up to 5% of assets can be invested in a single fund of a single management company and net asset value must be above €100m for foreign funds and HRK100m for domestic funds. A pension fund’s share of an investment fund cannot exceed 20% of NAV.

Some 2% of total assets can be invested in private equity. Derivatives can only be used for hedging purposes via futures, options and FX forward contracts. However, only FX forward contracts are permitted without precise rules set by Hagena. Similarly, capital-guaranteed products are allowed by law but additional regulation is needed for their use. Investments in hedge funds and direct real estate are not permitted. Buying securities issued by related parties is also strictly prohibited. At the end of March 2009, 93.2% of assets were invested in Croatia and only 6.8% internationally.

Pension fund asset managers have to guarantee a certain return for their investments. The amount depends on the average performance of the funds. This has fostered a herd mentality and similar asset allocations throughout the system.

The outlook
In response to the global crises and as part of wide-ranging efforts to curb the budget deficit in February 2009 prime minister Ivo Sanader said he was considering making it possible for individuals to switch their pension insurance contributions back into the first pillar or state pay-as-you-go system. Additionally, deputy premier Damir Polancec and finance minister Ivan Suker were instructed to draft amendments to the Pension Insurance Act. They have argued it is time to change the parts of the reform that are not sustainable in the long run.

The third pillar
The third, voluntary pension, pillar started in March 2002. It offered two options: individuals can either save in so-called open funds that are open to all or via occupational pension funds that are sponsored by individual companies. To encourage participation the government matches 25% of the contributions made to an individual’s account up to an annual contribution ceiling of HRK5,000. Individuals are also granted tax relief on contributions of up to HRK12,000 a year.

Third-pillar benefits are taxed as regular income under the income tax law. Benefits can be collected once an individual retires from the mandated schemes or upon reaching age 50. They can be paid as an annuity, a scheduled withdrawal, or a lump-sum (which cannot exceed 30% of the account balance).

Funds cannot be withdrawn before an individual reaches age 50, except if the individual dies or becomes disabled. At the end of March 2009, the third pillar had 132,750 members and HRK905m in assets, of which 89% where invested domestically.
Unlike most other CEE countries, the Czech Republic has not introduced a mandatory second pillar, so its private pension system is restricted to a voluntary third pillar.

Czech private pensions, known as supplementary pensions insurance funds, were introduced as legal entities in 1995 as part of the previous year’s radical overhaul of the retirement system. This included an incremental raising of the pensionable age from 60 to 63 for men as of 2013 and 59-63 years for women, depending on the number of children they have. Prior to 1994 the only source of retirement benefits additional to the state pension came from private insurance.

The supplementary pension funds were open to all aged over 18 who wished to participate.

Although the government provided a small, degressive state subsidy, there was no tax relief, few employers opted to contribute and overall take-up remained low, except among older members: the 1994 Act allowed members to start taking benefits at age 50 with a minimum insurance period of 12 months, thus acting as a form of state-subsidised saving late in working life.

In 1999 the government introduced tax relief on employee contributions and raised the subsidy by 25%. Employers also received tax relief, while their contribution was no longer counted as part of the employee’s taxable wage base. The increased subsidy only applied to schemes that extended the age of qualification for retirement payouts. The state contribution was also no longer applied to employer contributions.

The net effect was to dramatically increase the number of new participants, from around 8,000 a month in 1994-96 to 46,000 in 1999-2000.

From 2004 non-Czech EU citizens have been able to become members. By the end of 2008 the number of participants totalled 4.3m, equivalent to 60% of the eligible workforce.

Meanwhile, the share of employers who contribute to their workers’ pension schemes has grown to around a quarter. However, the age profile of pension fund members has remained on the high side, with those aged above 50 accounting for almost 50% of membership.

Under new legislation passed in 2007, employers’ contributions are subject to relief from personal and corporate tax and social security contributions up to a maximum annual CZK24,000 of combined pensions and life insurance payments. However, life insurance agreements, unlike pensions, do not qualify for a state contribution, which in effect accounts for the absence of any significant occupational schemes outside the supplementary pensions systems. Tax relief, meanwhile, has in-

### Czech Supplementary Pension Fund investment portfolio breakdown (%)

<table>
<thead>
<tr>
<th>Category</th>
<th>End-Dec 2006</th>
<th>End-Dec 2007</th>
<th>End-Dec 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>77.2%</td>
<td>73.7%</td>
<td>78.8%</td>
</tr>
<tr>
<td>Unit certificates</td>
<td>4.7%</td>
<td>3.5%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Real estate</td>
<td>0.7%</td>
<td>0.7%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Cash in banks and term deposits</td>
<td>9.7%</td>
<td>9.9%</td>
<td>9.6%</td>
</tr>
<tr>
<td>Shares</td>
<td>3.4%</td>
<td>3.1%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Treasury bills</td>
<td>5.9%</td>
<td>3.9%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Others</td>
<td>1.2%</td>
<td>0.9%</td>
<td>0.9%</td>
</tr>
</tbody>
</table>

Source: Association of Pension Funds of the Czech Republic
increased the number of participating employers from around 20% of occupational plans before 1999 to 25% as of 2009. Investment returns on employee contributions and pensions benefits are taxed at 15%.

In its early days the system was noted for the many funds that set up: 46 have been registered at one time or another. Since then there has been extensive consolidation, leaving only 10 as of April 2009. From 2009 pension fund companies were banned from offering any incentives to clients to switch to their fund.

The finance ministry was, through various agencies, in charge of the pensions industry until April 2006 when the Czech National Bank (CNB) (www.cnb.cz) took over as the country's pan-financial regulator. The trade association is the Association of Pension Funds of the Czech Republic (APF CR) (www.apfcr.cz), which was established in June 1996. All 10 licensed funds are members.

Investment
Initially the funds were barred from investing in any foreign securities. This rule was relaxed in 2001 to allow funds to buy OECD securities. However, a minimum 70% of assets must be invested in assets of the currency in which the plan holders’ liabilities are denominated. Current investment regulations include a maximum 10% (or CZK20m) of deposits in any single bank, 10% of securities by a single issuer, 20% of securities constituting the nominal value of a single issuer, and a 70% limit on non-fixed income securities.

The funds can also invest up to 10% in real estate, although only one, AXA, does so to a significant extent. Investment policy has always been highly conservative, with bonds typically accounting for around three quarters of the portfolio, while the equity share was always small. In 2008 funds became even more risk averse, with bonds accounting for 79% of average fund investment from 74% in 2007, cash and bank deposits 10.0% and equities 3% (from 6% a year earlier), while the share of foreign securities share fell from 11% to 8%.

Guaranteed return
Pension funds are obliged to deposit a minimum 5% of profit into a reserve fund and can distribute a maximum 10% of profit among shareholders, with the remainder accruing to plan holders. One of the key features of the system is that shareholders must make up any loss in a pension fund’s annual performance from the reserve fund and previous years’ undistributed profits, or if these prove insufficient, by reducing the share capital.

The guaranteed return came into play in 2008 when a number of funds recorded losses and made up the balance largely from their own capital. Despite the fact that on average the funds returned close to zero in 2008, the number of members has continued to grow.

Proposed changes
Although politicians have failed to agree on a World Bank-style second pillar, the government approved significant changes to the existing system in April 2009. For the first pillar there was an extension to the minimum retirement age, which

<table>
<thead>
<tr>
<th>Monthly supplementary pension fund state contributions (CZK)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participant contribution</td>
</tr>
<tr>
<td>--------------------------</td>
</tr>
<tr>
<td>100-199</td>
</tr>
<tr>
<td>200-299</td>
</tr>
<tr>
<td>300-399</td>
</tr>
<tr>
<td>400-499</td>
</tr>
<tr>
<td>500 and above</td>
</tr>
</tbody>
</table>

Source: APF CR

Timeline
1994 State Contributory Supplementary Act, to take effect the following year, provides for supplementary pensions insurance funds, with state contributions.
1999 Amendments to Act raise state contribution and introduce tax relief on employee and employer contributions.
2001 Investment regulations eased to allow purchase of OECD securities by pension fund companies.
2003 EU members permitted to join supplementary pension insurance funds.

Source: APF CR

is now set to rise to 65 years for men and for women with no child or one child, by 2030.

The third-pillar proposals include separating the assets of members and pension companies, and introducing a multi-fund, lifecycle system with funds of different risk profiles tailored for different age groups. Those with a heavier weighting in equities would be aimed at younger members, while risk-averse, investment grade bond weighted schemes would offer capital protection for members approaching retirement. The new system would still attract tax relief and state contributions, but critically would no longer offer yearly guarantees of a positive return.

The proposals envisage the old system closing to new members but running alongside the new for a number of years until its members retire or switch.

The pension funds industry argues that younger members would be inclined to switch because of potentially higher returns. At present the guaranteed return forces pension funds to adopt a conservative, thus low-yielding, investment profile. The industry has generally been positive about the proposals, although it wants to see more details about the co-existence of the new and old funds.

However, the timing of the proposed legislation has been unfortunate. The government responsible for the proposals fell in March and although the pensions change has been relatively uncontroversial, a new government formed after the October 2009 general election could make changes. In any case, the reformed system is not expected to be in place before 2011.
The road to pension reform began in earnest in 1997 when
the prime minister of a then newly elected government ap-
pointed a social security reform commission to reform the
pension system inherited from the Soviet era.

The commission’s proposal broadened the debate to in-
clude the sustainability and financing of the country’s pension
system for the future rather than just focusing on cur-
rent pensioners.

The introduction of a second pillar was scheduled for 2001,
as it was deemed prudent to first reform the existing first pil-
lar system before creating the framework for a voluntary third
pillar and later adding a second pillar. A draft Pension Act was
presented to parliament in April 2001, adopted in September
and came into effect in 2002.

Although the Estonian reform has many similarities to those
of other countries, following the three-pillar-pension system
with a state PAYG scheme supplemented by two private pil-
lars, the way the second pillar was introduced differed from
most. In the Estonian model contributions increased following
a reform.

The former first pillar contribution was 20% of a gross wage, paid by employers only. After
the reform this was divided between the first and the new second pillar, in effect redirecting
contributions to the second pillar from the first, at a new rate of 16+4+2.

The first pillar contributions were reduced to
16% of a salary. Members of the second pil-
lar have to contribute 2% of their gross wage, which is supplemented by 4% paid by the state.

Entry into the second pillar was mandatory
for those born before 1983 and those aged
over 60 could not join. Participation was vol-
untary for all others. Despite the extra con-
tribution required the number of participants has steadily increased, and seven years af-
after the reform some 584,649 people out of
a population of 1.3m participate and have amassed €750m in the system.

The success of the reform is ascribed to
the fact that it was sold on people receiving
4% ‘for free’ and that joining it was flexible,
being open until 2010 for new members.

Another factor was the use of the internet
for information distribution. A special web-
site, www.pensionikeskus.ee, was set up by the Central Depository for Se-
curities to give in-
formation on the pension system.

Another success factor was the tim-
ing of the reform. It came after finan-
cial crises of the late 1990s and long enough after the transition from the
Soviet-era financial system for Estonia’s financial sector to have consolidated and addressed the problems of the early years of independence.

In 2002 six pension fund managers were licensed by
the financial supervisory authority, the Finansinspektioon, (www.fi.ee). They were affiliated with the country’s larg-

<table>
<thead>
<tr>
<th>Estonia’s second pillar funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ergo</td>
</tr>
<tr>
<td>LHV-Seesam Asset Management</td>
</tr>
<tr>
<td>Nordea Pension</td>
</tr>
<tr>
<td>Sampo Pension</td>
</tr>
<tr>
<td>SEB</td>
</tr>
<tr>
<td>Swedbank</td>
</tr>
</tbody>
</table>

Source: Pensionikeskus

<table>
<thead>
<tr>
<th>Estonian pension asset management company average portfolio breakdown (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money market instruments 4</td>
</tr>
<tr>
<td>Term deposits 10</td>
</tr>
<tr>
<td>Other bonds 29</td>
</tr>
<tr>
<td>Units of other equity funds 22</td>
</tr>
<tr>
<td>Units of other investment funds 20</td>
</tr>
<tr>
<td>Other assets 1</td>
</tr>
<tr>
<td>Equities 6</td>
</tr>
<tr>
<td>Listed shares 10</td>
</tr>
<tr>
<td>Term deposits 10</td>
</tr>
<tr>
<td>Other bonds 29</td>
</tr>
<tr>
<td>Units of other equity funds 22</td>
</tr>
<tr>
<td>Units of other investment funds 20</td>
</tr>
<tr>
<td>Other assets 1</td>
</tr>
<tr>
<td>Equities 6</td>
</tr>
<tr>
<td>Listed shares 10</td>
</tr>
</tbody>
</table>

Source: Finance Ministry

Pension contributions for second pillar participants were augmented by an additional 4% from
the state, notes Pirkko Juntunen
The Estonian government has responded to the budget-losses. Looking ahead, the pension fund.

The second pillar funds generally offer three investment strategies, a lower risk (or conservative) fund that only invests in fixed income, a medium risk (or balanced) fund that can invest up to 25% in equities and a higher risk (or progressive) fund that may invest up to 50% in equities. More than 75% of assets are invested in the high-risk options.

At the end of 2007 the second pillar had 554,353 participants out of a labour force of 690,000 and the mandatory pension funds managed EEK11bn (€703m) in assets.

The Estonian reform imposed no restriction on investing internationally per se. Instead there is a currency-matching limit which states that investments denominated in currencies of countries outside the EU and OECD should not exceed 30% of total assets.

For geographical risk diversification a pension fund cannot invest more than 30% in one country. The equity risk exposure is limited to 50%, which also includes the units of mutual funds investing in equities. However, the finance ministry is considering a 70% limit.

Investments in money market instruments are allowed up to 35% and direct investments in real estate up to 10%, but no more than 2% in a single piece of real estate. The level of the management fees is determined by the finance ministry and range between 1.5% for fixed income funds and 2% for any other type of funds. A separate 1% for the net asset value is levied for redemptions, but there is no limit for entry fees. Since 2007 the topic of fees has come to the forefront because of falling equity markets. The finance ministry is considering reforming the triple-fee structure by removing the issuing fee to improve returns for pensioners and participants.

Estonia’s second pillar has very few explicit guarantees. There are no guarantees on absolute or relative rate of return, putting the investment risk on members. But pension fund management companies make contributions to a guarantee fund to meet damages claims against fund managers. The pension system’s architects wanted to build incentives into the process and so made a fund manager’s participation in his pension fund compulsory. It is deemed that the manager will be motivated to make reasonable investment decisions if it is financially linked to the pension fund.

Looking ahead

The Estonian government has responded to the budget-losses. Looking ahead, the pension fund.

| Timeline |
|------------------|------------------|
| 2001 | Pension Reform Act passed by parliament. |
| 2002 | Pension reform implemented and second pillar contributions start. |
| 2004 | Estonia joins the EU. |
| 2008 | Reforms to second pillar fee structure are contemplated as is increasing the allowance for foreign investments from 50% to 70%. |
| 2009 | Estonian government suspends contributions to the second pillar for two years. |

Source: Pensionikeskus

For geographical risk diversification a pension fund cannot invest more than 30% in one single country”

However, if the economy rebounds the government has promised to pay 6% over the next two years for those who opt to continue to contribute to their second pillar pensions. This measure is intended to save EEK1.6bn in 2009 and more than EEK3bn in 2010.

Third pillar

Participation in the voluntary third pillar can take two forms. Individuals can buy pension insurance policies offered by insurance companies or join a pension fund managed by pension fund managers. In both cases the pensionable age is decided between the person and the insurance company or fund manager but tax incentives apply only after the age of 55. Pensions can also be withdrawn in the event of total disability or permanent work incapacity.

Estonia’s taxation rules are favourable; contributions are tax deductible up to a limit of 15% of annual income. Benefits paid from private pensions are only taxed at 10% compared with the normal income tax level of 26% and benefits paid from a defined benefit-type insurance policy are not taxable. In the case of life-long annuities neither contributions nor benefits are taxed. This was the result of lobbying from the insurance industry when the legislation was implemented rather than being part of the original plan.

The volume of funds increased from EEK343m in 2006 to EEK1.1bn at the end of 2007, and the number of the clients rose from 25,107 to 42,000 during the same period.
Hungary led the central and east European region in its pension reform, passing a law on private pension provision in 1993 that created vehicles for private pension saving. This was followed by a 1997 law establishing a compulsory three-pillar pension system, based on an increasingly stretched state PAYG system, a second pillar of mandatory private pension funds and a third pillar consisting of voluntary private pension funds.

The new regime came into force on 1 January 1998, since when participation in the second pillar has been mandatory for career starters but voluntary for those already in the labour force at its inception.

Private pension funds are a *sui generis* legal association owned by their members who formally delegate responsibility for the fund’s management to a specialised asset manager. Typically, this asset manager is an established institutional player, whether a subsidiary of a bank or an insurer. Two examples of sectoral pension insurers are: Villamosenergiaipari Társaságok Nyugdíjpénztára (VITNyP), for employees of companies in the electricity generation and distribution sector, and Honvéd Önkéntes és Magánnyugdíjpénztár, the army pension fund.

Members must pay at least 8% of their gross income into a private pension fund, and they or their employer can opt to pay a further 2% of gross income into the fund tax free. A further 1.5% of gross income is paid into the state social security pillar. Members’ contributions are explicitly allocated to one of three reserves. The overwhelming majority – 95.5% – is allocated to the so-called cover reserve via their individual accounts, from which pay-outs will be made when the member retires. The remainder is allocated to a much smaller operational reserve, from which fund service costs are paid, including the management charge paid to the asset manager, and the final portion, typically less than 1%, is allocated to a liquidity reserve, which is designed to cover any other contingencies that may arise.

Members can exercise their ownership rights twice a year at a general assembly, at which, in theory, they can dismiss the fund’s manager and appoint a new one. New entrants can switch to another fund after six months, but there is a penalty charge equivalent to 1% of their assets in their fund.

**Investment**

Until 2008, funds were typically managed very cautiously, with high allocations to Hungarian state debt, mimicking their members’ low risk appetites. In response, legislation was introduced in 2007 requiring funds to offer three separate portfolios with different risk levels. The system was available to funds from 1 January 2008 and became compulsory on the first day of 2009.

### Average second pillar pension fund allocations in 2008 (%)

<table>
<thead>
<tr>
<th>Investment</th>
<th>Cash</th>
<th>Bonds</th>
<th>Mutual funds</th>
<th>Equities</th>
<th>Mortgages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>%</strong></td>
<td>1.7</td>
<td>57.8</td>
<td>24.4</td>
<td>12.6</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: *Stabilitás.*

Note: *When only some funds had introduced multiple portfolios*

### Hungarian average third pillar allocations in 2008 (%)

<table>
<thead>
<tr>
<th>Investment</th>
<th>Cash</th>
<th>Bonds</th>
<th>Mutual funds</th>
<th>Equities</th>
<th>Mortgages</th>
<th>Property</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>%</strong></td>
<td>2.96</td>
<td>70.37</td>
<td>14.21</td>
<td>6.95</td>
<td>4.98</td>
<td>0.54</td>
</tr>
</tbody>
</table>

Source: *Stabilitás*
But the timing was unfortunate, since funds that took the plunge early were badly affected by equity market turmoil in the final quarter of 2008.

The first option is a low-risk or ‘classic’ portfolio with an equity allocation of no more than 10%, no allocation to property or other alternatives and a maximum of 10% in unhedged foreign currency exposure. The second is a balanced portfolio with an equity allocation of 10-40%, a maximum allocation of 10% to property and 3% to private equity and no allocation to derivatives. The third is a growth portfolio with an equity allocation of more than 40%, a private equity exposure of up to 5% in total or 2% to an individual fund and an allocation of up to 5% to derivatives.

While members can choose which portfolio they prefer, few have done so and have gone along with age-based defaults. Those with more than 15 years to go before retirement enter the growth portfolio, those with between five and 15 years to go enter the balanced portfolio, while those with fewer than five years to go enter the low-risk ‘classic’ portfolio.

The regulator is the Hungarian Financial Supervisory Authority (PSZÁF) (www.pszaf.hu). The pension fund trade association is the Hungarian Association of Pension Funds, Stabilitás, (www.stabilitas.hu).

At the end of 2008, Hungary’s private pension funds had assets of HUF1,869.6bn (€6.7bn), up from HUF876.1bn in 2004.

Future changes
Stabilitás has expressed concern at government proposals to allow existing second pillar fund members to transfer their deposits back into the social security system on a tax-exempt basis. This move would help to fund Hungary’s high levels of public debt but is opposed by Stabilitás, which is concerned by the huge and negative impact it might have on funds’ assets under management.

Pay-out legislation, which would require pension funds to pay out members’ accumulated assets in the form of an annuity contract with an insurance company, is scheduled to be adopted in 2013.

Voluntary pension funds
Voluntary pension funds are organised on a similar basis to private pension funds. Payments are made by members or their employers into individual accounts, and the funds are technically owned by members, with management outsourced to asset management companies.

There is a substantial tax discount of 30% on contributions to a voluntary fund, up to a total of HUF100,000 a year, and payments can be made in a lump sum or as a regular contribution. The interest yield on deposits is tax-free. Withdrawals can be made at any time. However, to make a tax-free withdrawal, members must have left the sum on deposit for at least 10 years and must be at or above retirement age.

Investment regulations are the same as for private pension funds. A multiple portfolio system was introduced at the same time as for the second pillar.

At the end of 2008, voluntary pension funds had a total of HUF627.2m in assets.

---

<table>
<thead>
<tr>
<th>Sectoral pension insurers</th>
<th>Hungarian second pillar pension funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Honvéd Önkéntes és Magánnyugdíjpénztár</td>
<td>Aegon Magyarország Nyugdíjpénztár</td>
</tr>
<tr>
<td>Artisjus Kiegészítő Nyugdíjpénztár</td>
<td>Allianz Hungária Nyugdíjpénztár</td>
</tr>
<tr>
<td>Choinin Nyugdíjpénztár</td>
<td>Aranykor Nyugdíjpénztár</td>
</tr>
<tr>
<td>CIB Önkéntes Kölcsönös Nyugdíjpénztár</td>
<td>AXA Önkéntes és Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Dimenzió Magánnyugdíjpénztár</td>
<td>Budapest Országos Kötelező Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Elmű Nyugdíjpénztár</td>
<td>Dimenzió Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Első Hazai Nyugdíjpénztár</td>
<td>Erste Bank Országos Önkéntes és Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Mobilitás Nyugdíjpénztár</td>
<td>Életút Első Országos Önkéntes é Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Nyugdíbiztosítási Dolgozók Önkéntes Kiegészítő Nyugdíjpénztára</td>
<td>Évgyűrűk Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Richter Gedeon Nyrt mellett működő Nyugdíjpénztár</td>
<td>Honvéd Önkéntes és Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Taurus Önkéntes Nyugdíjpénztár</td>
<td>ING Önkéntes és Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Település-Szolgáltatók Önkéntes Nyugdíjpénztára</td>
<td>Generali Önkéntes és Magánnyugdíjpénztár</td>
</tr>
<tr>
<td>Vasutas Nyugdíjpénztár</td>
<td>MKB Bank Rt. Nyugdíjpénztára</td>
</tr>
<tr>
<td>Villamos energia-Ipari Társaságok Nyugdíjpénztár</td>
<td>OTP Bank Nyrt. Magánnyugdíjpénztára</td>
</tr>
<tr>
<td></td>
<td>Postás Magánnyugdíjpénztár</td>
</tr>
<tr>
<td></td>
<td>Premium Magánnyugdíjpénztár</td>
</tr>
<tr>
<td></td>
<td>Quaestor Országos Magánnyugdíjpénztár</td>
</tr>
<tr>
<td></td>
<td>Vasutas Nyugdíjpénztár</td>
</tr>
<tr>
<td></td>
<td>Villamos energia-Ipari Társaságok Nyugdíjpénztár</td>
</tr>
</tbody>
</table>

Source: Stabilitás

Timeline

1993 Voluntary pension funds established.
1997 Mandatory pension funds added.
1998 Three-pillar system introduced.
2007 Legislation creating multiple risk-level portfolios.
2008 Funds entitled to offer multiple portfolios.
2009 Multiple portfolios become compulsory.
2013 New pay-out legislation to be introduced.

Source: Stabilitás
Latvia moved faster than its fellow Baltic States to reform the social security system it inherited from the Soviet era and already in 1992 it was taking steps to create a modern welfare infrastructure. But inflation and economic turmoil wiped out any financial improvements so in 1993 the government asked the World Bank for help and was granted a loan for its Welfare Reform Project.

A Welfare Reform Concept was submitted to parliament in late 1994 and approved in 1995. However, by then the concept had moved on and subsequent legislation took a different shape. The welfare ministry was advised by the Swedish government and the Law on State Pensions that was approved by parliament in November 1995 and implemented in January 1996 introduced a notional defined contribution system for the entire working population and separated pension revenues from the state budget.

The launch of a second pillar was set for 1998 but was postponed and the Law on State-Funded Pensions came into force in July 2001. In its final form the second pillar system differed from the original plan of 1995 in several areas, for example private investment managers were not required to provide a minimum rate of return, the state did not provide any guarantees and the individual had the option of returning his/her savings to the first pillar at retirement in return for a pension calculated under a specified formula. On a contributor’s death, the funds are returned to the first pillar.

The second pillar is mandatory for new labour market entrants and those aged under 30 when the reform came into force, and optional for those between 30-49, while older employees were not allowed to participate. Initially only 2% of a wage was diverted to the pension fund, with 18% going to the state PAYG system, but in 2007 the rates were changed and the pension fund contribution increased to 4% and the PAYG proportion was reduced correspondingly.

Currently the pension fund contribution stands at 8% and it was scheduled to rise to 10% in 2010, with the contribution to both systems being equal.

A peculiar Latvian arrangement was that the State Treasury managed all the private assets for the first 18 months after the reform. In 2003 pension fund management companies licensed by the Financial and Capital Markets Commission (FKTK) began operating, with the State Treasury remaining as an option that could be chosen by participants and also working as the default for those who failed to state a preference of pension fund asset manager.

But in 2007 the State Treasury exited the system and its assets were put out to tender between the private companies.

The FKTK (www.fktk.lv) is the sector’s regulator. Pension fund asset management companies work under a number of quantitative and qualitative investment restrictions. For private companies investments are allowed in the EU and OECD countries and there is a fairly high cap of 70% for foreign investments.

At the end of December 2008, 1,065,564 participants, 88.5% of the workforce, had joined the second pillar system. Of the total, 58% had joined on a compulsory basis and 42% voluntarily. At the end of 2008 net assets totalled LVL464m (€660m).

The global financial and economic gloom had a negative effect on the second pillar plans. The average return on the plans at end of 2008 was -11.5%, after 2.5% at end of 2007. The assets of conservative plans placed in low risk assets returned 1.99%, while the performance of balanced and active investment plans, which depended on financial market fluctuations, posted average returns of -5.71% and -4.63%, respectively. Administrative fees at the end of 2008 were 1.52% of average net assets, and are by law capped
at 2.5%. For conservative funds fees stood at 0.76%, 1.57% for balanced plans and 1.68% for active funds. Additional fees are not capped by law but must be clearly stated in annual reports. Participants can switch asset managers once a year and funds within the same manager twice a year without incurring any costs.

Outlook
The global financial and economic crises, of which Latvia is one of the hardest-hit victims, has had an impact on the reform. Plans to increase contributions to 10% of a salary have been reversed, with the government announcing that it would reduce the proportion of social payments from 8% to 2% until the end of 2010 and then increase them to 4% in 2011 and 6% in 2012.

The IMF asked the government to reconsider but the ministries of finance and welfare responded that reducing the payments into the second pillar was part of planned structural reform and the money saved would be used to cover the costs of several social security mechanisms and the budget deficit. The proposal was upheld by parliament on 23 April 2009.

Third pillar
Work on the voluntary third pillar was started ahead of the second pillar as it would allow the development of capital markets and the accumulation of a reserve in the first pillar to offset the loss of contribution revenues. The Law on Private Pension Funds went through parliament in June 1997 and came into force on July 1998. Private pension funds have a legal status of financial and credit joint stock companies. They accumulate and invest contributions made voluntarily in order to increase their pensions. There are two types of private pension funds, open funds that can offer their services to everyone and closed funds that are exclusively for employees of the founder of the fund. Only employers with a collective affiliation contract can provide the closed funds while open funds are provided solely by commercial banks and life insurers.

There are no minimum or maximum ages set for joining these funds and when a participant leaves a job he or she has the right to continue participation or to transfer the accrued assets to another provider. A pensionable age must be stated and in general not be lower than 55.

Contributions of up to 10% of the annual taxable income of an employee are tax free if made by an employer and 20% of annual taxable income if made by a private person in their own savings in a third pillar pension fund. Since 2005 only the portion contributed by the employer is taxable.

At the end of 2008, there were six private pension funds operating: five open pension funds (subsidiaries of Latvian banks) and one closed pension fund. Between them they offered 19 pension plans.

The government reverses earlier plans and cuts the second pillar contribution level to 2% from 8% to the to cover budget deficits.

Timeline
- 2001: The Law on State Funded Pension implemented and second pillar contributions begin.
- 2003: Private asset management companies enter the second pillar system.
- 2007: The State Treasury exits the second pillar system as an asset manager.
- 2009: The government reverses earlier plans and cuts the second pillar contribution level to 2% from 8% to cover budget deficits.

Structure of state funded pension scheme investments (%)

<table>
<thead>
<tr>
<th>Investment</th>
<th>Shares and other variable yield certificates</th>
<th>Debt securities and other fixed-income securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-Dec 2007</td>
<td>Investment fund investment certificates 21</td>
<td>42</td>
</tr>
<tr>
<td>End-Dec 2008</td>
<td>Investment fund investment certificates 19</td>
<td>34</td>
</tr>
</tbody>
</table>

Source: FKTK
A non-mandatory second pillar

The reformed system was four years in the making and now the government has cut contributions, says Pirkko Juntunen.

Lithuania, with 3.6m inhabitants the most populous of the Baltic States, began its road to reform in 2000 when the government approved the Concept of Pension Reform based on a three-pillar system. Later that year a specialist working group delivered a pension reform White Paper which outlined a number of possible scenarios.

Under the state pension system established after independence from the Soviet Union, employers pay 31% of an employee’s gross salary to the State Social Insurance Office (SoDra) and employee pays an additional 3%. Of this, 18 percentage points goes to the old age pensions system.

The first draft on the Law on Pension Reform was prepared in April 2001 and a new draft followed in November after a change of government. It stipulated that joining the system was compulsory for those aged up to 30 while those above 50 were not eligible to join. The contribution rate was set at 5% of a gross salary and the system was expected to be up and running by 2004.

But in April 2002 the parliament returned the draft to the government, asking for it to be amended to make participation non-mandatory. In October 2002 an amended draft was put to parliament with an optional participation clause, no upper age restriction on participation and a gradual increase of contributions. The law was passed in September 2003 and came into force in 2004.

SoDra began redirecting money funds to the private system in mid-2004. Contributions started at 2.5% of a salary and increased by 1% of a salary a year to reach 5.5% by 2007, leaving 12.5% to the SoDra budget.

The law also provided for an annual open season from January to July during which additional workers could move into the mixed pension system and those who were already members could shift their savings between fund providers. However, it prohibited returning from the mixed to the public system and savings could not be moved between the fund providers for the first three years, until 2007, and then only once a year. However, participants are free to switch between the different funds of the same asset manager. The law also stipulated a cap on administration fees of a maximum of 10% of contributions and 1% of assets. All assets managers were required to offer a conservative pension fund, which was only allowed to invest in Lithuanian and OECD member state government bonds, and at least one other fund with a different risk level.

<table>
<thead>
<tr>
<th>Lithuanian pension asset management companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aviva Lietuva</td>
</tr>
<tr>
<td>Danske Capital</td>
</tr>
<tr>
<td>DnB Nord</td>
</tr>
<tr>
<td>Ergo Lietuva</td>
</tr>
<tr>
<td>Invalda</td>
</tr>
<tr>
<td>MP Pension Funds Baltic</td>
</tr>
<tr>
<td>Parex</td>
</tr>
<tr>
<td>SEB</td>
</tr>
<tr>
<td>Swedbank</td>
</tr>
</tbody>
</table>

Source: www.pensijusistema.lt

<table>
<thead>
<tr>
<th>Lithuanian portfolio allocation for second pillar pensions 2004-2006 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and CDs</td>
</tr>
<tr>
<td>2004</td>
</tr>
<tr>
<td>2005</td>
</tr>
<tr>
<td>2006</td>
</tr>
</tbody>
</table>

Source: The World Bank
Participation in the system increased from 440,000 people at the end of 2003 to 957,000 at end-2008 and assets have increased from LTL127.4m (€6.9m) to LTL2,223.8m over the same period.

The pension fund management companies are dominated by large Nordic banking groups Swedbank, DnB Nord, Danske Capital and SEB, which have 75% of the market. Small players continue to lose market share because of the shortage of efficient non-banking distribution channels. There are currently nine providers offering a total of 31 funds. Of these two are insurers. This has a direct impact on the regulation of pension providers. The asset management companies that manage pension funds are regulated by the Securities Commission (www.vpk.lt) while the insurers are regulated by the Insurance Supervisory Commission (www.dpk.lt). This raises the potential problems that although the regulators are the same, they may be interpreted differently by the two regulators.

Looking ahead
At the beginning of 2009, the then newly elected government opted to cut second pillar contributions from 5.5% to 3% for two years.

The reduction, which was intended to reduce the outflow from SoDra by LTL600m, was included in a package of measures intended to save LTL5.3bn to offset a 2009 budget deficit of LTL1bn, or 4% of GDP. This also included raising taxes and cutting budget expenditure to shore up the budget as revenues fall. The measure was controversial and after being passed by parliament it was vetoed by then president Vaidas Adamkus on the grounds that cutting the amount transferred to private pension funds did not comply with state commitments. His veto was later overturned by a parliamentary vote.

Subsequently, the government decided to further reduce contributions to 2% from the second half of 2009 until the end of 2010. It announced that the measure would be at least partially compensated by an increase in contributions to 6% from 2011. Discussions on allowing members to opt out of the second pillar are currently on hold.

Third pillar schemes
Legislation establishing third pillar supplementary pension funds is based on the provisions of supplementary voluntary pension accumulation law, effective since July of 2003. The funds operate on the basis of contribution accumulation in individual accounts and are managed by a pension fund management company. The third pillar remains small and there are no occupational employer-sponsored pension schemes. The social security contribution rate of 34% is deemed as rather high and with wages being generally low there is no space for supplementary insurance. Tax benefits are also more favourable for other types of insurance products. Contributions to private pension accounts are tax-exempt up to 25% of annual personal income and employer can deduct his contributions on behalf of the employee up to that same amount. Benefits from the pension funds are taxable at the same level as other income. However, life insurance products enjoy non-taxable contributions up to a reasonable ceiling and fully non-taxable benefits.

Timeline
2000
Government approves the concept of Pension Reform based on a 3-pillar system and same year the legislation for third-pillar pension comes into force.

2001
The first draft on the Law on Pension Reform was prepared but in July the same year political changes brought a new majority government into power and a new draft of the law was released in November.

2003
The final version of the law is passed and in September the same year.

2004
The State Social Insurance Fund Board (SoDra), established in 1990 straight after independence, started redirecting funds to the private system.

2007
Participants in the second pillar system are allowed to change fund providers for the first time.

2009
The Lithuanian government opted for reduction of contributions to second pillar from 5.5% to 3.0% for two years.
The Polish second pillar was launched in 1999 as part of a reform that also converted the state PAYG system into a notional defined contribution (NDC) first pillar. The second pillar was mandatory for those born after 1968 and voluntary for those born between 1949 and 1968. Pension contributions, amounting to 19.52% of an employee’s taxable income coming equally from the employee and employer, are paid to the Social Insurance Institution (ZUS), which then transfers three-quarters of the employee’s contribution (7.3% of taxable income) to the second pillar.

The contributions are accumulated in a single-purpose open pension fund, an OFE, each of which is managed by a special purpose pension company, a PTE. Market concentration and mergers have reduced the number of OFEs from 21 to 14 as of April 2009, although the three largest – Aviva, ING and PZU – together account for around 65% of assets and 55% of members.

Since September 2006 the regulator is the Financial Supervision Authority (KNF), (www.knf.gov.pl). The trade association is the Polish Chamber of Pension Funds (IGTE) (www.igte.com.pl), which as of April 2009 had 12 of the 14 licensed pension companies as members.

**Investment limits**

The OFEs operate under some of the region’s tightest regulations, including a prohibition on outsourcing and a minimum investment return benchmark based on the previous three years’ averaged performance. Key investment limits include a maximum 40% on listed equities and 10% on non-publicly traded or OTC shares.

There is no limit on investment in Polish state securities. Derivatives, whether for hedging or otherwise, are prohibited, as is investment in real estate.

The most contentious limit is an overall 5% cap on overseas investment, which years of lobbying have failed to lift. In 2009 the European Commission, which has long argued that the limit breaches the EU principle of free movement of capital, referred Poland to the European Court of Justice. With Poland having the region’s largest population, 38.5m, its second pillar is by far the largest in the CEE, with a membership of 14m at the end of the first quarter of 2009 and assets of PLN137.7bn (€31.6bn). Collectively the OFEs form the largest class of institutional investor in Poland. They were relatively heavily invested in equities, many being close to their 40% limit in 2007, and sustained heavy losses in the 14 months after asset values peaked in the last quarter of 2007. As a result the funds’ equity allocation had fallen to around 21% by March 2009.

**Payouts**

Legislation for pension payouts was passed in late 2008. Up until age 65 OFE members will receive programmed drawdown payments via the ZUS. At the same time they retain their rights

---

**Polish open pension funds**

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>End-March 2007</th>
<th>End-March 2008</th>
<th>End-March 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage bonds 0.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment fund certificates 0.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed shares 37.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds and treasury bills 58.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polish złoty bank deposits and securities 3.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polish złoty bank deposits and securities 3.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others 1.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment fund certificates 0.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed shares 31.9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds and treasury bills 62.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polish złoty bank deposits and securities 2.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others 2.4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment fund certificates 0.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Listed shares 20.6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds and treasury bills 74.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Polish złoty bank deposits and securities 2.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others 2.5</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source:** KNF
as OFE members, including capital accumulation on their funds and transfer rights to another OFE. This system, which took effect in 2009, affects women, who can retire at age 60. (The retirement age for men is 65). After reaching 65, the remaining proceeds in a member’s OFE account, irrespective of sex, will be transferred to the pension providers and likely paid out in the form of annuities. At present there is still no legislation dealing with this, and it is as yet unclear who will pay out the annuity products from 2014.

**Proposed changes**

Regulatory attitudes towards the second pillar scheme hardened in 2009 following the previous year’s poor results and the impact of the global financial crisis on the state budget. In May 2009 parliament voted to halve the maximum level of fees charged by pension societies to 3.5% of the value of contributions paid into the funds from 7% from 2010, not by 2014 as foreseen earlier. In addition, management fees will be capped at PLN 15.5m per company per month if net AUM of a fund exceeds PLN45bn. These changes have recently been approved by the president and are likely to come into force from 2010.

**Third pillar and occupational schemes**

Although the 1999 reforms legislated for occupational pension schemes, they did not prove particularly successful, partly because Poland’s then high unemployment rate gave employers little incentive to provide additional benefits. In addition, the schemes were legally complex and difficult to wind down. Until 2004 only 230 occupational schemes covering around 100,000 employees had been set up. New legislation introduced in April 2004 comprehensively overhauled the third pillar. It now consists of two elements: the individual retirement account (IKE), which individuals can set up with banks, investment funds, brokerages or life insurance companies, and the employee pension programme (PPE), established by companies. There were around 1,080 active PPEs as of April 2009.

PPE membership is open to all employees under age 70 with a minimum three months’ service (unless provided otherwise in the employment scheme), as well as partners of general or limited liability partnerships, and self-employed workers in a business contract with the company. Employees of more than one company can join all their employers’ schemes.

Employers can establish PPEs as:

- An agreement with an investment fund in one or more funds managed by the same management company.
- A unit-linked group life insurance agreement with a life insurance company or life mutual insurance company.
- A scheme managed by a foreign manager.
- A corporate pension fund (PFE), run by a specially licensed employee pensions society (PTE).

The employer’s contribution under a PFE agreement is mandatory and is exempt from social security tax up to a maximum 7% of an employee’s salary, while the employee’s contribution is optional. Investment revenues and benefits are tax exempt. Payouts can include lump sums and programmed withdrawals. Workers who change jobs can leave their assets in the original scheme until they reach retirement age or transfer them to their IKE or a new employer’s PPE.

The PFEs are the only third pillar entities legally designated as pension funds, but are complicated and time-consuming to establish. Employers must first set up a separately licensed employee pension society, followed by the PFE itself. The investment regulations are similar to those for OFEs. Collectively, at the end of the year 2008, the PFEs had 59,215 members and invested assets of PLN1.04bn.

### Table: Polish employee pension fund portfolio breakdown (%)

<table>
<thead>
<tr>
<th>Category</th>
<th>End-Dec 2007</th>
<th>End-Dec 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment fund participation units 68.3</td>
<td>Treasury bonds 18.1</td>
<td>Bank securities and deposits 3.7</td>
</tr>
<tr>
<td>Investment fund participation units 62.8</td>
<td>Others 0.7</td>
<td>Others 0.8</td>
</tr>
</tbody>
</table>

**Source:** KNF
Romania is the latest central and eastern Europe country to execute a private pension reform, implementing a new system only in 2007. Legislation for a mandatory second pillar was introduced first, by Law no. 411/2004 regarding pensions, with Law no. 204/2006 on voluntary third pillar pensions following two years later. But in the event the third pillar was introduced some months before the second.

The delays were despite a demographic situation that made a pension reform more urgent in Romania than almost anywhere else in the region. In 1990, at the start of Romania’s transition, some 8.2m employees to the state pay as you go system were supporting some 2.5m pensioners. In 2008, only 4.9m employees remained, supporting 4.7m pensioners. World Bank, IMF and Eurostat estimates suggest the public pension burden will become unmanageable in coming years and impossible to finance by 2030-50 without further substantial reforms.

The country follows a World Bank model, with a mandatory second pillar and a voluntary third pillar.

The second pillar became mandatory for all employees aged under 35 when it was put in place in 2007, and is voluntary for employees aged between 35 and 45. It is an individual, personal accounts DC system. Payments to mandatory pension funds are made through employees’ social security contributions, which are collected by the National House of Pensions (CNPAS), an agency within the labour, family and social protection ministry, which distributes the contributions to the relevant funds.

The CNPAS (www.cnpas.org), whose head is a secretary of state in the labour ministry, is responsible for managing the public pensions budget, paying pensions and doing accounting for public pensions and the second pillar.

The pension fund trade association is the Association for Privately Managed Pensions of Romania (APAPR) (www.apapr.ro).

Employers are not involved in the second pillar. They continue to pay social security contributions and send nominal declarations regarding their contributions to CNPAS.

Mandatory funds are managed by pension management companies, which are licenced by the state supervisory authority in charge of pension funds, the CSSPP (www.csspp.ro).

A pension management company can only run one fund but the funds may offer either high, medium or low-risk profiles. Individuals’ contributions currently stand at 2% of their gross income, and the reform legislation foresees the contribution level rising by 0.5 percentage points each year to 6% of income in 2016, at which point contributions will be capped.

However, in early 2009 the government announced a freeze on contributions to mandatory funds at 2% of gross income, but on the advice of the European Commission and the IMF agreed to return to the initial contribution calendar so that contributions

### Voluntary pension funds

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Source: APAPR</th>
</tr>
</thead>
<tbody>
<tr>
<td>ING Optim</td>
<td></td>
</tr>
<tr>
<td>BCR Prudent</td>
<td></td>
</tr>
<tr>
<td>AZT Moderato</td>
<td></td>
</tr>
<tr>
<td>ING Clasic</td>
<td></td>
</tr>
<tr>
<td>AZT Vivace</td>
<td></td>
</tr>
<tr>
<td>Aviva Pensia mea</td>
<td></td>
</tr>
<tr>
<td>Raiffeisen Cumulare</td>
<td></td>
</tr>
<tr>
<td>Eureko Confort</td>
<td></td>
</tr>
<tr>
<td>OTP Strateg</td>
<td></td>
</tr>
<tr>
<td>Concordia Moderat</td>
<td></td>
</tr>
<tr>
<td>Generali Stabil</td>
<td></td>
</tr>
<tr>
<td>Aviva Pensia max</td>
<td></td>
</tr>
<tr>
<td>BRD Primo</td>
<td></td>
</tr>
<tr>
<td>BRD Medio</td>
<td></td>
</tr>
</tbody>
</table>

Source: APAPR

### Average second pillar fund asset allocation (%)

- **T-bills & T-bonds**: 53.39
- **Corporate bonds**: 24.21
- **Supranational bonds (EBRD, EIB, IBRD)**: 7.01
- **Municipal bonds**: 3.89
- **Cash & deposits**: 7.82
- **Listed equity**: 2.96
- **Other investment funds**: 1.00

Notes: Derivatives: -0.02. Geographical breakdown: 72% investments in domestic markets (Romania), 28% abroad (out of which over 90% is in corporate bonds, RON-denominated, so no currency risk).
“Participants can switch but must pay a penalty of up to 5% of their net assets if they switch within two years of joining”

would reach 6% in 2016 as planned but with smaller than planned increases in 2009 and 2010 and a recovery in 2011. No pay-out legislation has yet been adopted, though a draft is currently being worked on to be finalised in 2010.

Fees
Participants can switch funds, but must pay a penalty fee of up to 5% of their net assets if they switch within two years of joining. Funds can charge an upfront entry fee of up to 2.5% of paid contributions as well as an asset management fee of up to 0.6% a year or 0.05% a month of the fund’s net assets. The fund covers the auditing fee while the pension fund company must cover all other expenses, including custody, trading and transaction expenses.

Investment restrictions
Mandatory investment funds can invest:
- Up to 20% of their assets in bank accounts and money markets instruments;
- Up to 70% in state securities (T-bills or T-bonds) issued by Romania or an EU/EEA member, with a 50% sublimit for T-bills with a maturity of less than one year;
- Up to 30% in EU/EEA municipal bonds;
- Up to 50% in shares listed in EU/EEA stock markets, with a sublimit of 35% for Romanian shares and 35% for EU/EEA shares;
- Up to 30% in corporate bonds issued by EU/EEA-based companies;
- Up to 15% in securities issued by other states, with sublimits of up to 15% in the US, Canada and Japan and 5% in other states;
- Up to 10% in municipal bonds from other states, with sublimits of up to 10% in the US, Canada and Japan and 5% in other states;
- Up to 5% in listed foreign bonds;
- Up to 5% in mutual investment funds worldwide;
- Up to 2% in private equity (not including private equity funds)
- Up to 15% in supranational bonds issued by the World Bank, the EBRD or the EIB;
- Up to 3% in commodities and their derivatives, including crude oil, cotton, coffee, wheat and metals traded on regulated markets in the US or the EU.

There are no explicit restrictions on investments made abroad.

Possible changes
The CSSPP is considering introducing lifecycling funds in the second pillar, but no consensus has yet been reached.
In addition, there is trade union pressure to introduce mandatory monthly inflation guarantee returns for second pillar funds, for which pension fund companies would have to pay. Parliament has rejected this proposal three times, but another vote is expected in the autumn. Industry associations argue that such a move would destroy the second pillar.

Mandatory pension funds

<table>
<thead>
<tr>
<th>Allianz-Tiriac</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generali</td>
</tr>
<tr>
<td>Aviva</td>
</tr>
<tr>
<td>Eureko</td>
</tr>
<tr>
<td>AIG</td>
</tr>
<tr>
<td>BCR</td>
</tr>
<tr>
<td>Aegon</td>
</tr>
<tr>
<td>BRD</td>
</tr>
<tr>
<td>OTP</td>
</tr>
<tr>
<td>Prima Pensie</td>
</tr>
<tr>
<td>KD</td>
</tr>
</tbody>
</table>

Source: APAPR

Timeline

2006
Primary legislation on pension funds introduced.

2007
May: First contributions collected for the third pillar funds
September: opting-in to new second pillar system begins.

2008
May: First contributions collected into the second pillar funds.

2010
Pay-out legislation to be introduced.

2011-2012
LIfecycling options expected for second pillar funds.

2016
Contributions to mandatory pillar reach their maximum of 6%.

Source: APAPR

Third pillar
The voluntary third pillar is open to everyone earning an income. Employers collect and distribute their employees’ contributions; the self-employed make their own contributions.

Voluntary pension funds are managed by pension management companies, life insurance companies and asset management companies, which must be licensed by the CSSPP. There is no restriction on the number of funds a company can run. Contributions are limited to 15% of the participant’s gross income and contributions of up to €400 a year are exempt from the 16% income tax flat rate. Both employers and employees may contribute, meaning the maximum tax-free contribution is €800 per year.

Penalties for switching funds are capped at 5% if the participant switches within two years of joining. Unlike in the mandatory system, the pension fund itself, not the management company, must cover operating expenses.

The investment limits are the same as in the mandatory system, except that the ceilings on private equity and commodities are higher, at 5% of assets.
Private second pillar pensions were introduced in 2005 as a compulsory system for all new entrants to the labour market who had not previously been insured by the Social Insurance Agency, the administrator of the first or state pillar system. It was voluntary for the remainder, who had until end-June 2006 to decide whether to participate. Second-pillar pension fund management was entrusted to a new class of single-purpose licensed asset manager, the pension asset management company (dss). In 2006 responsibility for pensions and other financial market supervision passed to the National Bank of Slovakia (NBS), (www.nbs.sk).

Licensing requirements included a minimum SKR300m (€10m) capital and a minimum 50,000 members within 18 months of operation. Market concentration and the minimum membership requirements reduced the number of players from eight to six. Net assets as of the end of the first quarter 2009 totalled €2.41bn.

The trade association is the Association of Pension Fund Management Companies (ADSS), (www.adss.sk), which was set up in December 2004. All licensed dss are members.

The state pension system is funded by a fixed contribution of 18% of gross wages, of which 9%, funded entirely by the employer, goes to a dss. While there are no tax allowances on second-pillar contributions, asset growth and benefits are tax exempt.

Benefits are payable as life annuities or programmed withdrawals combined with an annuity, provided the retiree has saved with the fund for a minimum period.

Slovakia opted for the lifecycle pension system. Each dss must offer a growth, balanced and conservative fund, with the growth fund carrying the highest risk and the conservative the lowest. Growth funds have been by far the most popular, accounting for 67% of assets in 2008, while conservative funds had only 4%.

**Investment policy**

General investment limits applying to all funds include a maximum 3% for a single issuer, 20% in total for issuers belonging to a single group, 25% for a single negotiable security, 20% for securities from an EU or OECD member state, 20% in bonds issued or guaranteed by the Slovak Republic, 10% on any single open allotment fund, 10% for deposit accounts in an individual bank and 25% of assets foreign collective investments or securities linked to a financial index.

Mortgage bonds can constitute 50% of the portfolio with a 10% single-issuer limit. The classes of funds have additional limits. Conservative fund investments cannot have any foreign exchange risk, and the bonds’ modified duration (interest rate sensitivity) cannot exceed 2%.

Balanced funds must contain a minimum 50% of shares, bonds and financial investments and a maximum 50% of assets not secured against foreign exchange risk. Growth funds can contain a maximum 80% of shares and 80% of assets not secured against foreign exchange risk. Each fund class has been subject to a relative 24-month perfor-
formance guarantee; from July 2009 the NBS will establish its own reference benchmark.

In practice even the growth and balanced funds have adopted relatively conservative strategies, a trend that intensified in 2008 as the financial crisis deepened. Over the year the share of bonds in all second pillar funds rose from 50% to 67%, while that of equities fell from 15% to 6%.

**Challenges**

A year after the system’s inception, a new coalition government headed by Robert Fico of Smer-Socialna Demokracia began a campaign against Slovakia’s second-pillar system that continues to this day. Fico has variously accused the second pillar of draining resources from the first pillar, mis-selling to clients and providing lower benefits to members than they would have received had they remained in the first pillar.

In 2007 the government introduced an opt-out period in the first six months of the following year, although it also allowed older workers who had earlier not joined the second pillar to opt in. In addition, the second pillar stopped being mandatory as of 2008, while the qualifying period for second-pillar pension entitlement was extended from 10 to 15 years. According to NBS data, in 2008 around 107,000 left the second pillar while 31,500 joined, reducing the total membership to 1.48m.

In November 2008, the government used the deterioration of pension fund performance following the global financial crisis to reopen the second-pillar opt out, with members having until the end of June 2009 to decide whether to stay or leave. In March 2009 parliament lowered fund management fees, from 0.065% of monthly average net asset value to 0.025% of average net assets from 1 July 2009.

However, the biggest blow has been the introduction of a performance fee/guarantee requirement. From July 2009, a dss must have in place a guarantee account to ensure each fund’s principal over a six-month period. Funds that make a loss the company is not entitled to any performance fee and must make up the balance, from a guarantee account or failing that from its own assets.

The new system will in practice force all funds, irrespective of their originally designated risk horizon, to sell equities and operate conservative, low-growth structures.

**The third pillar**

The third-pillar system predates the second pillar. It was introduced in 1996 and until the end of 2004 the supplementary pension insurance companies were the only ones whose members received preferential tax treatment. A law of October 2004, effective the following year, allowed many other investment vehicles, including bank savings accounts, insurance companies, investment funds and brokerages to offer third-pillar pensions. A supplementary pension insurance company was transformed into a supplementary pension asset management company (dds), licensed and supervised by the NBS. Dds funds are still the predominant form of third-pillar saving as only they qualify for tax benefits on employee and employer contributions. Their total membership stood at 848,000 at the end of 2008, up from 792,000 a year earlier.

Under the supplementary system a dds provides contributory funds – typically a range of portfolios, similar to that of a dss – and must also set up a supplementary pension payout fund used for the distribution of benefits. The payout funds are highly conservative structures. Investment limits on contributory funds include 5% (of pension fund assets) for single issuer’s security, or 10% of a single issuer nominal share capital. A dss is not allowed to acquire majority holdings in companies, securities of non-Slovak countries are limited to 25%, mortgage bond limits include 15% of those issued by one bank and 50% in total.

There is also a limit of 50% on Slovak state or state-guaranteed bond, with the additional requirements that portfolio must hold at least six separate issues, while a single issue cannot exceed 30% of the portfolio’s value. Investment strategies are even more conservative than those of dss. At the end of 2008 bonds accounted for 64% of assets, bank accounts 32% and shares a meagre 1.5%. Asset volume has nevertheless grown, from €936m at the end of 2008 to €959m by end-March 2009.

To qualify for payment members must have saved for at least 10 years, and be at least 55 years old, or 40 in the case of certain occupations such as dance artists. Payouts can take various forms, including endowments and lump sums.

<table>
<thead>
<tr>
<th><strong>Supplementary pension asset management companies</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Aegon dds</td>
</tr>
<tr>
<td>AXA dds</td>
</tr>
<tr>
<td>ING Tatry Sympatia dds</td>
</tr>
<tr>
<td>Stabilita dds</td>
</tr>
<tr>
<td>Tatra banky dd</td>
</tr>
</tbody>
</table>

**Timeline**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>Legislation establishes voluntary supplementary pension insurance through supplementary pension insurance companies.</td>
</tr>
<tr>
<td>2004</td>
<td>January: Legislation on retirement pension saving establishes the second pillar, mandatory for new labour market entrants, including pension asset management companies, to take effect the following year. October: The Act on Supplementary Pension Saving obliges supplementary pension insurance companies to transform into supplementary pension asset management companies, to take effect the following year.</td>
</tr>
<tr>
<td>2007</td>
<td>Six-month opt-out for second-pillar members. System no longer mandatory. Qualifying period extended from 10 years to 15 years.</td>
</tr>
<tr>
<td>2008</td>
<td>Further opt-out period.</td>
</tr>
<tr>
<td>2009</td>
<td>Pension asset management company fees reduced. Introduction of six-month performance guarantee funded by guarantee account.</td>
</tr>
</tbody>
</table>

Source: NBS
In 1992, a year after declaring independence from Yugoslavia, Slovenia reformed the PAYG system it inherited, raising the retirement age and pension contribution rates.

In 1996 the state pension system fell into deficit, primarily as a result of lowering the employer contribution rate to improve competitiveness, prompting the Pensions and Disability Insurance Act (PDIA), which was passed in 1999 and implemented in 2000.

This included an incremental rise and eventual equalisation in male and female retirement ages, extending the qualification period for the pension base from the best 10 years’ earnings to 18 years, and the introduction of supplementary pension insurance, albeit not as envisaged under the World Bank three-pillar system.

The creation of a mandatory second-pillar was resisted by the trade unions, which organised protests during the run-up to the law. Their main concern was an erosion of state provision to service a mandatory second pillar. However, they backed a voluntary system supported by tax exemptions. Consequently, a universal mandatory system was not included in the draft legislation.

The PDIA defined three types of supplementary pensions schemes and their managers:

- Mutual pension funds are run by banks, insurance companies and Kapitalska Druzba (the 100% state-owned company set up earlier to fund the state-pension deficit), and are owned by the fund holders. The minimum membership requirement is 1,000. Mutual pension funds can be individual or collective and open or closed.

  The latter are only available to those employed by a single employer, and to-date only one, the Closed Mutual Pension Fund for Civil Servants (ZVPSJU), has been set up. In existence since 2004 and managed by Kapitalska Druzba, it is an obligatory scheme for all public sector employees. At end-May 2009 it had 34,819 members and net assets of €159.4m. It is funded by employer contributions and by employees on a voluntary basis.

  There are currently six mutual pension funds with net assets at March 2009 of €513m and 241,527 members.

- Pension companies are joint-stock companies licensed solely to provide supplementary pension insurance. They were required to have accumulated a minimum of 15,000 members by the end of 2002. At end-March 2009 the three companies had net assets of €479m and a membership of 151,616.

- Insurance companies licensed to provide supplementary pensions insurance. As of June 2009 there were three. At March 2009 they had net assets of €280m and 126,435 members.

Forecasts

Schemes could also be individual or collective (occupational). The latter initially required the agreement of 66% of employees, but in 2002 this threshold was lowered to 51%.

At the start of 2003 Slovenes were allowed to take out another scheme in addition to membership of a collective pension. Both changes contributed to an acceleration of supplementary pension take-up. At end-March 2009 519,578 were

<table>
<thead>
<tr>
<th>Pension companies</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Moja Nalozba</td>
<td>Pokojninska družba</td>
</tr>
<tr>
<td>Skupna Pokojninska družba</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Insurance companies</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adriatic Slovenica Zavarovalnica</td>
<td></td>
</tr>
<tr>
<td>Zavarovalnica Triglav</td>
<td></td>
</tr>
<tr>
<td>Prva Osebna Zavarovalnica</td>
<td></td>
</tr>
</tbody>
</table>

Forecasts

Schemes could also be individual or collective (occupational). The latter initially required the agreement of 66% of employees, but in 2002 this threshold was lowered to 51%.

At the start of 2003 Slovenes were allowed to take out another scheme in addition to membership of a collective pension. Both changes contributed to an acceleration of supplementary pension take-up. At end-March 2009 519,578 were

Slovenia pension asset allocation (%)

<table>
<thead>
<tr>
<th>Total assets (£m)</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Membership</td>
<td>783</td>
<td>956</td>
<td>1,212</td>
</tr>
<tr>
<td>Mutual fund units 4</td>
<td>499,764</td>
<td>486,816</td>
<td>512,343</td>
</tr>
<tr>
<td>Shares 6</td>
<td>15</td>
<td>17</td>
<td>16</td>
</tr>
<tr>
<td>Other debt securities 31</td>
<td>41</td>
<td>39</td>
<td>38</td>
</tr>
<tr>
<td>Government debt securities 33</td>
<td>33</td>
<td>38</td>
<td>38</td>
</tr>
<tr>
<td>Others 3</td>
<td>5</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Others 2</td>
<td>6</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>Others 3</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>End 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and deposits 15</td>
</tr>
<tr>
<td>Government debt securities 41</td>
</tr>
<tr>
<td>Other debt securities 31</td>
</tr>
<tr>
<td>Shares 6</td>
</tr>
<tr>
<td>Mutual fund units 4</td>
</tr>
<tr>
<td>Others 3</td>
</tr>
<tr>
<td>End 2007</td>
</tr>
<tr>
<td>Cash and deposits 17</td>
</tr>
<tr>
<td>Government debt securities 26</td>
</tr>
<tr>
<td>Other debt securities 39</td>
</tr>
<tr>
<td>Shares 9</td>
</tr>
<tr>
<td>Mutual fund units 7</td>
</tr>
<tr>
<td>Others 2</td>
</tr>
<tr>
<td>End 2008</td>
</tr>
<tr>
<td>Cash and deposits 21</td>
</tr>
<tr>
<td>Government debt securities 33</td>
</tr>
<tr>
<td>Other debt securities 38</td>
</tr>
<tr>
<td>Shares 3</td>
</tr>
<tr>
<td>Mutual fund units 3</td>
</tr>
<tr>
<td>Others 2</td>
</tr>
</tbody>
</table>

Source: Bank of Slovenia
insured under voluntary supplementary insurance – 58% of those already in the first pillar – of whom 28,009 had individual insurance and 491,569 were in collective schemes.

Other legislation in 1999 created two additional supplementary pension schemes:

- The Compulsory Supplementary Pension Fund of the Republic of Slovenia (SODPZ) is the mandatory fund for employees in jobs deemed hazardous or with a limited term, including the police, military, railway workers, drivers, firefighters, ballet dancers and workers in industries such as iron and steel, textiles, glass, fishing and forestry. Only employers make contributions. The SODPZ provides a bridging pension for those workers until they reach the age to qualify for a first pillar state pension. At end-May 2009 the SODPZ had 39,813 members and net assets of €228.7m. Contributions are paid only by the employer. It is managed by Kapitalska Družba.

- The First Pension Fund (PPS) was set up to absorb some of the certificates from Slovenia’s voucher privatisation programme of the early 1990s. Citizens could exchange their privatisation certificates and shares in authorised investment companies (privatisation vehicles established in the early 1990s to collect and invest the certificates) for pension coupons. Between 1999 and the end of 2002 they could exchange up to 10,000 coupons for a life insurance pensions annuity policy. At end-May 2009 the PPS had 33,536 policyholders.

A separate Guarantee Fund, funded from the PPS assets, was set up in 2004 to cover the annuity payments of policyholders who reached age 60. Both are managed by Kapitalska Družba. Only pension systems set up under 1999 legislation qualify for tax relief, of up to 24% of premiums paid into the state system, 5.8% of the employee’s gross salary and a maximum (in 2009) of €2,604.54 a year. Employer contributions do not form part of the employee’s tax base.

Benefits are payable as monthly annuities, from age 58 (for both men and women) with a minimum 10 years’ membership.

Regulation is somewhat fragmented. The regulator for the mutual pension funds is the Securities Market Agency (ATVP) (www.a-tvp.si). The Insurance Supervision Agency (AZN) (www.a-zn.si) regulates pension companies and insurance companies providing supplementary insurance. The labour, family and social affairs ministry (www.mddsz.gov.si) is responsible for approving and licensing all pension schemes. The tax authorities deal with tax exemptions.

**Investment policy**

The key investment limits are a maximum 70% of assets in shares and corporate bonds traded on organised markets, 30% in investments not traded on organised markets and 30% in assets denominated in currencies other than the euro. There are additional restrictions related to investments as a share of technical provisions, as stipulated in the Insurance Act.

Fund managers have generally followed a conservative strategy, which relaxed somewhat in 2007 when Slovenia adopted the euro – thus eliminating currency risk on other euro-domiciled investments – but became more risk averse the following year. Equity has traditionally occupied a low portion (3% in 2008) while bonds generally account for around two-thirds of assets. This is due to a minimum guaranteed return requirement: the annual return must not be lower than 40% of the average annual return of government securities with a maturity of more than one year. This has produced herding and poor returns. The average 2007 nominal return was 5.5%, falling to 0.1% in 2008.

**Possible changes**

The unspectacular returns as well as the lack of mandatory membership has led to growing concerns about the future for pensioners. More than 40% of the working population has no supplementary provision, while Slovenia’s low birth rate makes the state pension system increasingly unsustainable.

Since 2007 a government working group has been examining the system and is due to report towards the end of 2009. However, the IMF – which recently advised the government to raise the retirement age and change the current state pension indexation from wages growth – acknowledged that while the government may provide further incentives for private pension provision, more fundamental systemic changes would prove politically unfeasible.

---

**Mutual pension funds**

<table>
<thead>
<tr>
<th>Fund manager</th>
<th>Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kapitalska Družba</td>
<td>ZVPSJU</td>
</tr>
<tr>
<td>Kapitalska Družba</td>
<td>KVPS individual and collective</td>
</tr>
<tr>
<td>Generali Zavarovalnica</td>
<td>Leon 2 individual and collective</td>
</tr>
<tr>
<td>Abanka Vipa</td>
<td>Abanka AII individual and collective</td>
</tr>
<tr>
<td>Banka Koper</td>
<td>OVPS individual and collective</td>
</tr>
<tr>
<td>Probanka</td>
<td>Delta</td>
</tr>
</tbody>
</table>

Source: Securities Market Agency

**Timeline**

- **1992** Reform of PAYG system inherited from Yugoslavia.
- **1999** Passage of Pensions and Disability Insurance Act (PDIA), which took effect the following year, raises retirement age, increases the pension base period to 18 years from 10 and introduces private supplementary pension insurance schemes.
- **2002** Threshold for employee participation in collective (occupational) schemes lowered to 51% from 66%.
- **2003** Slovenes allowed to take out an additional pension scheme in addition to being a member of a collective system.
- **2004** Closed Mutual Pension Fund for Civil Servants (ZVPSJU) established for public sector employees.

Source: IPE
Contact
EFRP
Koningsstraat 97 - rue Royale
1000 Brussels
Tel: +32 2 289 14 14
Fax: +32 2 289 14 15
efrp@efrp.eu

Members

Austria
Fachverband der Pensionskassen
Wiedner Hauptstrasse 73/4
1045 Vienna
Tel: +43 5 90 900 4108
Fax: +43 5 90 900 4097
www.pensionskassen.at

Belgium
Belgische Vereniging van Pensioeninstellingen – BVPI
Association Belge des Institutions de Pension – ABIP
Boulevard A. Reversalaan 80
1030 Brussels
Tel: +32 2 706 8545
Fax: +32 2 706 8544
www.pensionfunds.be

Finland
Association of Pension Foundations
Kalevankatu 13 A 13
00100 Helsinki
Tel: +358 9 6877 4411
Fax: +358 9 6877 4440
www.elakesaatoyhdistys.fi

France
Association Française Professionnelle de l’Epargne Retraite – AFGEN
13, Rue Auber
75009 Paris
Tel: +33 1 4451 7680
Fax: +33 1 4451 7689
www.afpen.tm.fr
Centre Technique des Institutions de Prévoyance – CTIP
10, Rue Cambacérès
75008 Paris
Tel: +33 1 4266 6849
Fax: +33 1 4266 6490
www.ctip.asso.fr

Germany
Arbeitsgemeinschaft für betriebliche Altersversorgung – aBa
Rohracher Strasse 12
69115 Heidelberg
Tel: +49 6 221 1371 7814
Fax: +49 6 221 2421 0
www aba-online.de

Hungary
Hungarian Association of Pension Funds – STABILITAS
Merleg Str. 4
1061 Budapest
Tel: +36 1 429 74 49
Fax: +36 1 266 63 49
www.stabilitas.hu

Ireland
Irish Association of Pension Funds – IAPF
Suite 2, Siam House
25 Lower Mount Street
Dublin 2
Tel: +353 1 661 2427
Fax: +353 1 662 1196
www.iapf.ie

Italy
Società per lo sviluppo del mercato dei Fondi Pensione – MEFOP
Via Milano 58
00184 Rome
Tel: +39 06 4807 3501
Fax: +39 06 4807 3548
www.mefop.it

Netherlands
Stichting voor Ondernemingspensioenfondsen – OPF
Bezuivenhoutsegel 12
2594 AV The Hague
Tel: +31 70 349 0190
Fax: +31 70 349 0188
www.opf.nl

Norway
Pensjonskasseforeningenes Fellessekretariat
Postboks 2417 Solli (Hansteens gt. 2, 0253 Oslo)
0212 Oslo
Tel: +47 23 284 590
Fax: +47 23 284 591
www.pensjonsskasser.no

Sweden
Swedish Pension Funds Association – C/O ABB AB
Kopparbergsveagen 2
721 83 Västeras
Tel: +46 (21) 32 51 02
Fax: +46 (21) 32 53 55

United Kingdom
National Association of Pension Funds – NAPF
NIOC House
4 Victoria Street
London SW1H 0NX
Tel: +44 207 868 1300
Fax: +44 207 222 7585
www.napf.co.uk

Portugal
Associação Portugueza de Fundos de Investimento, Pensions et Patrimônios – AFPPFP
Rua Castilho, N° 44 – 2° PT – 1250-071 Lisbon
Tel: +351 21 799 4840
Fax: +351 21 799 4842
www.afppfp.pt

Romania
Asociatia pentru Pensile Administrete Privat din Romania – APAPR
Str. Gheorghe Manu nr. 5, Et. 3-6, Sector 1
Bucharest
Tel: +40 (726) 737 725
www.apapr.ro

Spain
Association of Pension Funds Management Companies of Spain
Bajaklsa 30
821 05 Bratislava 25
Tel: +421 2 5710 6822
Fax: +421 2 5710 6890
www.adss.sk

Sweden
Swedish Pension Funds Association – C/O ABB AB
Kopparbergsveagen 2
721 83 Västeras
Tel: +46 (21) 32 51 02
Fax: +46 (21) 32 53 55

About the EFRP

While acknowledging the diversity of European pension systems, the European Federation for Retirement Provision (EFRP) promotes the development of occupational pensions, meaning workplace based supplementary and privately managed plans or schemes.

Occupational retirement plans are sponsored by companies as part of employee compensation or negotiated by the social partners in collective labour agreements. These collective schemes can be administered by pension funds – often governed by representatives of employers and employees – or commercial pension providers.

EFRP represents the various national associations of pension funds and similar institutions for workplace pension provision. It affiliates associations in 16 EU member states and five other European countries totalling to 28 Member Associations. About 75m EU citizens are covered for their occupational pension plan by EFRP Members. Through its Member Associations the EFRP represents €3.5trn in assets (2007) managed for future workplace pension payments.

Within EFRP the Central & Eastern European Countries Forum (CEEC Forum) has been established to discuss issues common to pension systems in that region. The CEEC Forum brings together nine CEE countries.

Established in 1981, the EFRP has developed from a circle of friends of pension fund managers to a professional organisation. The Federation is consulted by the European institutions on initiatives in the field of supplementary pension provision. Today, the EFRP is recognised as the leading voice on workplace pensions in Brussels.