THE ROMANIAN PENSION REFORM

BRAM BOON

He is currently General Manager at ING Life Insurance Romania. He has worked for ING since 1999 when he was Operation Manager at ING Bank South Netherlands, Sales Manager at ING RVS Netherlands, Managing Director at Aetna Life Indonesia and Sales Manager at ING Life Insurance. Boon is also the president of the Association of Privately Managed Pensions in Romania (APAPR). He has several prestigious professional degrees: Managing for Value – ING Business School, Holland, an MBA at the Erasmus University Rotterdam, a master’s degree in Actuarial Science in Amsterdam, a master’s degree in Mathematics at Utrecht University.
I. A SHORT HISTORY OF THE PENSION LAW

All Romanian governments, as from 1996, had plans to reform the pension system. They had acknowledged the fact that the public system, with one of the lowest replacement rates in Europe, less than 30%, could not provide old-age protection for an aging population and that this raised serious equity issues.

Then in 2000, a new Social Security law was introduced. One of the main issues in that law was the attempt to produce more coverage for the state pension by increasing the retirement age from 55 to 60 years old for women and from 60 to 65 years old for men.

There were also other Social Security issues inherited from the Communist System: there were still some professions receiving extremely high pensions, and that was also cleared up at that time.

The first steps in introducing private pensions in Romania were taken in 2004, when the Parliament adopted two highly criticized laws: the law on occupational pensions and the law on privately managed pension funds. The first law was supposed to take effect in 2005 and the second one in 2008. However, the legislation on occupational pension funds was so cumbersome, so unfriendly to the market and provided so little benefits to the participants that it was completely unworkable.

Meanwhile, the regulator of the private pension market, The Supervisory Commission of the Private Pension System (hereafter the Commission) was legally created in June 2005. The Commission is an independent entity, under the control of Parliament, which will regulate, coordinate and supervise the private pension market in Romania. The implementation of the Commission was financed through a World Bank loan. In future, the Commission will finance its activities from the fees paid by the private administrators.

After months of discussions with the insurance and asset management companies,
unions and other stakeholders, a draft law on Voluntary Pensions was submitted to Parliament in November 2005.

The new law replaced occupational private pensions with voluntary private pensions. In other words, it allowed employees to contribute to a private pension fund, independent of the decision of the employers or unions. However, the draft law allowed only those contributors who are enrolled in the Public social security system to contribute to the voluntary pension funds and it avoided dealing with the categories that did not pay social security contributions.

Employers have to pay the contributions to the pension fund chosen by the employee. The law gives employers and unions the right to suggest pension schemes to the employees.

During the process of drafting the law, there was a heated debate between the asset management and insurance industry, on one side, and the government on the other, with regard to considering other savings instruments, that might have counted as retirement plans, as contributions to voluntary pensions (and allowing them to receive similar fiscal treatment). That proposal was rejected repeatedly, not only by the Government but also by the political class.

With respect to investment returns, the final draft of the law gave up on requiring an absolute return guarantee on the assets. However, the provision had supporters, especially among the unions and left-wing parties. What is left in the draft law is a relative return guarantee: the return of a given fund has to be above a minimum return rate calculated for all funds (either the weighted average of all funds minus 4 percentage points or 50% of the weighted average of all funds, whichever is less).

The law introduces a series of stipulations that will take effect after Romania becomes an EU member. For example, any administrator authorized in EU/EEC can administer a pension fund in Romania. In other words, authorization in an EU/EEC member state waives the obligation of a pension fund administrator to obtain authorization in Romania. Romanian pension fund administrators can receive contributions from participants from other member states and eligible Romanian citizens can contribute to funds located in other EU/EEC countries. A Romanian administrator who wants to receive contributions from abroad, must, however, be authorized by the Commission. The Commission will regulate these transfers within the EU or EEC by notifying the supervisory authorities of these states or requesting information from them. The attempt to regulate the inflows and outflows of contributions from/to EU member states described by the law seems burdensome and will probably prove unworkable.
Thus, the pension reform started in Romania with the introduction of the third pillar as a voluntary pension system, but the pension system in Romania needed to be diversified, based on a three-pillar pension system, involving both the public and private sectors.

The draft that would modify law 411/2004, referring to mandatory private pensions, was later adopted and the second pillar became operational as from 2007.

II. WHY WAS THE PENSION REFORM NECESSARY?

A key issue in understanding the pension reform in Romania is the acceleration of the aging process. Between 1965 and 1980 there was a “birth reform” that pushed up the birth rate, producing a real baby boom at that time. All these people will retire around 2030.

Immediately after the Revolution, youngsters were not interested in having families of five children, so the population went down tremendously, meaning that contributions will go down too. This situation will create a growing imbalance, since all contributions collected in the public social insurance system were immediately redistributed to the retired people; whereas the active workers’ contributions for the pension system were not accumulated in an individual account to be kept for their retirement.

To make matters worse, the average net pension represented 35% of the average net salary, the average number of employed people was very low, and there were more retired people than active workers.

III. THE ROMANIAN PENSION SYSTEM IN A NUTSHELL

The new architecture of the pension system provides for new principles of administration and financing of the pensions. The three pillars of the pension system are:

- Pillar I: State Pension Scheme
- Pillar II: Private Pension Funds
- Pillar III: Voluntary Pension System
Pillar I - Mandatory State Pension Scheme

This pillar is actually the old public system and it is directly administered by the State through National Pension House (an autonomous institution for the management of the public pension system) and is financed on a PAYG basis. Until the introduction of the new system, the contribution level was set at 9.5% of the gross salary for the employee and 19.75%, 24.75%, 29.75% for the employer, depending on the working conditions. The monthly payments are the employer’s responsibility. This pillar will remain operational, but with a decreased level of contribution.

Pillar II – Private (Mandatory) Pension Funds

This pillar is regulated by Law 411 (2004) on private pension funds, in force as of January 25, 2007. Within 6 months of the enforcement date of this Law, the Commission had to produce regulations in order to apply the Law. This Pillar was launched on 17th of September 2007 and offers old-age pensions.

Pension funds belonging to the second pillar are to be administered by pension companies, licensed by the Private Pension Supervision Commission, or by any entity authorized for this activity in another member state of the European Union or one belonging to the European Economic Area, and will operate on a capital accumulation principle.

This pillar functions through contracts between the participant and a licensed pension company. Participation in this pillar is mandatory for all employees under age 35 and optional for those between 35-45 years old. Any person who has not entered a pension fund within 4 months of the date when he/she should legally have done so, will be assigned to a pension fund at random by the recording institution.

The contribution level is set at 2% of the gross salary and it will grow during the next eight years by 0.5% each year, until it reaches 6%. This contribution is a part of the social security contribution (Pillar I), in other words, the employee pays no extra money for the second pillar.

An eligible person cannot contribute to more than one fund at a time and the benefits stage starts when the age limit for retirement is reached, provided the social security system conditions are fulfilled or the personal assets reach the minimum sum set by the law for a private pension.

The benefits can also be paid in case of disability or diseases that will not allow a return to work (as defined by Law 19/2000 on the social security system) or in case of the participant’s death (the existing assets from his account will be inherited by his legal or testamentary heirs).
During the benefits stage, the participant can obtain a lump sum or annuities for a five-year period, if his personal assets—as a consequence of a short contribution stage—are not enough for him to receive a private pension, as stipulated by the Commission; or a private pension, if his personal assets fulfill the conditions imposed by the law.

The participants in a private pension fund must comply with the eligibility criteria issued by the Commission:

• they are insured in Pillar I (all employees, except military personnel, lawyers, etc., who contribute to their own funds)

• their age is between 18-35 or 36-45 years old.

The enrolment process involves the following steps:

• signing an individual contract or random assignment (after the 4-month sales window)

• sending the participant’s information to National Pension House;

• validation from the NPH;

• random assigning of those eligible persons who failed to sign a contract or signed more than one contract.

Participants are given the possibility of transferring their contributions from one fund to another but they cannot ask for a transfer between funds before the payment of the first contribution.

One guarantee offered by the new system is that the personal assets will not be worth any less than the overall amount of the contributions paid, minus transfer penalties and legal commissions.

The collection of contributions in the second pillar has not yet started. There are some issues that still need to be clarified—whether collection should take place only on a certain day of the month or each administrator be allowed to collect the contributions according to its own calculations. If collection on one particular day is approved, this will also influence the investment process.
Pillar III - Voluntary Pension System

The Voluntary Pension System was regulated by the Law 204/2006 on voluntary pensions, in force as of May 31, 2006.

Pension funds belonging to Pillar III are to be administered by pension companies and by companies authorized in the insurance and investment field, licensed by the Private Pension Supervision Commission.

This pillar also operates on the basis of the accumulation system, with the difference that the contribution is voluntary. The minimum level is set by each administrator, while the maximum level is set by law at 15% of the monthly gross salary. The third pillar allows both the employee and employer to contribute and each of them is entitled to a deduction of 200 euros per fiscal year.

The participant in a voluntary pension fund may be an employee, a public servant or a person authorized to conduct an independent activity according to the law, a person who runs his/her activity in an elective profession or is appointed in a function within the executive, legislative or judicial authority, or any other person who obtains an income from professional or agricultural activities.

The administrator is allowed to have more than one fund and the contributors may choose to contribute to more funds as long as the maximum level is not exceeded.

During the contribution payment period, the participant is allowed to modify the contribution or to suspend the payment. The participant can also choose to transfer from one fund to another.

IV. ELEMENTS TO BE CONSIDERED IN BECOMING A PROVIDER IN THE SYSTEM

Briefly, what does one have to do in order to become a provider in this system?

1. Setting up a Pension Company

According to Law 411/2004 on private pension funds, the private pension funds activity in Romania can be undertaken by: local registered companies (joint stock companies) authorized by the Supervisory Commission of the Private Pension Funds or by any entity authorized for this activity in another member state of the European Union or belonging to the European Economic Area.
There are four (4) steps to be followed in order to administer private pension funds:

- the setting up of a Romanian legal entity to manage a private pension fund;
- the authorization of the new entity to manage the pension fund;
- the authorization of the private pension scheme prospectus;
- the authorization of the private pension fund.

The main (relevant) requirements for the authorization of the establishment of the pension company are as follows:

- joint stock company with at least 2 shareholders;
- sole corporate purpose: administration of pension funds and, optionally, provision of private pensions;
- the name of the pension company has to contain the collocation: “pension fund”;
- the share capital is represented by shares issued by the pension company, which are nominative, cannot be converted into shares to bearer and cannot be preferential shares;
- the Contract of Association of the pension company has to stipulate that the shareholders cannot benefit from preferential rights or other privileges and that the limitation of rights or imposition of additional obligations is forbidden;
- the accumulated contribution of natural persons cannot exceed 5% of the share capital of the pension company;
- the board of directors should have an odd number of members, but not less than 3 persons.

The private pension administrator has the following functions:

- to administer and invest the pension fund’s assets;
- to convert the contributions into fund units;
- to arrange the payment of the participants’ or beneficiaries’ rights, according to the law;
to calculate the net assets and the fund unit on a daily basis;

to keep records of the individual accounts and their respective updates and provide the necessary documents for participation, notification, information or transfer;

to manage the daily operations of the pension fund;

to mandate and monitor the marketing agents;

to maintain relationships with all entities involved;

to prepare, present, publish and distribute to the Commission and the participants the required financial statements and reports;

to manage and file the documents related to the pension fund, the participants and beneficiaries.

2. Shareholders

The founders of pension companies may be both Romanian or foreign individual persons and/or legal entities. Requirements for shareholders are the following:

- to have a steady financial situation, capable of sustaining the institution in case of necessity;
- to justify in a satisfactory manner the source of funds meant for participation in the share capital;
- to provide all the information necessary for identifying relationships of affiliation with other persons;
- to have operated, in case of legal entity shareholders, for at least 3 years, except for those resulting from the merger or division of another legal entity that had been operating for at least 3 years prior to that merger or division.

3. Share capital requirements

The minimum share capital necessary for the administration of a pension fund has to be the equivalent, in domestic currency (RON), of 4 million Euros in cash, calculated at the exchange rate of the National Bank of Romania as of the date of establishment. The capital should be fully deposited prior to the filing of the application for granting of a licence.
4. Privately administered pension fund (Pension Fund)

The pension fund and the private pension fund’s administration company (Administrator) are different legal bodies. The pension fund is established in order to put into practice a private pension scheme, whose prospectus has been authorized by the Commission in accordance with the Law. The pension fund is established on the basis of a civil incorporation agreement in accordance with the dispositions of the Romanian Civil Code, with the provisions of the Law and of the Commission’s norms. A pension fund shall have at least 50,000 participants; this minimum number of participants shall be achieved during the first 3 years following the date of setting up the pension fund.

The founding members shall sign an administration contract with an administrator, authorized by the Commission, through which the private pension fund assumes one of the pension schemes whose prospectus has already been authorized by the Commission.

Through the administration contract, the founding members of the pension fund empower the administrator to represent the private pension fund in all relations with third parties, including appearing before a Court of Law. In order to be authorized by the Commission, the fund must prove the existence of a depository bank and a financial auditor.

The financial resources of the pension fund consist of:

- net contributions converted into fund units;
- beneficiary rights not claimed within the general term of prescription;
- interest and delay penalties for contributions not paid in due time;
- amounts resulting from the investment of the revenues mentioned previously.

The name of the pension fund shall contain the phrase “privately administered pension fund” and a pension fund cannot be declared insolvent.

5. Depository bank

The Administrator shall designate only one depository, to which it shall entrust the keeping of the pension fund assets, based on a deposit agreement previously approved by the Commission.
In order to perform the depository function, this bank has to hold a valid authorization issued by the Commission. Any entity authorized in such capacity on the territory of a member state of the European Union or belonging to the European Economic Area may also be a depository. The depositaries that have been authorized, approved or subjected to a similar procedure in order to operate as depository of the pension fund assets in a member state of the European Union or belonging to the European Economic Area are exempted from the requirement of being approved by the Commission.

6. Financial auditor

The administrator shall designate a financial auditor to draw up a financial audit report regarding the activity of the administrator and the activity of the pension fund, based on an audit contract, previously approved by the Commission.

In order to perform the audit activity, the auditor has to hold a valid authorization issued by the Commission. It may also be a financial auditor of any entity authorized in such capacity on the territory of a member state of the European Union or belonging to the European Economic Area. Auditors that have been authorized, approved or subjected to a similar procedure in order to operate as financial auditors in the pension market of a member state of the European Union or belonging to the European Economic Area are exempted from the requirement of being approved by the Commission.

7. Investments

As in many other cases, the industry is still very heavily regulated. Based on the percentage of the low risk investments included in the investment policy, the pension funds are rated according to three risk profiles. (i) Low: more than 85%; (ii) Medium: more than 65%; and (iii) High: at least 50%.

The law places some restrictions on the investments of the fund’s assets. The assets cannot be invested, for example, in art objects, vehicles or real estate. The investments of the assets of the private pension funds are exempted from taxes. The assets of the pension fund may be invested only in:

- money market instruments, including accounts and deposits in RON at a bank, Romanian legal entity, or at a branch of a foreign credit institution authorized to carry out its activity on Romanian territory and not subject to the procedure of special supervision or special administration or having had its authorization
withdrawn, without exceeding a percentage higher than 20% of the total value of the pension fund assets;

- public securities issued by the Ministry of Public Finance of Romania, issued by member states of the European Union or belonging to the European Economic Area, up to 70% of the total value of the fund assets;

- debentures and other exchange securities issued by the authorities of the local public administration of Romania or of the member states of the European Union or belonging to the European Economic Area, with a percentage of up to 30% of the total value of the pension fund assets;

- exchange securities traded on regulated and supervised markets of Romania, of the member states of the European Union or belonging to the European Economic Area, up to 50% of the total value of the pension fund assets;

- public securities and other exchange securities issued by third states, up to 15% of the total value of the pension fund assets;

- debentures and other exchange securities, traded on regulated and supervised markets, issued by the authorities of the local public administration of third states, up to 10% of the total value of the pension fund assets;

- debentures and other exchange securities of non-governmental foreign bodies, if these instruments are listed at authorized Stock Exchanges and comply with the rating-related requirements, up to 5% of the total value of the pension fund assets;

- sharing securities issued by exchange security collective investment bodies of Romania or of other countries, up to 5% of the total value of the pension fund assets;

- other forms of investments provided for by the Commission’s regulations.

Depending on the type of instrument issuer in which the administrator may invest, the maximum percentages allowed are as follows:

- 5% of a pension fund’s assets may be invested in a single trading company or in each of its asset categories, without exceeding 5% in total;

- 10% of a pension fund’s assets may be invested in the assets of a group of issuers and the persons affiliated to it.
V. THE RESULTS SO FAR

Although it is very recent altogether, because it was only in May last year that we started with voluntary pensions, there are already 6 authorized administrators of 7 funds, 10,000 marketing agents, only 75,000 participants, and 6 million Euros in asset management. However, Pillar III is not really a success yet, because we started it before Pillar II. The population is of course aware of Pillar II, but that is not the case yet with Pillar III; so everybody is still waiting, two years or more, before choosing Pillar III. This year we are expecting a huge development in that respect.

As the CEO of ING we have been able to accomplish a lot in a very short period of time. In the first four months we have already got 38 percent of a market of 3.8 million eligible people. Behind this success is the brand name that delivers trust, and we believe that it is extremely important for people to trust you if you are starting an elementary pension system. Your brand awareness is extremely important for you. Fortunately, we have been investing for a long time in our life insurance business, so we were known for life and pensions, which helped us a lot.

Strange though it may seem, the best way to mobilize your company to leap at this challenge is to set an objective that leaves everybody in a state of shock, so that is what we did. We started by saying that we wanted 1 million participants, over 30% of the market.

As a consequence, what happens in the market is that there is a shock and everybody says; “My God, we have to work differently now”, because it means that some days you have 40,000 applications in your office. It is amazing that we have a company with only 300,000 life customers.

So, the key was distribution and we learnt a few things from Poland; there, the workforce is “flex force”. This means that the marketing agents were recruited by the tied agents and we were able to get 45,000 of these marketing agents linked to our company in a couple of months; but think what it means to license all these marketing agents.

The key was to have the proper processes in place to identify the process for taking in the customers, sometimes 40,000 a day, and licensing 45,000 marketing agents; to get the commission paid at the right time, get the agency organized and start the flow through these agencies.

Another element that was extremely important in this initial success was marketing. Why? Because there was no awareness at all in Romania and we needed to create it. In the end, we chose a kind of quiz for the marketing campaign; our own tied
agents were the actors in the panel. Questions were asked, questions that we knew were going around in the market, and the answers were given by the agents, in the form of a quiz.

The tied agents were happy because they were on television, the customers were happy because they got the answers to the questions; the regulator was extremely happy because he finally achieved awareness. It was a very striking thing to do.

And the last reason to explain the initial success has to be the commitment of the employees. It was so much work to do, that you really had to delegate as much as possible. Fortunately, we had a young company. The average age was 27 years old, people were really thrilled to work and to come up with new ideas and they were really willing to jump into this because they were able to work at a level that they had never worked at before.

It was also fed by management: with every 100,000 clients we won for our company, we all went out to a pub. We had a lot of publicity inside and outside the company, a lot of “PR”, so that was the reason for our success.

FINAL CONSIDERATIONS

Firstly, the private pension system includes the notion of an individual account and gives the participant a higher degree of control over the sums that he/she pays for his/her pension. The control refers mainly to the fact that the participant knows at any given time the value of his/her personal assets, the evolution of the fund, etc. Additionally, in order to maximize the performance, the participant can transfer from one fund to another. The employee is the beneficiary of his/her contributions.

The private system also offers more transparency with regard to the method used to increase the contributions of the employees, but the actual amount can only be known at the moment of actual retirement. Until that given time, employees can receive an estimate of the monthly pension that they might receive.

Last, but not least, it also allows the possibility of forming a pension from multiple sources. Compared with the public system, in which the average pension was 35% of the average salary, in the new system, all three pillars may bring a pension equal to 80% of the average salary.

Of course, the legislative frame can be improved in the years to come. Among the possible amendments to the law for Pillar II we suggest changes to allow
the administrator the possibility of having more than one fund. Multiple funds with different risk profiles may be more suitable for people in different walks of life. A continuous intake procedure should be implemented and the collection of contributions should also be ratified. The minimum performance guarantee, equal to the inflation rate, should not be introduced, as it limits the options of the administrators.

By the same token, some of the amendments to the law for Pillar III could be that the contribution payment should be handled directly by the employee. The level of fiscal deductibility should be higher and one of the two players should be given the possibility of accumulating the deductibility. And a minimum employment period should be introduced, after which the employer’s contribution passes to the participant.

Given that policy design is an exercise in permanent learning from experience, we offer some preliminary lessons from our point of view. All information regarding the reform should be provided by the regulator and not by the fund administrators. During the implementation process, there was a serious lack of information sustained by the regulator, and the administrators actually educated the market. Finally, the proper legislative frame should be provided and the Supervisory Commission should include people who are experienced in the field.