Pension Reform in Eastern Europe: Experiences and Perspectives

Presentations given at the International Seminar of the same name, held in Kiev, Ukraine on 26th and 27th May 2004

INTERNATIONAL FEDERATION OF PENSION FUND ADMINISTRATORS

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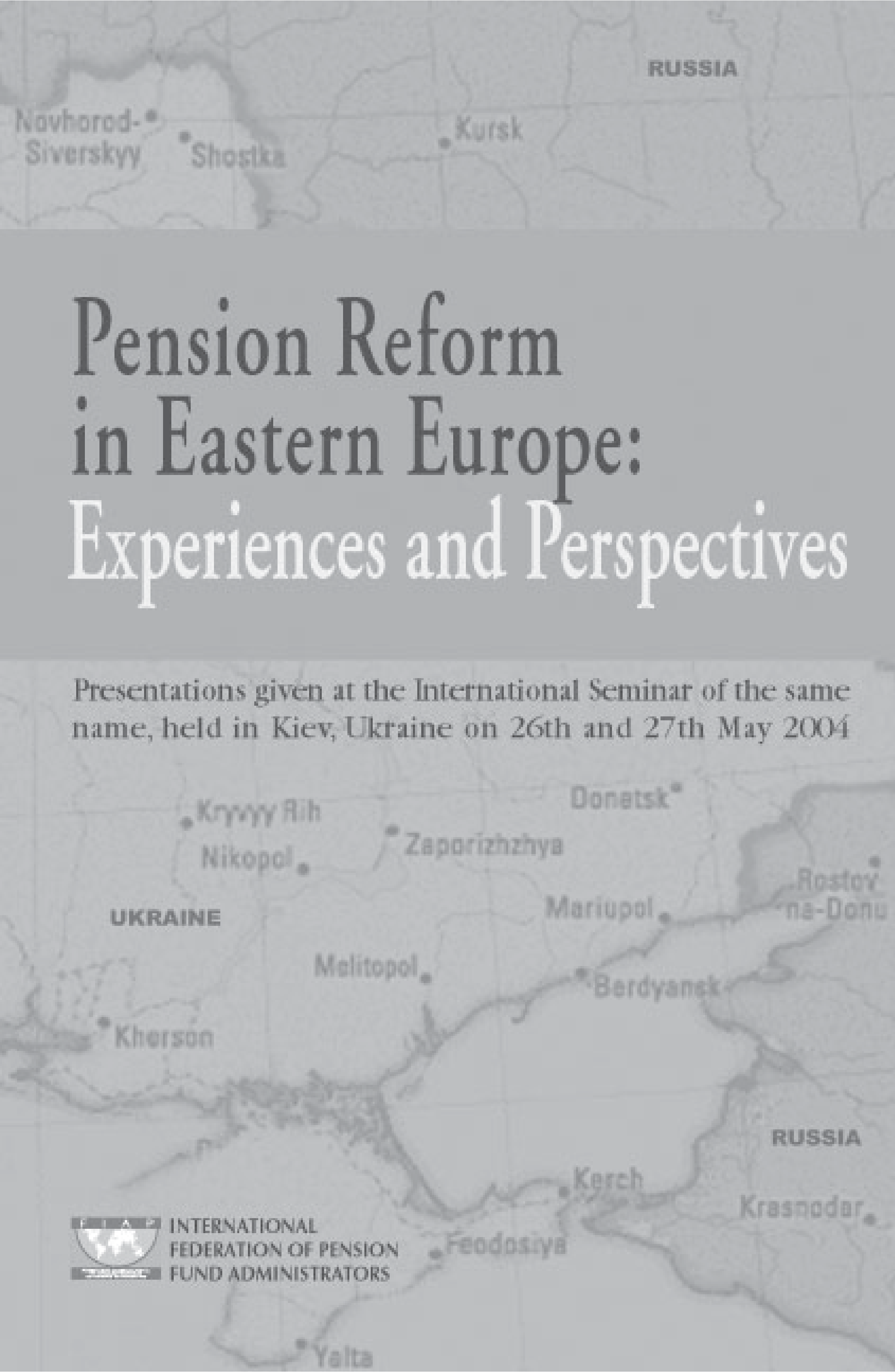

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Presentation

Ever since 1981, different countries around the world have been implementing reforms in their pension systems, replacing their PAYG systems partially or totally with a new system based on individual capitalization and private management of savings, leaving the State to regulate and subsidize. The main reasons for this process are the demographic changes being faced by the world –greater life expectancy and fewer births– which have meant in practice that there are increasingly few active workers to finance the pensions of those who retire. Thus countries that are symbols of the traditional system, such as Germany, France or Italy, have had to introduce "parametric reforms" in recent years, such as raising the age of retirement or increasing the contribution period, in order to cope with this crisis.

However, with different nuances, the world is currently studying in depth the idea that people should be the main contributors in savings schemes that finance their pensions, through plans that are managed by private companies.

These reforms will not only ensure social security benefits in the future. They have also been an instrument exerting positive pressure on governments to constantly improve their financial markets and regulation mechanisms, so that the economy as a whole focuses for preference on creating work and investing resources for those who will shortly be retiring.

Twenty-five countries have brought in "structural reforms" so far in this area, and to those should be added others which have introduced personal savings plans with tax incentives. This figure certainly demonstrates the force of this modernizing process. Clearly outstanding in this respect are nations which until very recently had centrally planned economies.

In view of the above, the International Federation of Pension Fund Administrators (FIAP) felt that it would be appropriate to meet in the Ukraine in May 2004 to hold its Annual General Meeting and, at the same time, an International Seminar entitled "Pension Reform in Eastern Europe: Experiences and Perspectives" the contents of which are presented in this book. It contains an analysis of the progress of the new social security systems, with special emphasis on the expansion that the individual capitalization systems have experienced in Eastern European countries such as Bulgaria, Croatia, Slovakia, Estonia, Hungary, Kosovo, Latvia, Macedonia, Poland and Russia, and in Asia, Kazakhstan.

Experts from international organizations took part in the seminar, such as the World Bank, the International Labour Organization (ILO), the Organization of Economic Cooperation and Development (OECD) and the International Association of Pension Fund Supervisory Authorities (AIOS) and it awakened great interest among government authorities, specialists from investment banks and industry representatives.

FIAP thanks all the authorities, professionals, sponsors and participants who made it possible to hold this International Seminar, which undoubtedly contributed towards reaffirming the importance of pension systems and their impact on the standard of living of the population.

In the words of the Kiev Declaration of FIAP's Annual General Meeting, "individual capitalization systems are making a decisive contribution towards solving the pensions problem and, in conjunction with other economic policies, also represent an instrument which contributes to the economic development of nations".

GUILLERMO ARTHUR
President of FIAP

WORDS OF WELCOME

Pavlo Gaidutski
Myhailo Papiev

Words from the Vice-president of Administration of the Ukrainian Presidency

PAVLO GAIDUTSKI

Ladies and Gentlemen:

The event in which we are taking part is of great importance from many points of view, because it should be considered not only as a useful activity for specialists but also as an opportunity to bring about an increase in social security culture in the general public.

It is well-known that in our country the level of confidence in the population towards financial institutions is still low. This is due to certain faults which have occurred in the Ukrainian financial market, a situation typical of the financial markets of the former Soviet Union. In the first place, there is the fact that citizens lost the money that they had deposited in the Soviet Union's savings banks. These facts are compounded by different cases of dishonest conduct among the managers of the pension funds set up in the early 1990s, the bankruptcy of certain banks, etc. This is the reason behind the population's lack of confidence towards the pension funds, a situation that needs a considerable amount of work in terms of explanation, propaganda and promotion. So far the institutions that have been most active in this sense are the "Kyivmiskbud" Holding and the Arkada Bank, which have been carrying out a pilot plan in the social security field for the past five years, first of all under the auspices of the Presidential decree and later within the framework of a special law.

However, we can see that the implementation and introduction of privately-based pension or social security schemes benefit everyone. Thanks to this, employers are able to solve many social problems, citizens have an additional stimulus to receive pensions in better quantities, and the State receives a considerable resource through investment, providing it with a mechanism to handle social stability. We are convinced that the campaign to explain the advantages of the new pension reform is the most important task for all those taking part in this seminar and we are prepared to learn from the experience of all the countries represented here, from the road already covered by the pension fund administrators and from all the experts working in this field.

However, we understand that this is a long-term process and that certain problems have arisen in various countries where the new pension systems have been implemented, so we realize that we have much to learn in order to be successful in this area.

Finally, I want to wish you all a time of fruitful work and great success in your activities. Thank you.

Words from the Minister of Labour and Social Policy of the Ukraine

Myhailo Papiev

Organizers and participants in this international seminar:

You know that the most important thing for us, the Ukrainians, is to learn from international experience in pension reform. Our reform began only in January this year, when our government took the decision on the three-pillar system, i.e. the pay-as-you-go system, the capitalization system and the private pension funds.

The funds which were operating prior to 2004 worked virtually without a legislative basis, with only the Arkada Bank acting on the grounds of a presidential decree and, later, under the terms of certain laws adapted by parliament. We only began the reform in January 2004 and I can now tell you that there are various officially registered private pension funds, while just one company has obtained the status of official administrator. In other words, we are only talking about the very beginning of a private pensions system.

The aims of the State are in the first place to guarantee the transparency of the private funds' activities; secondly to ensure the supervision of the activities of those funds and guarantee that citizens have transparent access to information about their accounts and other aspects of details. But it is also important to create stimuli so that employers use the private funds more actively.

You know that we have three modes of existence for the pension funds, each of which has its special features.

We are only at the beginning, which is why I wanted to greet those taking part in this international seminar. I, as minister, have studied the experiences of Chile, Poland, Hungary and Croatia and I want to say that it is a sphere of activity affecting every citizen in the country, so any type of experience that you can share is extremely important to us.

My dear colleagues, I wanted to greet you on the occasion of this international seminar and tell you how important it is for these recently formed organizations, such as the private pension funds, to take part in international meetings and conferences. For this reason I am grateful to Guillermo Arthur for providing the opportunity to exchange our ideas and opinions. We are sure that this will encourage the development of social protection for the citizens of the Ukraine.

Thank you for listening.

CHAPTER I

Reform Experiences in Eastern Europe

1 Pension reforms in Eastern Europe

Agnieszka Chlon-Dominczak

Pension reforms in Eastern Europe

Agnieszka Chlon-Dominczak[1]

There are quite a number of countries that have brought in mandatory pension funds or are in the process of doing so as a part of their pension system reforms in the region of Central and Eastern Europe and Central Asia. It is a process that began seven years ago, in 1998, when Hungary and Kazakhstan decided to have mandatory funded schemes. They were followed by Poland (in 1999), Latvia (in 2001, though the introduction of the reform of the pay-as-you-go pillar was implemented earlier), Croatia, Estonia and Bulgaria in 2002 and most recently – Russia. Similar schemes are planned in Macedonia and Slovakia as from 2005. Discussions are continuing in Lithuania and Ukraine. This shows that the speed at which mandatory funded pension systems have been introduced is extremely fast.

The reasons for the multi-pillar pension reforms are similar across countries. Firstly, it is to make pension systems sustainable in the long term through reducing the implicit pension debt and diversify the existing risks. Secondly, most of countries in the region have demographic problems, such as the ageing of the population. Creation of defined contribution systems (in particular funded ones) adjusts pension schemes to demographic risks, though it

[1] Director of the Economic Analysis and Outlook Department at Poland's Ministry of Economics, Work and Social Policy.
Ms. Chlon-Dominczak's prior responsibilities include: Economist at the Gdansk Institute for Market Economics and Researcher at the World Bank. She also held two positions in the Polish Government's Social Security Reform Office: Executive Director and Consultant. She also worked as a Member-Consultant to the Pension Fund System Reform Team in Poland, Russia, Estonia, Latvia and Slovakia.
Ms. Chlon-Dominczak is also the author of several publications on Pension Funds Systems and Labor Economics.

does not reduce them. Thirdly, funded systems encourage people to work for longer: the more people work and save for their pensions, the higher the pension they receive. Currently, participation in the labour market in the analysed countries is fairly low as well as retirement ages. Fourthly, a shift to funded schemes helps to achieve better balance between individual and collective responsibility in the pension system.

Furthermore, having a funded scheme helps people to understand how important it is to save for their old-age, not only in the mandatory system but also in voluntary systems. It also helps to develop and strengthen the financial markets.

Though reasons for introducing the multi-pillar pension reforms were common across the countries, the design of individual schemes varies. There are some similarties, but also many differences in setting up particular elements of those schemes, both from the design and implementation perspectives.

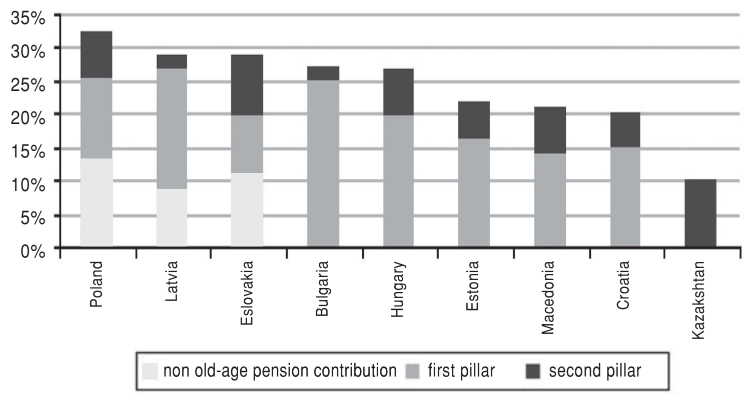
1. Design issues

From the perspective of the overall system design, there are two policy choices, which are important for the funded schemes – contribution level and coverage of workers– who should be covered mandatorily and who can have a voluntary choice of participation. These choices are usually made by policy makers, taking into account possible transition costs and the need to finance existing pension payments. In Poland the cost of the transition is 1.6% of GDP, while in Hungary it is 0.6%. Transition costs are financed by a combination of three elements: current tax receipts, reduced expenditure on current pensions (for example through lower pensions indexation) and debt.

Size of transition costs is one of the reasons why the majority of countries decided to leave significant pay-as-you-go pillars, treating the funded part as complimentary. This was not the case in Kazakhstan, where the funded system replaced the simple pay-as-you-go scheme that existed before. Division of contributions to the pension system is shown in Figure Nº 1. The general level of contributions is quite high in Poland, Hungary, Kazakhstan and Slovakia and less so in Latvia, Estonia and Bulgaria. As a rule, contributions to the funded pillar are carved out of the mandatory contribution that existed before. In Estonia, funded system participants have to pay a contribution that is higher by two percentage points.

FIGURE Nº 1

Contributions to the pension systems

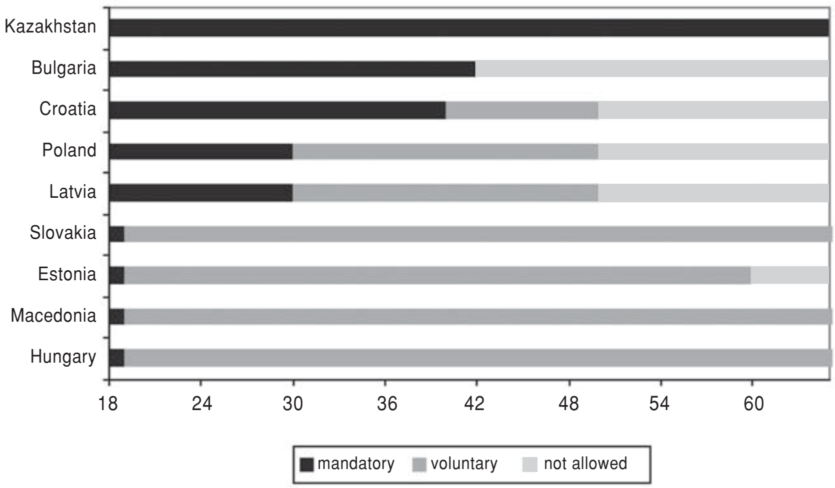


Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

Funded systems usually automatically cover younger workers, with a choice left for older workers (Figure Nº 2). Again, an exception to this rule is Kazakhstan, where all workers were covered by the new scheme. In Estonia, Latvia, Poland, Croatia and Bulgaria, older workers, above a certain age (ranging from 40 to 60 years, depending on the country) were not allowed to participate in the scheme. In all the countries, younger workers (new entrants or workers below a certain age limit) are obliged to participate in the funded scheme. Others could choose, whether to join pension funds or not[2].

[2] It should be noted that the choices also varied as far as pay-as-you-go system rules. For example in Hungary, a choice was between the old and the new pension system, while in Poland, workers below 50 years of age were also automatically covered by the reformed rules of the pay-as-you-go scheme.

FIGURE Nº 2
Participation in the funded pillar



Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

Let us look at the design of the funded schemes from the perspective of the funded pillars.

The State often involves itself in collecting the contributions, including those of the funded scheme. In most of the countries it is so. The only exception is Hungary, which has a de-centralised collection scheme. In two countries (Kazakhstan and Croatia) there is a separate collecting agency, in three (Poland, Macedonia and Slovakia) it is done by social security administrators and in the remaining three (Latvia, Estonia and Bulgaria) there is a joint collection of contributions with taxes.

If we look at the matter of supervision, there is a trend towards consolidation. In five countries it is fully consolidated and in two, partially consolidated (Kazakhstan and Poland). Supervision in Croatia and Macedonia is separate.

As far as charges are concerned, countries limit the types and frequently also the level of charges and fees, as illustrated in Table Nº 1. The types of charges that are allowed include those contribution-based, asset-based and perfomance-based. Also transfer fees can be charged in the case of changing a fund. Sometimes the costs of certain operations are charged directly to the assets, as happens in Poland for example with transaction costs.

TABLE Nº 1
Design of charges

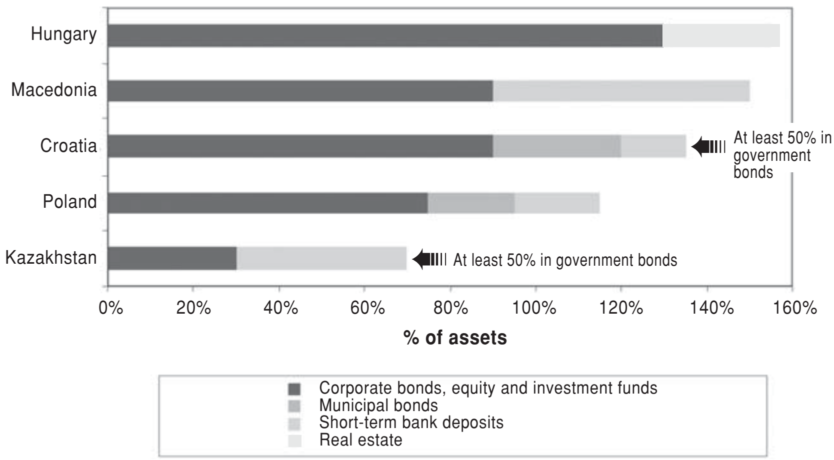
Country	Limit on charge structure	Tipes of charges			
		Admission fee	Contri-bution based fee	Asset manage-ment fee	Performance fee
Hungary	✓	☑	☒	✓	☒
Kazakhstan	✓	☒	☑	☒	☑
Poland (2004)	✓	☒	☑	☑	☑
Latvia	✓	☒	☑	☑	☒
Croatia	✓	☒	☑	✓	☑
Bulgaria	✓	☒	☑	☑	☒
Estonia	✓	☒	☑	☑	☒
Macedonia	✓	☒	✓	☑	☒
Slovakia	✓	☒	☑	☑	☒

Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

Also investment limits vary considerably from one country to another, as we can see in Figure Nº 3. Freedom of investment is highest in Hungary, where more than 100% of assets can be invested in equity, corporate bonds and investment funds, while in other countries, the limits are stricter. Additionally, Croatia and Kazakhstan oblige their pension funds to invest at least 50% in government bonds. Such obligation is also implicit in Kazakhstan, when existing limits are lower than 100% of assets.

There are also restrictions on foreign investments which also show a great disparity. The smaller countries allow higher levels of investment in foreign equities. For example Slovakia is going to raise the level from the current 50% to 70% in the future. Larger countries have lower limits: Poland and Bulgaria allow only 5% of assets to be invested abroad. This may be a problem in the future, when there will be little room to invest pension funds assets in the relatively small financial markets in these countries.

FIGURE Nº 3
Investment limits



Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

Another very important element of the design are the guarantees. Over half the countries guarantee a special minimum rate of return for the pensions sector, relative to the sector performance (Kazakhstan, Poland, Croatia and Slovakia) or to an external benchmark (Hungary). In order to meet obligations resulting from these guarantees as well as to create reserves against fraud or misuse of assets, the law in several countries obliges pension funds to create mandatory reserves, at the company (fund) or at the sector level. Reserves at company level are mandatory in Hungary, Kazakhstan, Bulgaria and Estonia. Until 2004 they were also mandatory in Poland. Reserves at sector level, in the form of guarantee funds, exist in Hungary, Poland and Estonia. The guarantees are costly, as pension funds have to put aside part of their assets in a reserve fund or guarantee fund. At the end of the day, pension fund participants pay for it. The most important question is whether the result is worth the price.

As regards payouts, most countries have opted for mandatory annuities, either through insurance companies or through some specialised company with a licence (Hungary, Croatia, Bulgaria, Estonia and Slovakia). Mandatory annuitisation is also envisaged in Poland, though the issue of the annuity providers has not yet been decided. In Latvia various types of annuities, including deferrals, are allowed. In Macedonia, pensioners can opt for a scheduled withdrawal and in Kazakhstan lump-sum payments are allowed when small amounts are involved.

Finally, the legislation includes certain obligations as regards transparency and accountability of pension fund providers. The most important information, including annual financial statements, investment structure and shareholder information is published in the press or on the Internet. Clients receive information about their individual accounts by mail, but also by internet or the telephone service. Most of the funds have some type of web page where they provide all relevant information. Investment results and values of pension fund units is also published in the newspapers.

2. Implementation issues

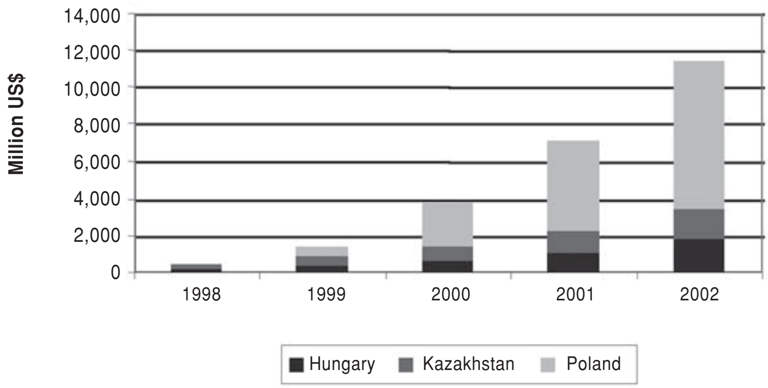
It is not possible to assess the efficiency of the new multi-pillar systems after just a few years of operations. However, first lessons and conclusions can be drawn.

Pension funds are becoming one of the most important local institutional investors in the region. This stems from the fact that the size of the assets grows very rapidly. At the end of 2002 in the three countries that implemented reforms earliest, the total value of pension fund assets exceeded US$ 11 bln, which is shown in Figure Nº 4. The size of assets in each country depends on the number of members (determined by the population size) and the level of contributions. For example, Poland is a large country with a big population and quite large contributions and as a result has the largest assets.

There are also differences in the investment structure, as shown in Figure Nº 5. The first observation is that the actual investment porfolio is more conservative, compared with established investment limits, than in the schemes' design. The share of investment in government debt securities (GDS) exceeds 50% in all the countries. Investments in equity are relatively small, with Poland and Kazakhstan having a slightly higher exposure (around 20%) than other countries.

FIGURE Nº 4

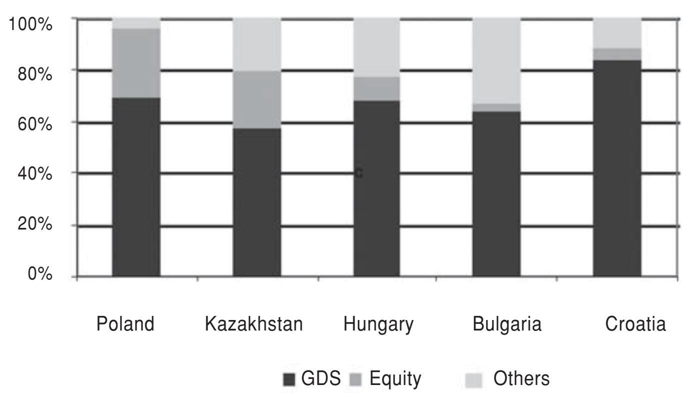
Assets of pension funds (US$ million)



Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

FIGURE Nº 5

Investment structure of pension funds (2002)

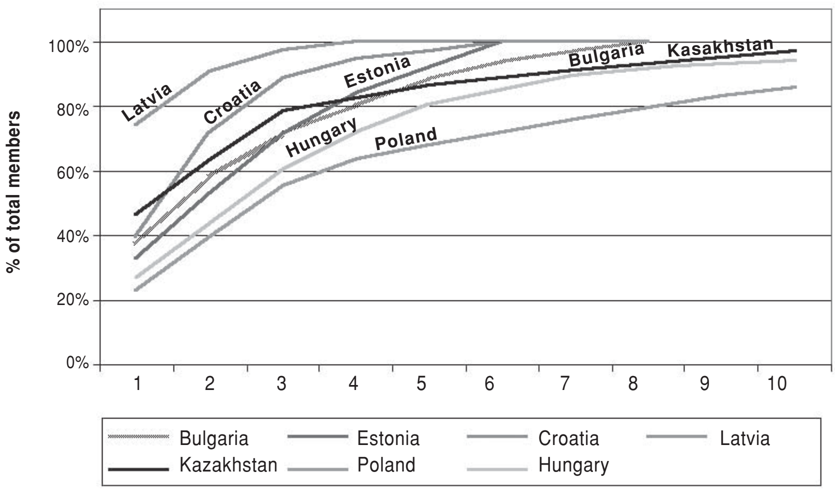


Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

It is also important to point out that the concentration of the market is quite high (Figure Nº 6). All the countries tend to have 60% of the participants in the four largest funds. The case of Latvia and Kazakhstan is interesting, where the largest funds are the state funds. However, with time the share of state funds will fall as people switch from the state funds into the privately-managed funds.

FIGURE Nº 6

Concentration of pension funds market (2002)



Source: Chlon-Dominczak Agnieszka, Evaluation of Reform Experiences in Eastern Europe in: FIAP, Pension Reforms: Results and Challenges, 2003.

As far as charges are concerned, they also vary significantly from one country to another, depending on the legal limitations, supervision practices and competition. Especially the latter is important in the early stages of the scheme's implementation. What is interesting is that economies of scale are almost non-existent. Namely, though the level of charges and costs in the largest funds seems to be relatively modest, there is a great variety in these levels in the case of smaller funds. Costs are usually higher at the initial stage, which is driven by the high costs of sales and advertising. Afterwards, reductions can be observed. A significant portion of the costs covers those items, which are imposed by legislation, such as costs of guarantees and mandatory reserves, costs of reporting or costs of supervision.

3. Conclusions

What conclusions can we draw from the experience of countries in Central and Eastern Europe and Central Asia so far?

Firstly, if people can choose between the pay-as-you-go system and the funded one, a significant share will decide to participate in the latter. Sometimes it is referred to as 'overswitching', but it might also be due to goverment underestimation. There are a few hypotheses that may explain this pheonomenon. People may distrust existing schemes, as they usually do not deliver very high pensions to current pensioners. They also may believe that private managers will deal with their pension savings better than public institutions. If they save their money for a long period of time, the yield may be higher.

Secondly, the markets are usually concentrated. The biggest funds are those with the backing of banks or insurance companies, perhaps because their sales systems are more efficient. Additionally, their shareholders have been present in the market for some time and have more experience in sales and advertising and, what is also important, their brand names are better known.

Thirdly, changing from one fund to another does not occur very often, especially compared with the experiences of countries in Latin America. There may be two explanations for this. Either the design of the system has functioned very well, or people are not interested in changing because the pension funds offer very similar strategies. What can be seen, as already mentioned before, is the move from public funds to privately-managed funds.

Fourthly, the assets continue to grow fast because at the moment no payments are being made, or if they are, they are very small. However, the investment structure seems to be quite conservative. In the long term, investments in equities should increase, there must be diversification of risk between public and private investments, within pension schemes and not only within funded pillars. As pay-as-you-go pillars are, by definition, public, funded pillars should be more exposed to private markets. It is also important to diversify country risk and increase the levels of foreign investment, especially in countries that have a very low limits of such investments.

Finally, on the matter of commissions and costs, it still costs a lot of money to administer these systems, especially at the beginning, but as systems mature, costs are getting lower. Thus, any comparisons of costs should be done after longer experience. What is important is to re-think the issue of guarantees *vis à vis* the costs of these guarantees. At the end of the day, the costs of the guarantees are paid by pension fund members. That is why the subject of guarantees should be re-examined and excessive guarantees should be eliminated. What is important is to have a more competitive environment, which would help to reduce the costs. In order to achieve it, it is also important to work on increasing client awareness.

Multi-pillar systems seem to be becoming a new blueprint for the region, though with significant variations from one country to another. Can it extend further? Obviously there are political economy issues that prevent the introduction of these systems in certain countries, in view of the limitations inherent in such systems with regard to the intra-generational redistribution associated with the change to defined-contribution systems, the problem of increased public deficit, related to financing the transition costs, lower public control over private asset managers and also larger investment risk, resulting in differences in future pension levels.

The transition costs issue is especially important for the new members of the EU, as they need to comply with the Maastricht criteria for public deficit and debt levels. In the light of the difficult public finance situation, shifting to a multi-pillar pension system is a challenge, especially if the assets of mandatory pension funds are treated as private assets. In such case, countries that have funded pillars, by definition, have higher public deficits that countries that have not implented such reforms. Though in the long run, their fiscal situation will be better, in the short term they pay a price for it.

Finally, some thoughts for the future. In the long term we must have responsible, transparent systems, with investments that assure proper diversification of assets. We must keep costs down, not only by obliging the pension fund managers to have low charges, but by having a legal system that prevents costs from rising, which includes reviewing the system of guarantees as requirements imposed on pension funds by law.

2 Pension reform in Croatia

Zoran Anusic

Pension reform in Croatia

ZORAN ANUSIC[1]

In my presentation I will talk about pension reform in Croatia, its achievements, problems and current status.

Unlike most of the countries that have decided to leave the reform of the pay-as-you-go pillar for the final stage, as mentioned by other speakers, in Croatia pension reform began in 1998 with the introduction of a very extensive reform of the pay-as-you-go system, a thorough and restrictive parametric reform. Legislation about funded pillars was passed in 1999 and then the guidelines were established, leading to the setting up of the supervisory authority and registry, Hagena and Regos, in the year 1999.

Although legislated in 1999, the second pillar was launched in 2002 due to fiscal pressures in the country. Perhaps one of the most note-worthy aspects of the Croatian system is that it went hand-in-hand with a large-scale reform of contribution collection and administration throughout the period 2001-2003.

The political economics of the reform have apparently been quite favourable in Croatia because, on the one hand, there were various champions of the reform, i.e. many people who were quite prepared to

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1 Graduated from the University of Sarajevo and received his Masters' degree from Florida State University.
Since 1998, Mr. Anusic is a Senior Economist at the World Bank working on pension reforms in Croatia, Ukraine, Russia, Serbia, Montenegro and other countries.
On 2001 and 2002, he was an Advisor to the Deputy Prime Minister. Prior to his current position, Mr. Anusic took two positions in the Croatian Government: Coordinator of the Committee for Pension Reform of the Government of Croatia and Cabinet Advisor for Pension Reform.
Mr. Anusic has plubished a book and 20 articles. He has also participated in many macroeconomic and econometric modeling scientific projects. His most significant contributions have been in the fiscal and economic policy area.

fight for this reform, and on the other, two very important institutions, Hagena and Regos, have been successfully established and enabled the second pillar to get off to a smooth start. Education and information campaigns have been very successful and we have been able to rely on solid support, not only from the industrial and financial sector but also from employers and workers. The initial support received from the pensioners turned, as you can imagine, into an opposition which gave rise to a decision of the Constitutional Tribunal in 1998.

The first pillar reform contained a package of measures which can be labelled as a fairly standard parametric package. Retiring age has been raised from 55 to 60 years of age for women and from 60 to 65 for men; then, the calculation period now includes all the years of service; the indexing plan was reduced to figures below the average wage (this model has recently been turned around) and there were also elements to tighten the disability criteria.

As a result of the first pillar reform, it was projected that the pay-as-you-go pillar would decline from about 14% of GDP, as it currently stands, to 10% of GDP in 2020, thus allowing the second pillar to develop, which is the upper part of Figure N° 1. Following the recently passed legislation and restoring wage indexation, there is no longer a descending path for the pay-as-you-go share in GDP and this may endanger development of the second pillar. Furthermore, if the contribution to the second pillar continues to be 5% out of 20% total contribution rate, the benefit outcome will not be spectacular; it might be expected that the resulting multipillar replacement rates would be only some 35%, see Figure N° 2.

FIGURE N° 1

Pension system forecast prior to 2004 legislation expanding pay-as-you-go system

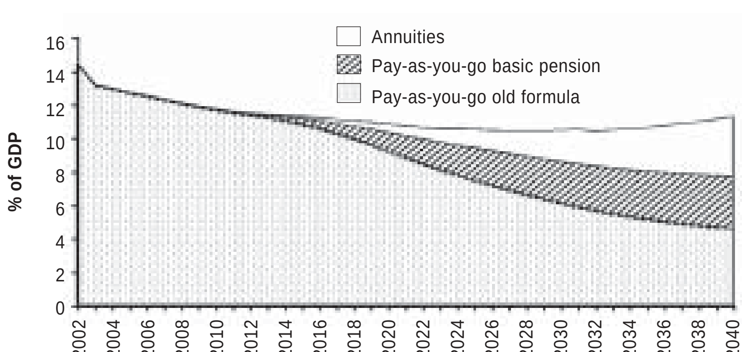
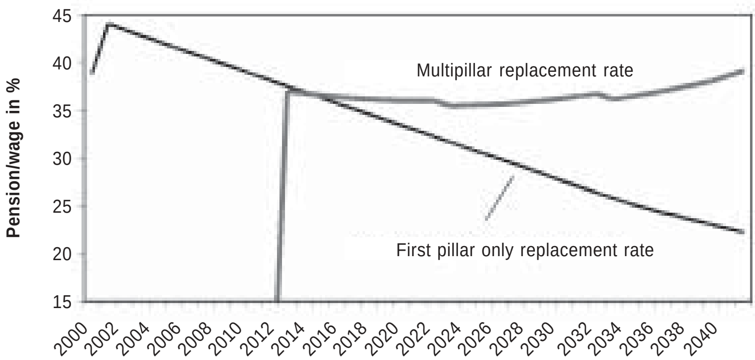


FIGURE N° 2
Target replacement rates (Before 2004 legislation)



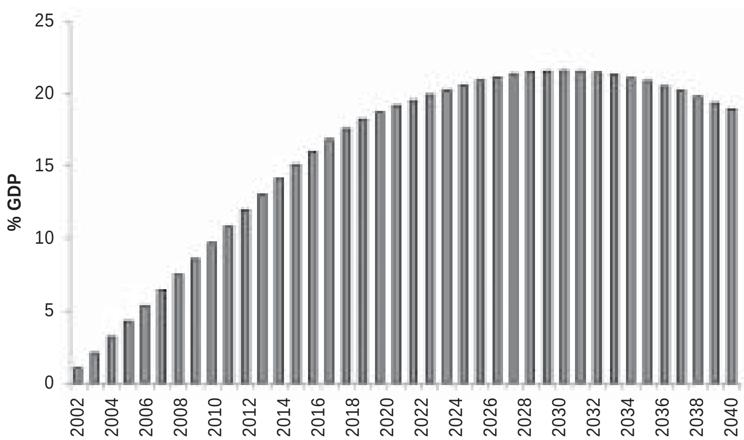
Regarding eligibility for the second pillar, workers under 40 years of age mandatorily enter the multipillar system. Workers between 40 and 50 may choose and workers over 50 years of age are obliged to remain in the pay-as-you-go system.

The pension contribution rate stands at 20% of gross income, 5% of which is paid into the individual accounts of second pillar participants. Second pillar participants pay the remaining 15% into the pay-as-you-go system. The only pension benefit offered by the second pillar is price-indexed life annuity.

It is interesting to analyze the current results of the second pillar. At this moment we have four pension funds. At the starting point there were seven, but in 2002 and 2003 the smaller funds were absorbed by the market leaders in the phase of concentration. There are 1,100,000 second pillar participants, out of a total number of 1,460,000 employed, which gives a second pillar participation rate of about 80%, which is quite a high rate. Net assets currently stand at five billion kunas, or some 3% of GDP. If the contribution of 5% is maintained, the second pillar assets would saturate at some 22% of GDP around 2020, see Figure N° 3; at that point the payout is expected to start being greater than the accumulation of contributions.

The real rate of return was 2.76% last year, but if we study the figures since the beginning we are talking of 7.47% per year. This is due to the fluctuations of the market.

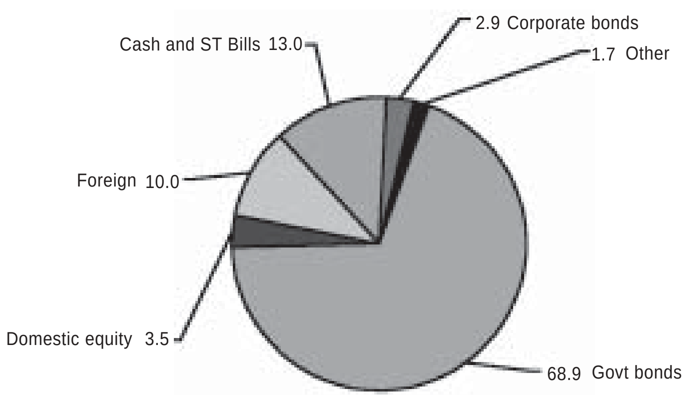
FIGURE N° 3
Second pillar forecast



Another very important feature is that there is very low switching frequency. In other words very few people have switched from one fund to the other. So far, out of over a million people, only ten thousand have switched.

The current second pillar portfolio consists mostly of Government bonds. It is very interesting to note that 10% of assets is being invested abroad, just two years after the system began, see Figure N° 4.

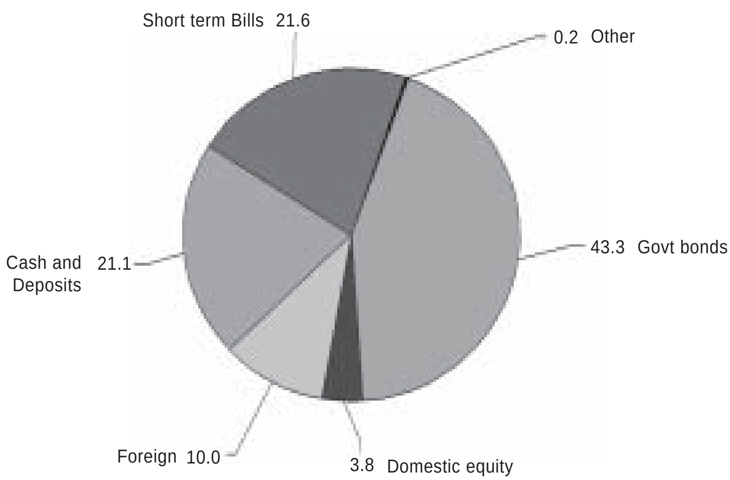
FIGURE N° 4
Second pillar portfolio (%) - March 2004



Let us look now at the third pillar, which is at a very beginning: It is an emerging sector, with four open funds in the month of March, two closed funds, a few pending, and approximately 11,000 participants. The net assets are still about six million dollars, so we can really speak of an emerging or rising industry.

Unlike the second pillar, at the end of 2003 investment limits were completely eliminated in the voluntary system, so they are conducting their investment policy along the prudent person principle. Let us look at what has happened since March in the voluntary pension system. As expected, the result is a lower share in government bonds and a larger share in other instruments, including local fixed income and equities, see Figure N°5.

FIGURE N°5
Third pillar portfolio (%) - March 2004



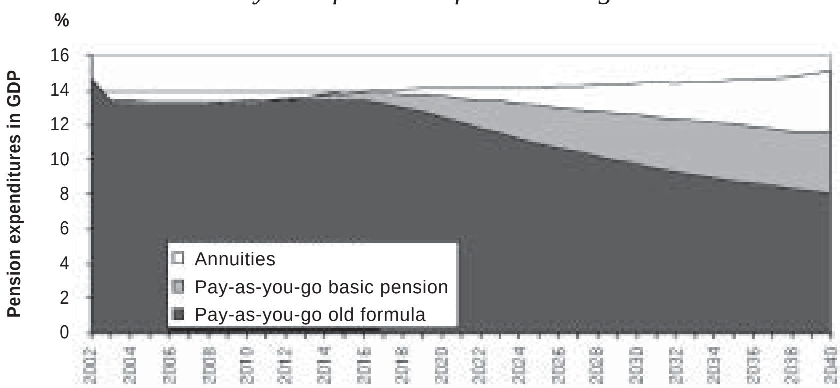
As was said earlier, a reform of the collection and fiscal reporting system accompanied pension reform. If we were suggesting a second pillar which, by its nature, has to rely on precise and prompt information on an individual basis, why not apply new data flows to the whole fiscal system? This is why in Croatia it was suggested to conduct this mini-fiscal reform. It was done in part to improve compliance and reduce administrative costs. The unification of the flows of data for all contributions, including the second pillar, was in the hands of a new institution, Regos, which has been administering monthly individual forms for all contributions, personal income tax and surtax, with the aim of providing monthly information to the relevant institutions such as Tax Department, Pension Institute, Health Fund, second pillar funds, local communities, etc.

It is interesting to analyze the fiscal impact of this mini-reform. The objectives have been met even more effectively with substantial improvement in the collection rate in Croatia. We can see that compliance improved between 2% and 3% in 2002 and up to 5% in the year 2003. This has really helped Croatia to fund a good part of the second pillar transition costs that were pointed out by other speakers as one of the major obstacles for second pillar introduction. So I want to emphasize that the Croatian experience, apart from successfully implementing a three-pillar reform, has consolidated the flows of data and funds in such a way that there is better collection, more collection and better compliance.

Finally, I would like to summarize the successes achieved and the pending problems yet to be solved. As indicated before, the reform of the pay-as-you-go pillar has helped to stabilize pay-as-you-go finances for the year 2000, with the pension expenditure/GDP ratio gradually declining before 2004, see Figure N° 1. The second-pillar administration and collection system has been very robust and reliable. As emphasized, employers do not know which fund their members have chosen and there are various other factors that stress the importance of this private individual aspect of the second pillar. It has really been the greatest achievement of Regos. Pension reform in Croatia had started without major problems.

FIGURE N° 6

Pension system forecast after 2004 legislation



With respect to the supervision of the system, Hagena, the supervising institution for the funded pension system, has also done an excellent job. There have been no difficulties with regard to performance records, partly because Hagena has an efficient daily tracking system on the funds' portfolios. A broad and effective education campaign for the general public has to be mentioned as well.

Finally, the list of problems has to be mentioned. Current government is proposing an increase in the funding of the pay-as-you-go system and this may well be somewhat problematic for our second pillar, as shown in Figure Nº 6. Second, the administrative costs of the second pillar are high, even though we have the centralized individual accounts system administered by Regos. Fund management commissions are too high given the centralized account administration system. The current contribution rate for the second pillar is only 5% out of 20% total contribution rate, whilst our actuarial analyses show that it should be raised to 10% if we want to achieve higher replacement rates for the oldest participants in the second pillar. So far we have not seen significant effects on our capital markets, partly because the assets are in government bonds. The results have improved, but the market shows us that there is not much impact on investments, Furthermore, the development of new instruments has been slow, which has been observed in many other countries that have started funded pension pillars.

3 Pension reform in Bulgaria

Nikola Abadzhiev

Pension reform in Bulgaria

NIKOLA ABADZHIEV[1]

First of all, on behalf of the representatives of Bulgaria, I would like to thank the organizers of this conference, the Ukrainian Arkada Bank and FIAP, for the opportunity to take part in it.

One of the most important and successful reforms to have taken place in Bulgaria in the period of transition to democracy and market economy is related with the pension provision system. In spite of quite a complicated economic and social situation, the reform of the pension system, which normally causes considerable problems, is moving forward.

This reform began in the year 1994 with the establishment of the first voluntary pension funds and was implemented between 1999 and 2003. Now, as a result of that, we have a new three-pillar pension system, which is already showing its social and economic advantages. All the elements of the pension system are functioning effectively and the elements referring to pillars II and III, the mandatory and voluntary supplementary pension, are working at full speed.

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1 Ph.D. in Economics. His defended his dissertation in Moscow and he is an expert in the economics research and labor organization fields.
Dr. Abadzhiev is currently the Chairman of the Bulgarian Association of Supplementary Pension Security Companies (BASPSC) and one of its founding members.
He was Deputy Director of the Bulgarian Trade Unions Economics Department and played an important role as founder and Executive Director of one of the first Supplementary Pension Security Companies in Bulgaria. He was also a Director at the State Security Supervision Agency.
Dr. Abadzhiev has great experience in Social Policy, Financial Analysis, Social Security Economics, Modern Pension Systems Development, Pension Fund Investments and Investment Policy and Capital Markets Development.

What stages did the Bulgarian pension reform go through? In practice, the reform in Bulgaria did not start from the top. In other words, it was not begun by the government but from the lower levels. The first supplementary pension funds in Bulgaria were created as public limited companies with shares in the years 1994 and 1995, on the initiative of financial institutions, banks, trade unions and insurance companies. When these companies started their activities, they leant mainly on international experience.

In the year 1997, the Bulgarian Association of Supplementary Pension Security Companies was set up. We believe that this was a very important stage in the pension reform, because then we were able to use the full potential of the pension funds and the possibility also arose for the government to take part in the pension reform. The experience of those companies played a very important part in defining the strategy and objectives of the reform and also in the adoption of new legislation in this area.

In 1999, the law on supplementary pension insurance was drafted and adopted and in 2000 the law on the supplementary mandatory pension system was adopted. Here we can also see other significant stages in the development of the pension system in Bulgaria: in 2000 the special state supervisory agency was set up and the pension companies were licensed. Between the years 2001 and 2002, the occupational and universal pension funds began collecting contributions and in 2003 the new Social Insurance Code was adopted which in practice elaborated the existing legislative base and reinforced the philosophy of the pension reform implemented in Bulgaria.

What were the problems of social insurance prior to 1999 when the state supervisory agency came into being? As we can see, there was easy access to the system, lack of funds to pay the benefits, inadequate financial coverage and a high level of unemployment. There were unfavourable trends in the economic situation, social injustice, high taxes on pension funds and a low level of pensions as such.

The main characteristic of the system that existed before 1999 was the fact that it was based on the pay-as-you-go principle. The basis of the system was the redistribution of funds between those who were working and the pensioners. In the year 1997, Bulgaria found itself in a deep economic crisis, as a result of which the pension system went through a very difficult time. Due to these new circumstances, the incentives appeared for achieving consensus in society with regard to reforming the pension system. There was no doubt about the need to carry out the reform. On that basis, in 1998 the government gave its support to the idea of creating a three-pillar pension system and also adopted the philosophy of implementing a radical reform of the system.

What were the main objectives of the reform? A higher level of social justice, an increase in the level of protection for the population and improvement in the material conditions of pensioners, a fortification of the structure of the pension system and diversification of the methods of social security for pensions.

In order to achieve those objectives, it was necessary to carry out a deep comparative analysis of the potential strategies for implementing this reform. We are going to look at the results of this analysis.

As we can see, the first alternative consisted in an attempt to carry out the reform within the framework and limits of the existing pay-as-you-go system, but no effect was achieved. On the contrary, those attempts showed that the most outstanding features of the pay-as-you-go system are its disadvantages.

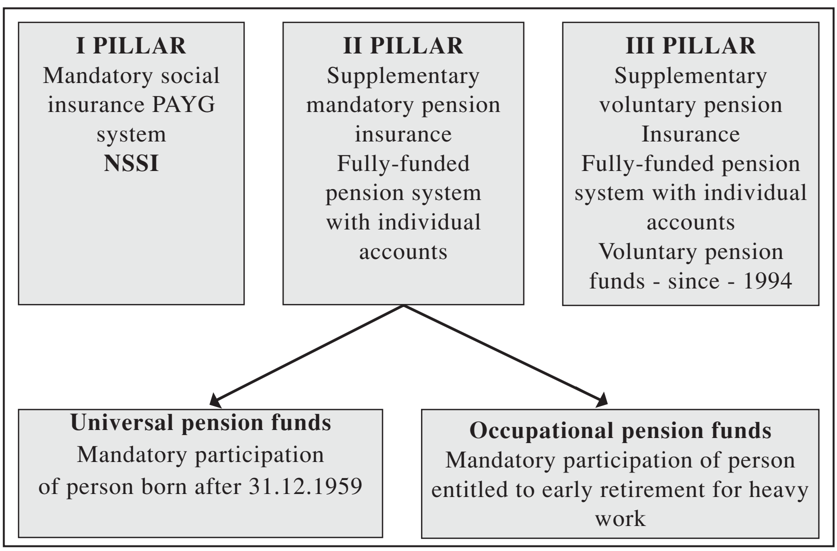
The second alternative was to completely abolish the first pillar. However, despite all the deficiencies and weaknesses of the pay-as-you-go system, bearing in mind the tradition of social security in Bulgaria and due to the potential conflict between the generations, it was decided that it was impossible to reject the first pillar of the system altogether and switch completely to the individual capitalization system.

The third alternative? It was proved that the combination of the positive features of a modernized public pay-as-you-go system with the advantages of a fully-funded mandatory supplementary system (Pillar II) and a voluntary supplementary system (Pillar III) was the only possible strategy to achieve the objectives of the pension reform. It was precisely the selection of this option that helped the successful implementation of the pension reform.

Important pre-requisites for the reform were the political support, the attitude of the population, the international experience, the positive results achieved in Bulgaria in the social insurance sphere and the significant support of the financial institutions.

Finally, the foundations were laid for the model that Bulgaria has today. In Diagram N° 1, you can see the Bulgarian model, which has a first pillar, the mandatory social insurance system, a second pillar –mandatory supplementary pension insurance, and a third pillar– supplementary voluntary pension insurance. A feature of this second pillar is that it has two types of funds: the universal pension funds set up for those born after the year 1959, and the occupational funds which are, for example, for certain categories of workers who work in hard conditions and are entitled to retire at an earlier age.

Diagram N° 1
Bulgarian Pension Model



What are the main characteristics of the Bulgarian model? I do not want to list this information in detail now, but here you can see some of the main features: reform of the social insurance system, the mandatory nature of participation in this system in which each fund is a separate legal entity, centralized collection of contributions, public control of the pension companies' operations, public supervision of the activities of the pension funds and tax incentives for contributors/employers and fund members.

Here we present the Financial Supervision Commission. You will remember that at the beginning I mentioned the creation of a special independent state supervisory body for the pension funds in 2000. In 2003, this body was incorporated in the structure of the Financial Supervision Commission which supervises all non-banking financial institutions in the country, including pension funds.

Diagram N° 2, shows the structure of inspection and regulation operations etc. and then we have the description of the functions of those agencies.

Diagram N° 2
State supervision

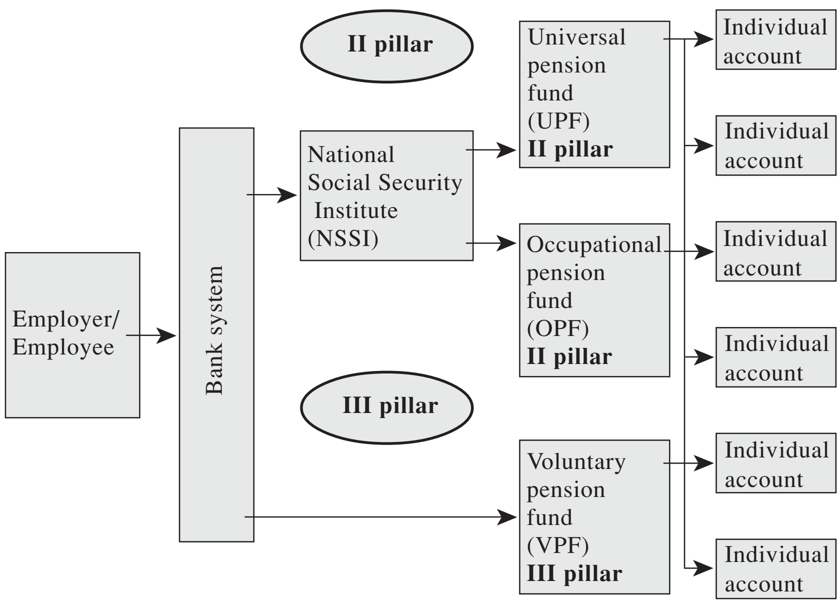
FINANCIAL SUPERVISION COMMISSION
Specialized state body competent to regulate and supervise investment, private pension provision and insurance activity in the country

DIRECTORATE OF SOCIAL INSURANCE SUPERVISION
Directly regulates and supervises the activity of pension funds and their managing companies in compliance with the Social Insurance Code.
There are two departments in the directorate:
– Licensing and Risk Valuation Departments and
– Supervision Department.

Now we can see certain specific features of the Bulgarian pension model which differentiate it from the models adopted by other countries. In particular, these are: retaining a more important role for the public pay-as-you-go system, a gradual increase of the coverage of the fully-funded system by transferring an increasing portion of mandatory contributions towards it, the establishing of the possibility for each company to manage three supplementary pension funds, mandatory payment of contributions in occupational (100 per cent paid by the employer) and universal pension funds. In the case of universal pension funds, the distribution of the payment between the employer and the worker is currently 75% and 25% respectively, and the law provides that this ratio should reach 50% each.

In Diagram N° 3, we can see a very special feature of the Bulgarian pension system, showing the interaction between the public and private systems. Here we can see a combination of the direct and indirect collection of contributions for supplementary pension funds. Employer and member contributions for the Pillar II funds are collected by the National Social Security Institute and are then transferred to private pension funds, while members and employers make direct payments into the pension fund for pillar III. In our opinion, adopting this scheme for collection of contributions is one of the significant factors in the success of the Bulgarian pension reform.

DIAGRAM N° 3
Path of pension fund contribution

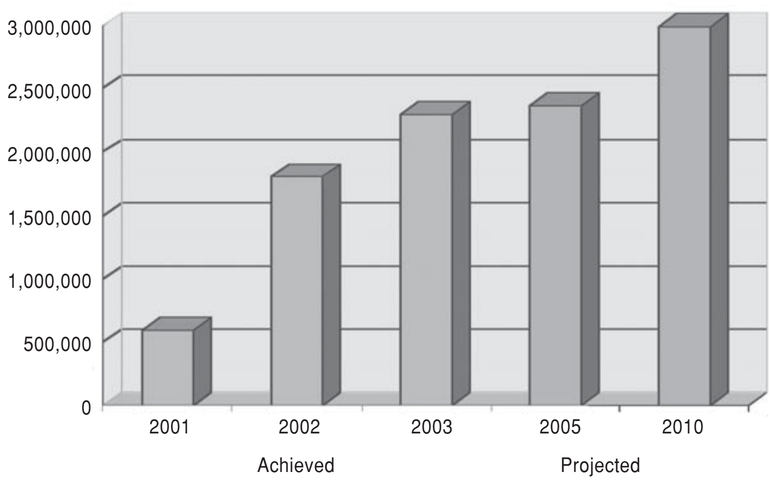


As I have already mentioned, the Bulgarian pension system reform has a ten-year history and here we can see the position in our country today. What are the realities as of 2004? There is a serious legislative basis and a working three-pillar pension system. We can, therefore, see a new branch of activities that did not exist in our country before, based on modern economic and managerial principles. We have eight licensed and fully operational pension insurance companies which manage 24 Pillar II and III pension funds. Over 2 million of our citizens now have their individual accounts in these funds where they are accumulating resources for their pensions.

Figure N° 1 is a confirmation of the results that I have presented. This shows the growth in the number of members and we can also see that the rate of these increases is quite high. At the end of 2003, we already had 2,294,966 people, representing 27.2% more members than in the year 2002. As regards the growth rate in financial resources, we can also see the positive trends for the year 2003. The resources for that year are up 54% on the figures for the year 2002.

FIGURE N° 1

Rate of increase of pension fund members



On Table N° 1, which shows the achieved return, we can see that the three types of funds achieved a very good return, thanks to their investment policies. For example, the average return for the universal funds in 2003 is over 11.23%, for occupational funds it is 11.00%, and for voluntary funds it is 11.09%. On the following transparencies we can see the levels of distributed return in the fund members' individual accounts for all types of funds.

Looking at the data regarding the Bulgarian pension funds' investment portfolios, it should be noted in advance that the Social Insurance Code lays down a very conservative framework for the investment activities of pension companies.

TABLE N° 1
Rate of return

	Arithmetic average rate of return	Weighed average rate of return
UPF		
– From 01-01-03 until 31-12-03	11.23	10.99
– From 01-04-02 until 31-12-03 (21 months)	22.79	22.73
OPF		
– From 01-01-03 until 31-12-03	11.00	11.01
– From 01-01-02 until 31-12-03 (24 months)	23.19	22.98
VPF		
– From 01-01-03 until 31-12-03	11.09	-
– From 01-01-02 until 31-12-03 (24 months)	23.17	-
– From 01-01-02 until 31-12-03 (Net distribution rate)	20.77	-

References:
- Average interest rate on bank deposits in BGL 2003 - 5.38%
- Inflation rate - 5.60%.

What was the structure of the investment portfolio for the year 2003? Figure N° 2 shows the data for the investment portfolio of the funds collected, proving with all the evidence that in spite of the conservative legislation and the resulting limitations, it is also possible to register a number of fund achievements and successes. We have to gradually reject those conservative investment models and the State, on the other hand, should search for and propose to the pension funds investment instruments that will enable investment opportunities and the substantial financial resources thus accumulated to be used even more effectively for the development of the economy of the country. Certainly, our opinion is that the liberalization of the existing investment regime should be done very carefully and gradually, simultaneously with the increasing of the financial power of the pension companies and funds and should be accompanied by even greater guarantees for the assets of the fund members.

In Table N° 2, it is also possible to see the pension funds' share in public investments.

FIGURE N° 2
Investment portfolio (total pension funds as of 31.12.2003)

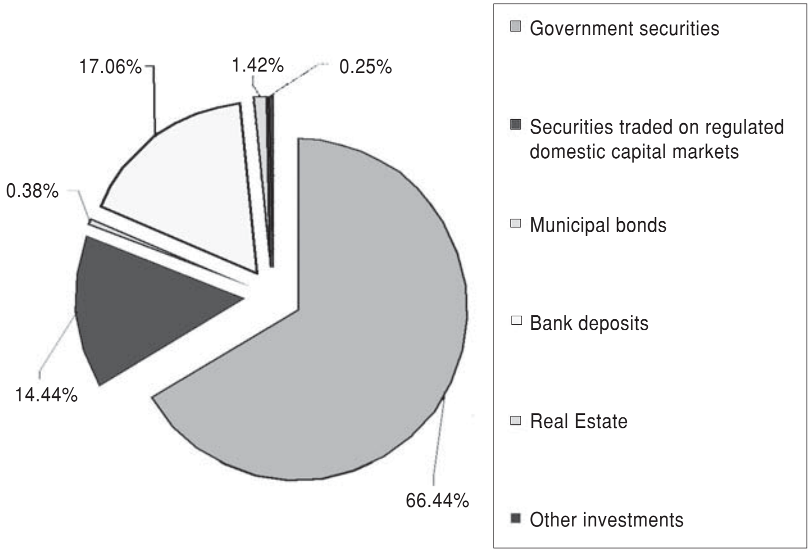


TABLE N° 2
Types of government securities held by pension funds as of 31.12.2003

	UPF		OPF		VPF		Total	
Types of government securities	**Value (thousands)**	**Share (%)**	**Value (thousands)**	**Share (%)**	**Value (thousands)**	**Share (%)**	**Value (thousands)**	**Share (%)**
Discount T-bonds	795	1.02	146	0.15	244	0.21	1,185	0.41
Interest-bearing T-bonds	39,083	50.34	46,610	48.48	44,530	39.20	130,223	45.32
ZUNK bonds	23,830	30.69	32,672	33.98	31,612	27.83	88,114	30.66
Eurobonds	2,425	3.12	4,426	4.61	12,381	10.90	19,232	6.69
Global bonds	11,502	14.83	12,288	12.78	24,828	21.86	48,618	16.92
Total	77,635	100.00	96,143	100.00	113,594	100.00	287,372	100.00

Finally, I would like to underline the fact that though Bulgaria undoubtedly has very positive results and trends, we also have to recognize that, for the future development of the system, we must solve some very serious problems which also have a number of options or alternatives for their solution.

Here we show our priorities and challenges for the next stage of development of our pension system, and I would like to mention just a few of them: reinforcement of the privileged participation mechanism, growth of the specific weight of capitalization and strengthening of the role of the universal funds, increasing the contribution rate for supplementary funds, daily asset valuation and rationalization of the switching process.

To conclude, I would like to say that the successful activity of the pension funds in Bulgaria guarantees the achievement of even more important results for the country's economic development in general.

4 Pension reform in Hungary

Csaba Nagy

Pension reform in Hungary

CSABA NAGY[1]

First of all, I want to thank the organizers for their kind invitation and the opportunity of sharing experiences with you in relation to the pension reform in Hungary.

As Agnieszka has mentioned, Hungary was one of the first countries in Eastern Europe to embark upon pension reform in the early 1990s. Being among the first, of course, has brought several advantages but the lack of experience led to several issues and disadvantages that still have to be sorted out.

One of the merits of the early start lies in the opportunity of accumulating experience regarding the second and third pillars. By contrast, countries starting their reform efforts later, in the second wave, have been able to learn from the mistakes made by the early reformers.

1. Background

To give you a little background information about Hungary, let us look at a few major facts. You are well aware that Hungary went through a transition in the beginning of the 1990s and the economy began to develop according to the challenges of the international

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1 President of the National Savings and Commercial Bank of Hungary (OTP) Pension Funds and President of the Hungarian Pension Funds Association (STABILITAS). He is also a Board Member of the National Pension Guarantee Fund and a member of the Advisory Board to the President of the Hungarian Financial Supervisory Authority.
Mr. Nagy was also Head of International Audit Risk Management Departments at OTP.

trade and money markets. In paralell to this, the old paternalistic social schemes had to be reviewed and redesigned.

Now let us take a look at the changes in the insurance sector from 1989. After several years of parliamentary discussions, the most important milestone in Hungary was the creation of pension funds in 1993. Thus we have already had ten years of history and experience in the field of these voluntary funds. The second major milestone, that we are going to talk about in detail, was the setting up of so-called private pension funds. This is a sort of partial opting-out scheme dating back to 1998, the regulation of which has been gradually developed since then.

It may be helpful at this point to give a bit of additional information to enable you better follow the developments. The figures that appear in Table N° 1, characterizing the current pension sector, looked very different in 1998. You can see that as of the end of 2003 in Hungary we have 18 mandatory (private) and 83 voluntary funds. By comparison, in 1998 there were 36 mandatory funds. The decrease is explained by mergers and buy-outs. The number of voluntary pension funds was much higher at that time, almost 200, and has now diminished to only 83.

Hungary is a relatively small country with slightly over ten million inhabitants, of whom 4,100 thousand are present actively or passively on the labour force market. There are 2,300 thousand insured people participating in the mandatory funds, and this is nearly 54% of the labour force. As the choice of opting out was offered to all workers in 1998, and they could make their voluntary decisions on joining, we can conclude this is a high percentage.

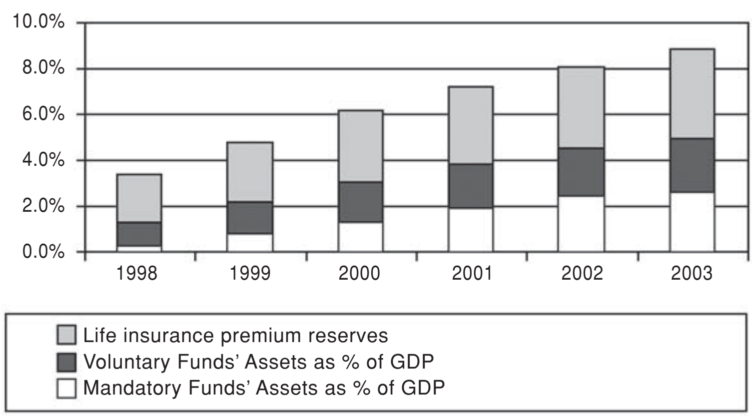
As regards voluntary funds, there are 1,300 thousand participants, that is 28 % of the economically active population. Figure N° 1 shows the cumulated pension as a percentage of GDP.

TABLE N° 1
Savings as of end 2003

Concept	Insurance companies (Life + composite)	Mandatory private pension funds	Voluntary pension funds
Number	20	18	83
Number of insured/people (in thousands)	2,670	2,305	1,218
Reserves (billion HUFs)	650.2	561.4	434.4
Reserves in million EURs*	2,444	2,111	1,633
Reserves as percentage of GDP	3.73	2.59	2.34

* (1 EUR = 266 HUFs); data as of December 31st, 2003.

FIGURE N° 1
Accumulated pension savings as percentage of GDP

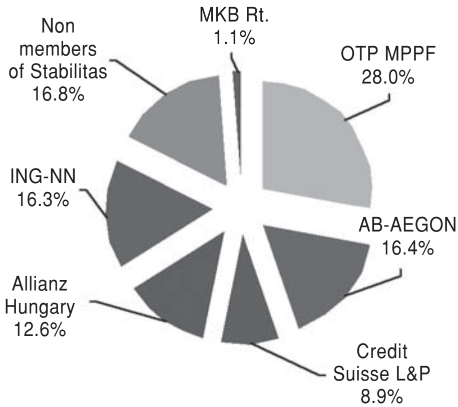


We can meet very well-known names in the insurance sector on the Hungarian market, such as Aegon, Allianz, ING. The subsidiaries of these international enterprises were already established in Hungary when pension funds started their operation. See Figure N° 2, for more details.

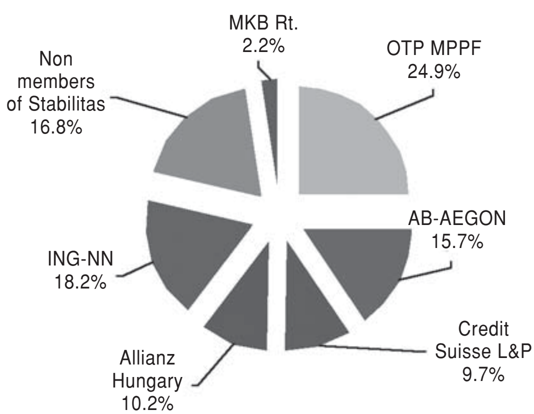
There is one domestic (Hungarian) bank called OTP, the initials of which are perhaps familiar to you, that has got involved in setting up and operating the pension business.

We, the management of OTP Private Pension Fund, are very proud of having achieved the best results and a market share of 28 % based on the number of fund members (i.e. covered). We are proud, as I said, of having achieved this success on our own. I hope that the OTP logo will soon become well-known in other countries due to successful acquisitions and enterprises in the region.

FIGURE N° 2
Market share



Based on number of members



Based on value of assets

Please note that STABILITAS referres to the Hungarian Association of Pension Funds and includes the six names shown on the above charts.

The establishment of the STABILITAS Association was agreed in 1998, after a kind of agency war was experienced in the pension business. There was a lot of debate about how to attract people into our funds. The leaders of the "big five" decided to sit down and discuss the need for stabilization of the market, since the common goal is to cover the majority of the younger population in the mandatory pension funds. The sixth member joined the association later. In this respect this resolution and stabilization approved very successful, since membership in the private pension funds has exceeded the most optimistic government projections.

The association also takes part in the process of improving regulation and encouraging harmonisation. Based on the successes achieved last year, we applied for and gained membership of EFRP (European Federation for Retirement Provision). We are fully prepared to get involved in the activity of this international association as from 2004.

2. Major characteristics of Hungarian pension funds

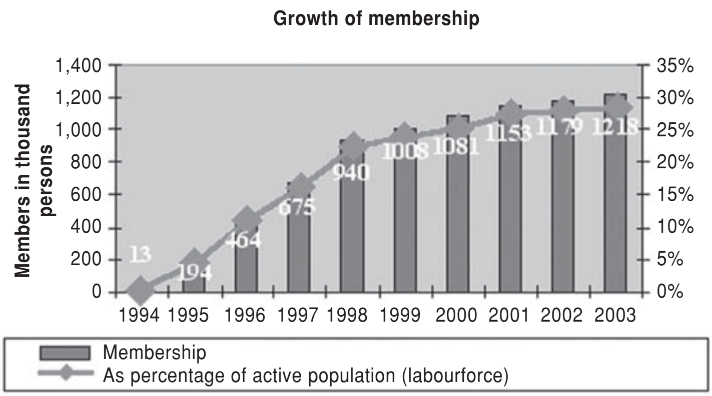
Regarding the main features, well, these are non-profit organizations. Any surplus or profit will be distributed among the members of the pension fund. It is important to emphasize that these schemes are fully-funded. We are talking about defined contribution (DC) schemes, i.e. the benefits are determined on the basis of the payments and contributions on behalf of the members and on the returns of the investments of the assets.

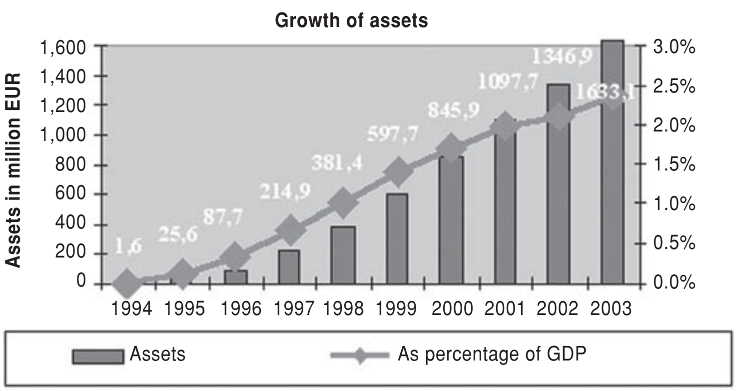
Another very important aspect to bear in mind is mutual ownership. This means that the members or associates are the owners of the pension funds. The representatives of the members are duly appointed by the annual general meeting every five years. The founders or employers can sponsor or support the funds, but decisions regarding the operation will remain with the duly elected representatives.

I am going to give you an example to explain how mutual ownership works. Regarding OTP Private Pension Fund, there are today over 650,000 members in our pension fund. No more than one hundred delegates have to be elected, who are prepared to take part in representation of and communication with other members, though their knowledge regarding the operation and administration of the fund may be fairly limited. I believe that employees of the different regions and branches will make a suitable choice as they have quick and direct access to information through the commercial network.

Regular communication or training seems to me essential, because it is desirable that representatives have somewhat specialized knowledge of the activities they are engaged in.

FIGURE N° 3
Voluntary pension funds

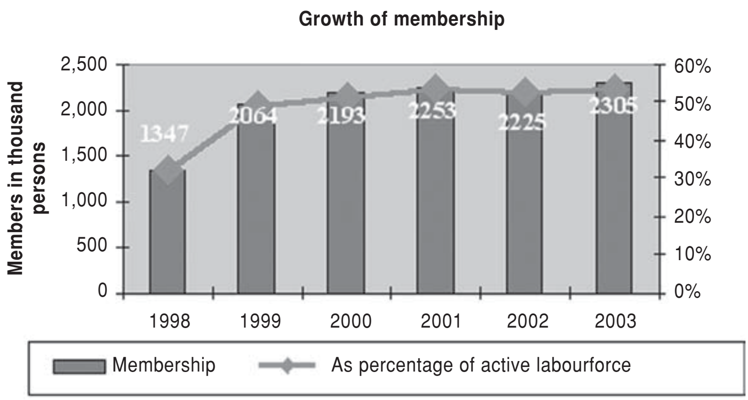


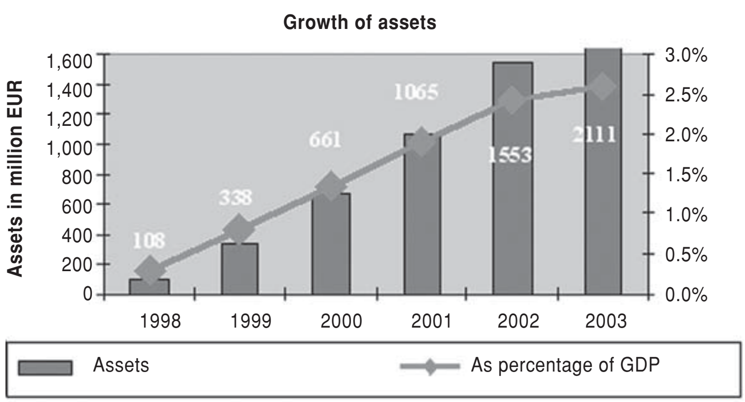


Funds are indeed useful and effective savings vehicles, with the aim of providing supplementary pensions after retirement. Only 28.4% of the active population is covered by voluntary funds and I believe this ratio has to increase in the future. We are talking about a lack of coverage affecting three million people, 71.6% of the active labour force.

We can now see the growth of these funds on the following bar-charts, both the voluntary and mandatory funds.

CHART N° 4
Mandatory private pension funds





3. Issues in focus

I was asked to talk a little about current issues of the Hungarian system and also comment on those who were for and against it.

Referring back to 1998, the year in which funds representing the second pillar started their operation, the reform was followed by political elections in the summer and changes in different directions came into effect. What did they cause? Pensioners usually constitute a major segment of the electors who are generally attracted by promises that have an impact on the costs of social security in the future. The arrival of the new government led to a cut in the rate of contributions to the second pillar, in order to allocate more resources to the pay-as-you-go first pillar, while keeping the total rate of contribution unchanged.

Initially in 1998 the rate of contribution was set as 6 % of the gross salaries, followed by 7 % in 1999 and 8 % in 2000 and so on. Either the employer or the employee has the option to make additional payments up to 10 % of the wage base in order to increase future pension provisions. This system seemed to me to be an excellent idea.

The new government arrived and immediately froze the rate of 6 % at that level and did not seem to worry about the reduction in members' future pensions implied by the changed scheme. It has also cancelled previous guarantees and obligations in relation to the second pillar. This situation was resolved only when corrective political changes were effected following the elections in 2002.

Another feature of the scheme that gave opportunity for manipulation was the final date up to which people who voluntarily joined the two-pillar system were allowed to change their minds and return the old scheme. Originally this date was set as 31st December 2000, and this date for return has been deferred to end of 2002. Such unfavourable decisions cannot be regarded as very helpful to the Hungarian pension system.

During the recruitment of members we have to bear in mind that the labour force in Hungary was only allowed up to 31st August 1999 to choose whether to stay in the old scheme or become covered by the two-pillar scheme. Freezing the rate at 6 % was a real draw-back to the growth of the second pillar, while the deferral of the date of return aimed to push members who had switched to the two-pillar scheme to return to the old pay-as-you-go (PAYGO) scheme.

As I said, the elections in summer 2002 were favourable with respect to pension reform efforts, as the supporters of the two-pillar scheme gained power again and started immediately to make corrections according to the original ideas of the pension reform.

This is the situation of the second pillar in Hungary today. It is not quite clear what we are going to face after the following elections in 2006. We will see then what happens. I personally would be very happy if we could reach an agreement or guaranteees for stability in legislation and ensure the development of our pension system without having to be subjected to this continuous cut and thrust.

Regarding the development of voluntary mutual pension funds, let me refer back to Figure N° 3. There we can see the number of members between 1994 and 2003. In 1997 and 1998 there was a boom. These are the years in which the establishment of the second pillar was in focus. This was the time of powerful marketing campaigns. The government also started a sort of education campaign directed at citizens, emphasizing not only the advantages of the second pillar but also the importance of the savings in supplementary pension funds. The latter had achieved little recognition and acceptance in Hungary prior to the campaign. The mentality of the population has changed thanks to the education campaigns, and many citizens got enrolled in the second and third pillar at the same time.

In Figure N° 3 and N° 4 you can see the accumulation of pension assets up to the end of year 2003. The magnitude of 2.1 billions of euros is quite significant, considering the size of my country. It is a great achievement to have reached 2.6 % of Hungarian GDP (see Table N° 1). The accumulation of assets in the voluntary pension funds shows 1,600 million euros, 2.3 % of the GDP.

I would just like to add in parenthesis that I am quite pleased with these figures. I have just read the figures characterizing the Dutch pension system. Are you aware of the percentage of Dutch savings in the third pillar compared to their national product? Under 10 % perhaps? Well, it is 58 %, i.e the ratio of savings in pension funds in the Netherlands to the GDP. Since in Hungary it is 2.3% of GDP, obviously we have to work hard on accumulation if we are ever to catch up with the Netherlands.

The total reserves of life insurance, voluntary and mandatory funds make up 9 % of the Hungarian GDP (see Figure N° 1).

4. Challenges

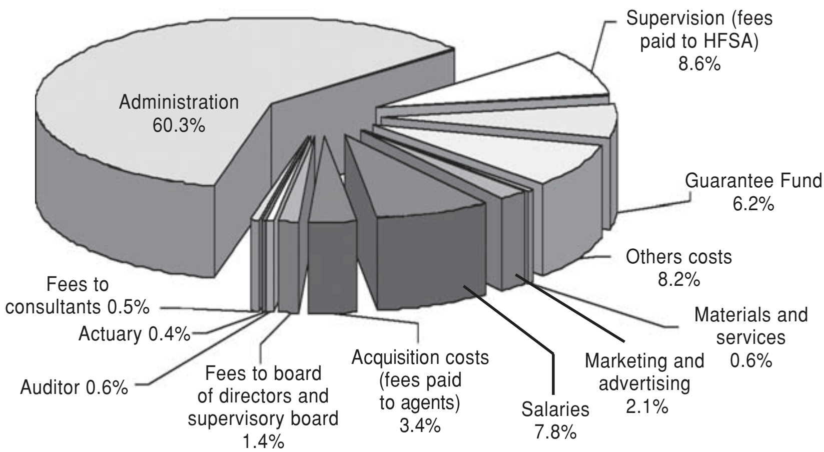
What are the great achievements of the pension reform in Hungary? I believe I have mentioned them already. A high proportion of the active labour force opted out and switched to the two-pillar scheme. The private mandatory pension funds operate in a competitive environment and the accumulation in members' individual accounts in the mandatory system gives greater transparency, more responsibility and better results as compared to the state pay-as-you-go system. It is also clear that the segments of the population targetted by voluntary and mandatory funds are quite different.

Hungary is the only country where the collection of the (mandatory) contributions lies with the private funds. In other countries collection by the social security institutions is typical, and paid contributions will be regularly transferred by the social security to the fund. The Hungarian system, of course, is more costly and it is more difficult to levy unpaid contributions, due to the rather low fees that members can be charged.

I would like to say a few words regarding fees and costs of operation. Out of the contributions paid in, between 93 % and 95 % is allocated to the individual account of the pension fund member, while a portion between 4.5 % and 6 % goes to the operating resources of the pension fund. In other words, an average 5 % management fee is charged to finance the costs of administration of the Hungarian funds.

In Figure N° 5 you can see most expensive items. Managing the largest fund in Hungary, I have to admit that it is hard to operate economically and little profits can be achieved without reducing the rate of allocation to members' accounts. There are too many regulations, it is a highly sophisticated system and changes are needed in the short term if not immediately.

FIGURE N° 5
Breakdown of typical costs of private pension funds in Hungary



5. Summary

Finally I would like to summarize our main objectives for the future. Of course, we aim to have have a cheaper, more transparent system, that allows us to reduce the costs of operation in the first place. Secondly, we must emphasize the system of good governance, and finally, we aim to have a pension system that is more independent of political changes. These aims are equally in the interest of members, managers and providers of services to the funds as well.

5 Pension reform in Poland

Pawel Wojciechowski

Pension reform in Poland

PAWEL WOJCIECHOWSKI[1]

I want to say that after what Agnieszka has presented here, we should all feel slightly uncomfortable, because she has said it all. I shall therefore make a few more personal comments on where we are now, five years after the pension reform was implemented in Poland. I want to draw your attention to the fact that although the systems vary greatly from one country to another, the problems are very similar. Of course if things are designed properly at the beginning there are less problems in the future, as it is in the Polish case.

I shall divide my presentation into four parts. Firstly, I would like to discuss the rationale that prompted the reform, in particular the fiscal approach that emphasizes the financial sustainability of the system. Secondly, I would like to touch on the issue of client's needs, such as security and profitability, as well as other issues such as portability of the system. Thirdly, I would like to address the question that is particularly relevant to the Polish system

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Dr. Wojciechowski's prior positions were, among others: Executive Director of PBK ATUT Investment Fund Company S.A and the Polish Fund Management Group. He was also Advisor to the Minister of Privatisation and an Analyst at the Center for Regional Economic Issues, Cleveland, Ohio, USA.
Dr. Wojciechowski is also author and co-author of Investment and Fund Management publications.

today: Are the domestic capital markets adequate to support the investments of pension funds? Fourthly, I would like to touch the issues of prospects for fund administrators, such as Allianz, where I work in this private-public partnership.

As we look back five years after the reform was implemented in Poland we can proudly say that the system was designed properly. With support of World Bank experts such as Michal Rutkowski we introduced the multi-pillar approach. So far we are still missing the well-designed personal part of the third pillar, which will be implemented at the beginning of September this year, as the so-called Individual Retirement Account, abbreviated IKE.

Of course, we have introduced the public-private partnership in Polish pension reform with active participation of the largest European financial institutions, such as Allianz. Also we introduced the defined contribution (DC) scheme often recommended by the World Bank, and more often now also by the European Union, as the DC form enhances a certain mobility in the system and perhaps portability in the future within EU. See Table N° 1.

A good solution is also the EET[2] system design that exempts taxing contributions and capital gains, but not benefits. That worked well in the mandatory II pillar, but not so well in the voluntary III pillar. That is a TEE[3] system, which offers insufficient tax incentives and therefore has not developed quickly in Poland. Today in the III pillar there are only 250,000 participants, in comparison to 10 million clients in II pillar pension funds.

In the II pillar - the premiums passed to the individual accounts in pension funds are collected from the payroll by central administrator - ZUS. In the III corporate part, premiums are collected and transferred by corporations whereas in the III personal pillar they are collected directly from individuals. Again various solutions well serve the purpose.

2 EET: Exempt - Exempt - Taxed.
3 TEE: Taxed - Exempt - Exempt.

TABLE N° 1

Poland introduced in 1999 one of the most comprehensive pension systems of all CEE countries

Trends in PF systems	Poland	Explanation
Multipillar	+	I pillar - mandatory public II pillar - mandatory, private asset managers III pillar - voluntary, occupational and personal(1)
Public - private partnership	+	II pillar - private asset managers PTE manages OFE III pillar - investment, insurance(2)
Defined Contribution	+	I pillar - notional DC, linked to inflation and wages II pillar - funded, DC, individual III pillar - funded, DC/DB, individual collective
EET	+	II pillar - EET III pillar - TEE
Liberal investment limits	+/-	II pillar - rigid restrictions, ex. 5% foreign investments III pillar - liberal
No minimum guarantee	-	II pillar - minimum guaranteed return

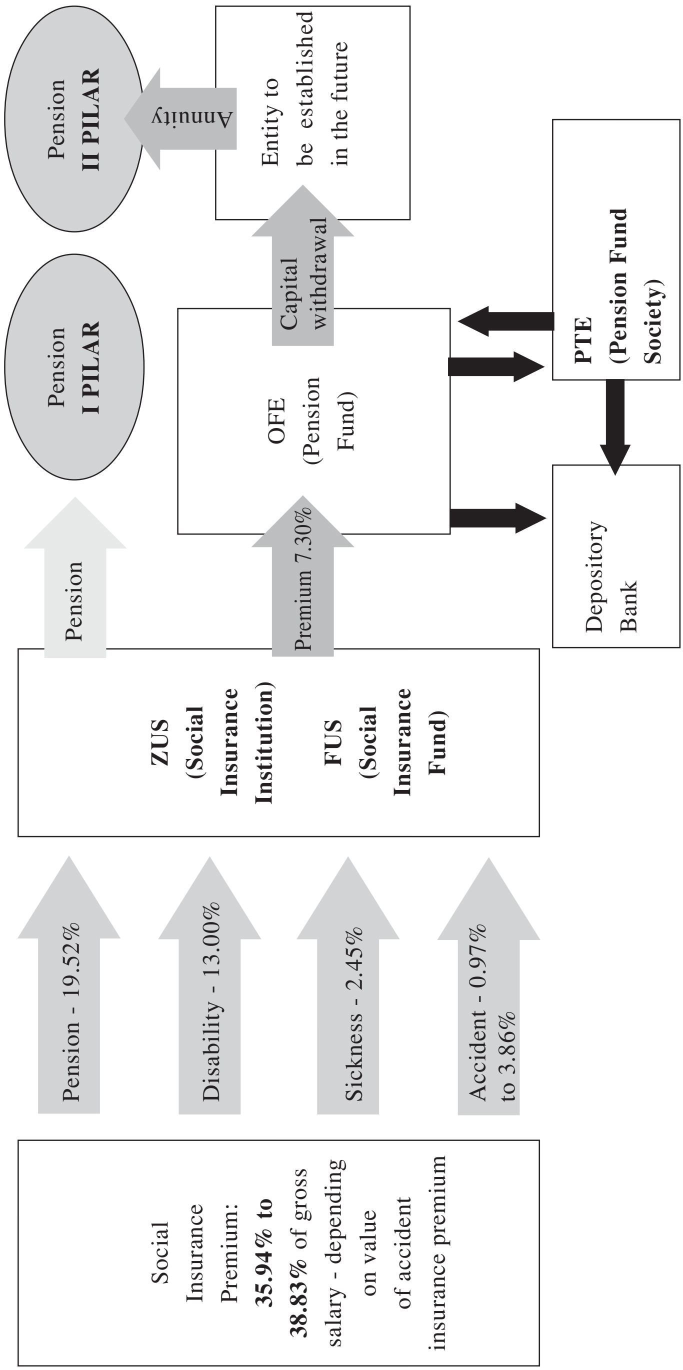
(1) In September 2004 - III pillar Individual Retirement Account (IKE) scheme is introduced.

(2) Also banking products are allowed as III pillar Individual Retirement Accounts.

If we look at the multipillar pension system in Poland, Figure N° 1, a large part, almost 20% of the social security contribution, is for retirement. 7.3% of that goes to the II pillar pension funds, and the rest goes to the I pillar which is administered by ZUS. As the projected replacement rate from the two mandatory pillars is relatively low and amounts to about 40%, many experts advocate that the III pillar should be developed to increase that rate. Also many things are not considered in calculations, such as the cost of the annuity provider which forms part of the II pillar. That is the missing part of the system, which has not been designed yet.

FIGURE N° 1

Mandatory contribution is almost 20% of wages



Let's discuss the second point - the client's perspective. Since we have the expectation of a relatively low replacement rate of 40% then how can we increase it, say to 60%? Let us look at the II pillar pension figures in the last 5 years versus I pillar valorisation. With the contribution of 100 zloty to II pillar and 167 zloty respectively to the I pillar, according to the split between first and second pillar provided by the law, we will accumulate more in the II pillar, i.e. 972 zloty, which is more than in the I pillar, i.e. 554 zloty, if we extrapolate the up-to-date performance and valorisation results. The average rate of return of II pillar pension funds was 13%. That is more than we expected. Ms Lewicka, former Vice-Minister of Labour can confirm that governmental simulation had assumed a real rate of return of 5% before the reform started. Now almost 5 years down the road we are well above that level, with average yearly inflation not exceeding 5% in the same period. Thus the pension funds exceeded that point of reference and the ZUS valorisation based on inflation by more than 30% as well. Many people who had to choose between the I and II pillar are very pleased today, of course, if they chose the II pillar in 1999.

But are these good investments enough to increase the replacement ratio? No, of course not. The individual pension accounts such as IKE will have to develop in order to reach the replacement rate of 60%. We have made the calculation and you can see, Diagram N° 2, that the "cake" would grow larger, if the personal III pillar were implemented. Then almost half of the pension will come from the II pillar and roughly the same part of that cake would be composed of I and III pillars.

Now, let us look at the third subject, the relation between pension funds and capital market development. The pension funds in Poland will reach almost 1/3 of Poland's GDP in 2020. If we look at the pension funds portfolios, Table N° 2, we can observe that they are quite aggressive with almost 30% in equities, with the regulatory limit of up to 40%. Unfortunately there is not sufficient depth in other classes of securities. Although the investment limits are liberal in Poland, that market is very shallow in most classes of assets, except treasury securities. It is not the limits that are the most important in investment activity but the market depth in classes of assets admitted to pension fund portfolios, Table N° 3. It makes no difference whether the limit for corporate bonds is 60% or 40% if the total market capitalisation is only 2.6 billion zloty, almost 150 times smaller than the capitalisation of the Warsaw

TABLE N° 2

Portfolio Structure (%) of OFE as of Dec. 31st 2003

Name of pension fund	Trea-suries	Debt listed securities guaranteed by SP or NBP(1)	Deposits	Shares listed on GPW(2) market	Shares listed on CeTO(3) market	NFI(4) Shares	Investment certificates	Investment funds partici-pation units	Other
AIG	53.63	0.00	8.17	34.19	0.09	0.00	0.00	0.00	3.93
Allianz	66.08	0.00	2.08	30.97	0.00	0.00	0.00	0.00	0.88
Bankowy	55.54	0.00	8.50	34.08	0.00	0.55	0.00	0.00	1.34
CU	61.96	0.00	3.34	31.03	0.04	0.00	0.00	0.00	3.64
Credit Suisse	63.59	0.00	1.72	32.59	0.13	0.18	0.00	0.00	1.79
DOM	59.02	0.00	4.34	32.96	0.00	1.94	0.00	0.00	1.73
Ergo Hestia	64.48	0.00	3.98	31.53	0.00	0.00	0.00	0.00	0.00
Generali	61.86	0.00	4.39	33.64	0.10	0.00	0.00	0.00	0.00
ING NN	64.85	0.00	0.37	33.07	0.05	0.02	0.00	0.00	1.65
Kredyt Banku	59.18	2.45	3.37	31.26	0.00	0.00	0.00	0.00	3.75
Pekao	61.97	0.00	9.38	26.58	0.23	1.55	0.00	0.00	0.28
Pocztylion	59.81	0.00	4.15	31.06	0.00	0.38	0.00	0.00	4.60
Polsat	62.00	0.00	5.55	32.45	0.00	0.00	0.00	0.00	0.00
PZU	59.79	0.00	6.96	31.84	0.07	0.00	0.00	0.00	1.33
SAMPO	63.08	0.00	6.59	30.31	0.03	0.00	0.00	0.00	0.00
Skarbiec	64.32	0.00	1.56	31.03	0.00	0.31	0.31	0.00	2.46
Average	61.32	0.15	4.65	31.79	0.05	0.31	0.02	0.00	1.71

Source: KNUIFE.

(1) SP: State Treasury; NBP: National Bank of Poland.

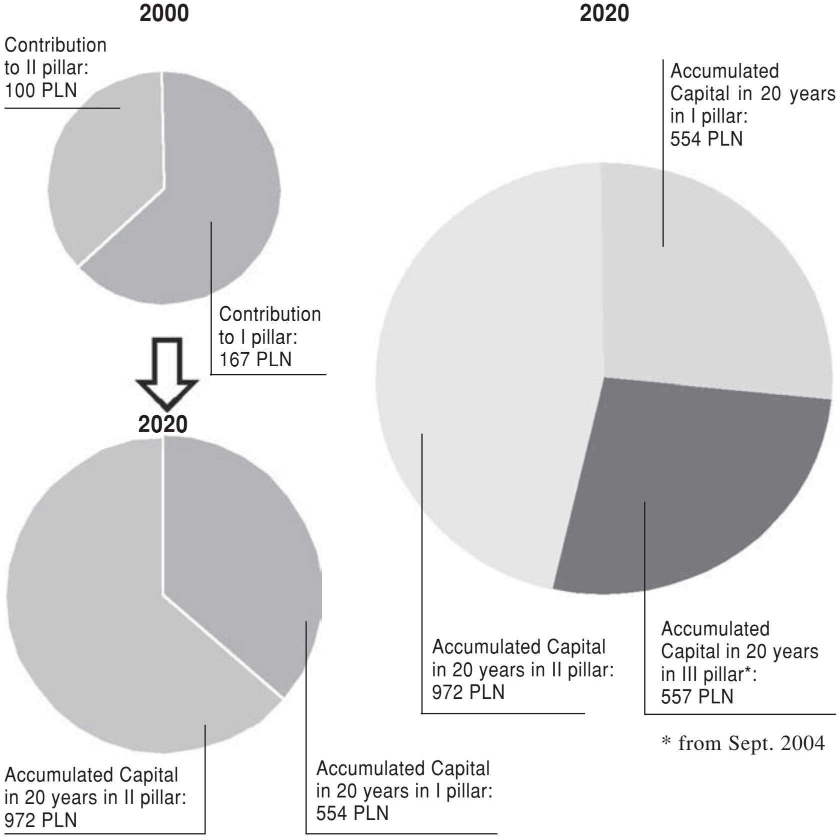
(2) GPW: Warsaw Stock Exchange.

(3) CeTO: Over the counter.

(4) NFI: National Investment Funds.

DIAGRAM N° 2

Share of first pillar in future pension will decrease



Source: Own calculations.

Stock Exchange equity market. It is therefore no surprise that pension funds have barely 0.01% of corporate bonds in their portfolios. And the latest regulatory change that raises the investment limit from 40 to 60% makes no difference to us, because there is nowhere to invest.

Now if we look at the Warsaw Stock Exchange equities market itself - it is important to ask whether the stock exchange can support the constantly growing appetite of the pension funds. We can observe that since the time the pension funds entered the market in 1999 the WSE remain stagnant, with an exception of the

TABLE N° 3
OFE investment limits vs depth of capital market

Type of investment	Market depth 2002 (bln PLN)	Market depth 2003 (bln PLN)	Investment limit - old law %	OFE exposure 2003 %	Investment limit - new law %
Treasuries	195.8	184.6	no limit	63	no limit
Equities on WSE	110.5	167.7	40	32	40
Corporate bonds	2.2	2.6	20	0.01	60
Banking deposits & papers			20	5.0	20
Revenue bonds			-		20
Corporate debt			20	0.6	40
Mortgage bonds		0.2	30		40
Depositary receipts			-		10
Foreign investments			5	0.3	5

Source: Own, based on MoF and WSE.

TABLE N° 4
System guarantee for II pillar in CEE countries

CEE country	Minimum rate of return	Level of guarantee industry	Weighting cap %	% Market share of the biggest PF
Croatia	YES- market relative	NO	25	42
Hungary	YES	0.4 NAV		
Poland	YES- market relative	0.5 NAV*	15*	29
Bulgaria	NO			
Estonia	NO			
Latvia	NO			
Lithuania	NO			
Macedonia	NO			
Slovakia*	NO			
Slovenia	NO			

Source: Own, based on FIAP and country surveys.
* From January 2005.
NAV: Net Asset Value.

last 6 months when there was renewed interest in IPOs as a result of the relatively good market performance in 2003. Lately we can observe that more privately owned Polish companies are interested in raising capital through IPOs, in particular from pension funds.

Now, let us look at foreign investment limit. On one side we have quite liberal investment regulations that allow up to 40% to be invested in equities, but on the other side a very restrictive 5% foreign investment limit, which is the lowest of all Central and Eastern European countries. Only Poland and Bulgaria have this 5% limit. It must be increased in the near future.

Now an important matter in the design of the Polish II pillar, which has been widely criticized by industry experts, is the mechanism of a minimum rate of a return. If we look at the guarantees granted by the CEE countries, Table Nº 4, we can observe that only three countries have guarantees, including Poland.

Although the latest regulatory change capped the weighting in calculating the rate of return to 15%, that in fact is applied only to two pension funds with the largest weight as reflected by their largest assets. Also some modification has been implemented, Table N° 5, such as an increase of the measurement period from 2 to 3 years as well as an increase of the calculation frequency from 2 to 4 times per year. All these changes however have not eliminated the fundamental source of problems generated by the mechanism of minimum rate of return. The mechanism is short-sighted, but is applied in the long term to a 20 to 30-year product. Some of my colleagues have made a comparison: it is like running a marathon, checking the time every hundred metres and punishing those who are behind with heavy penalties. Since the guarantee is relative to market performance it does not guarantee anything for the clients, excepts covering the risks of being in the worst Pension Fund at some very specific point of time. Such a mechanism therefore induces herd effect among funds, creates inefficiencies and it is very costly, with no obvious benefits to the client. The pension funds have to create special provisions such as reserve or guarantee funds, which are a significant part of the administration costs covered by fund administrators, which on are passed on to the clients anyway.

Now, my last point. How does the public-private partnership work? It is the key element of the system. In the first five years of operations, the industry incurred total cumulative losses of 2.5 billion zlotys. As of today, only a few fund management companies have both reached their break-even points and covered their losses, see Table N° 6. The larger the company, the greater are the economies of scale, the larger are the profits. However most of fund management companies will never recover losses. And they will consolidate, so it is expected that there will be only 10-12 companies after the next 5 years. But obviously, the government should not change the regulations that affects the financial results of fund management companies, such as fees. The "rules of the game" for the industry should remain stable to induce trust in public private partnership and not spoil a well-designed pension system.

TABLE N° 5

System Guarantee - II Pillar Poland

	Existing law	New law 2004
Level of guarantee	Minimum of (half market average) and (weighted market average -4%) whichever is lower	
Weighting	no cap	weight capped at 15%
Measurement period	2-year rate of return	3-year rate of return
Measurement frequency	4 times per year	2 times per year
"Pecking order"	Reserve Account 1.5% NAV of Underperforming PF ↓ Own Equity of Underperforming PF ↓ Guarantee Fund 0.1% NAV of all PFs	Guarantee Fund 0.4% NAV of Underperforming PF ↓ Own Equity of Underperforming PF ↓ Guarantee Fund 0.1% NAV of all PFs ↓ Guarantee Fund 0.4% NAV of all PFs

TABLE N° 6
Financial results of PTEs (mln PLN)

PTE	1999	2000	2001	2002	2003	1999/ 2003
CU	-90.2	-54.9	43.5	57.7	49.9	6.0
ING NN	-103.8	-32.1	18.9	60.0	39.2	-17.8
AIG	-82.4	2.4	6.7	21.4	12.1	-39.8
Allianz	-58.7	-10.2	-0.6	0.2	5.4	-63.9
Zurich (Generali)	-42.4	-80.7	6.7	6.4	40.2	-69.8
Credit Suisse	-49.1	-58.5	17.2	4.5	0.2	-85.7
Poczta Polska-Cardif	-47.1	-24.0	-7.5	-9.5	0.6	-87.4
Kredyt Banku	-19.7	-31.1	-30.6	-20.3	1.4	-103.1
Polsat	-78.7	-24.5	-4.7	-1.4	2.1	-107.2
Pekao Pioneer	-18.3	-3.9	-90.1	-3.6	0.2	-115.8
Ergo Hestia	-135.4	-16.3	-0.4	-11.0	-1.2	-164.3
PZU	-143.9	-81.8	-46.0	4.4	67.6	-199.7
Skarbiec-Emerytura	-104.2	-39.7	-47.3	-29.6	17.8	-203.0
Dom	-134.7	-25.7	-32.8	-25.5	4.7	-214.0
PKO/Handlowy	-90.1	-25.3	-88.5	-21.1	-0.8	-225.8
Sampo (Norwich Union)	-55.2	-182.0	-4.0	3.4	1.5	-236.2
BIG BG* (Skarbiec)	-170.4	-36.7	-22.1	-	-	-229.2
Arka-Invesco* (Pocztylion)	-34.6	-13.6	-	-	-	-48.2
Epoka* (Pekao)	-53.9	-16.8	-	-	-	-70.7
H-M-C* (Pekao)	-22.7	-54.7	-	-	-	-77.4
Pioneer* (Pekao)	-69.9	-16.8	-	-	-	-86.7
Total	-1,605.4	-826.9	-281.6	36.0	238.1	-2,439.9

In 1999 there were 21 funds and now there are only 16. After the modification of the regulations was announced in the middle of July 2002 all consolidation processes slowed down and almost stopped. After limiting the front-end fees the value of the industry declined 5 times, not only because of the decreased value of future profits but in particular because of the greater risk of future unexpected regulatory changes. The prices per fund member suddenly declined from 500 euros per member in the year 2000 to 100 euro per member in 2004. Table N° 7

In conclusion I must emphasize that Polish reformers used all the best available practices, which will benefit pension fund clients more than originally expected. Since it is important to increase the replacement rate, a development of voluntary personal part of III pillar is expected, with more generous tax incentives in the future.

I believe that with the growing assets of pension funds, the capital market will develop more rapidly now and the foreign investment limit will be gradually liberalized. Also the minimum guaranteed rate of return should be abandoned as a stumbling block to providing long-term efficient investment results. In addition, some other missing elements of the reform should be introduced very soon, such as the law on annuities companies and the part of the law related to the so-called type B conservative pension funds that are supposed to be introduced next year.

TABLE N° 7

Market share of pension funds (NAV)

	OFE	NAV (mln PLN) Dec. 31st 1999	% market share
1	Commercial Union	678.9	30.23
2	Nat-Ned (ING NN)	478.2	21.29
3	PZU Zlota Jesien	360.2	16.04
4	AIG	178.6	7.95
5	Zurich Solidarni (Generali)	96.9	4.31
6	Norwich Union (Sampo)	75.5	3.36
7	Bankowy	74.9	3.33
8	Skarbiec-Emerytura	58.1	2.59
9	Winterthur (Credit Suisse)	50.7	2.26
10	Ego*	34.4	1.53
11	Orzel (Ergo Hestia)	32.3	1.44
12	Dom	31.8	1.42
13	Allianz	30.5	1.36
14	Pocztylion	27.9	1.24
15	Pioneer*	13.9	0.62
16	Pekao Alliance (Pekao)	10.0	0.45
17	Arka-Invesco*	5.2	0.23
18	Epoka*	3.2	0.14
19	Polsat	2.9	0.13
20	Kredyt Banku	1.6	0.07
21	Rodzina*	0.2	0.01
	Total	2,245.9	

Source: Own, KNUiFE,

* Acquired and consolidated funds.

Continuation Table Nº 7

	OFE	NAV (mln PLN) Dec. 31st 2003	% market share
1	CU	12,710.5	28.35
2	ING NN	10,046.9	22.41
3	PZU Zlota Jesien	6,272.7	13.99
4	AIG	3,833.9	8.55
5	Skarbiec- Emerytura	1,619.5	3.61
6	Generali	1,481.5	3.30
7	Sampo	1,374.9	3.07
8	Bankowy	1,368.1	3.05
9	Allianz	1,210.7	2.70
10	Credit Suisse	1,143.9	2.55
11	Pocztylion	937.5	2.09
12	Ergo Hestia	915.4	2.04
13	Dom	749.7	1.67
14	Pekao	722.0	1.61
15	Kredyt Banku	264.2	0.59
16	Polsat	181.8	0.41
	Total	44,833.2	

Source: Own, KNUiFE,
* Acquired and consolidated funds.

6 Pension reform in Kazakhstan

Aydar Alibayev

Pension reform in Kazakhstan

AYDAR ALIBAYEV[1]

The capitalization system in Kazakhstan has been developed over several years and I will be basing my remarks on various aspects of it. In the first place, each citizen of Kazakhstan pays a mandatory contribution corresponding to 10% of his/her monthly income, which will continue to be his/her property. Each worker is also entitled to pay voluntary contributions. As from 1999 the age of retirement has been increased to 58 years for women and 63 for men.

In 1998, new institutions appeared such as: Capitalization Pension Funds (CPF), Social Security Asset Management Company and custodial banks. These pension funds were set up as public limited companies and may be open or corporative. At present there are 16 pension funds in the market, receiving the contributions of all the contributors, and their capital stock in 258 tenges. The CPF receive contributions form members who may be workers of one or several founding companies. Their capital stock is around 0.72 million U.S. dollars.

The capital stock is made up of the contributions of the founders and also commissions. At the moment our commissions are, on average, 15% of the return of the investments. Until the year 2003, when changes were made in legislation, the commission level was 1% of the contributions and 10% of the return on the investments.

Also participating in the pension market are the Social Security Asset Management Companies and their capital stock is approximately 1.43 million dollars.

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[1] He is currently President of the Pension Funds Association of the Kazakhstan Republic and also the representative for Kazakhstan in FIAP.

One management company can manage the assets of various pension funds. At present there are 8 organizations in the market which handle the management and investment of the social security assets.

A custodial bank records all the accumulation operations of the social security assets and their placement, receives the investment income and reports regularly to the CPF on the state of its accounts and the activity of the management company. The custodial bank controls the investments of the social security assets of the CPF and is obliged to block (leave unfulfilled) the instructions of the management company if these are not within the terms of the law. A CPF may only have one custodial bank.

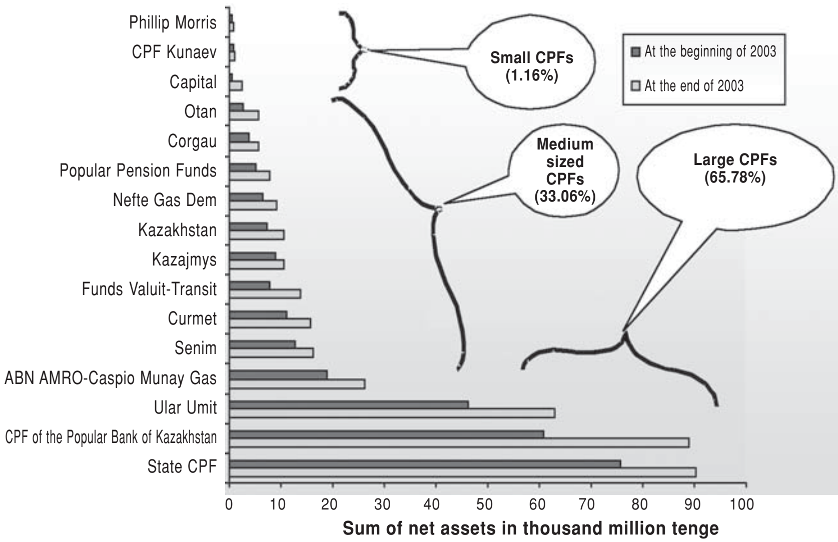
All the professionals involved in the social security market interact among themselves on the basis of a tripartite custody agreement.

Figure Nº 1 shows the placement of the pension funds in the market. The first group, consisting of the leaders of the pension market, occupies about 60% of the market. Then there is another group of smaller pension funds (33%) and finally a group of small funds whose share is a little over 1%. This figure also shows the difference in the development dynamics of the funds.

Figure Nº 2 makes it easier to see the dynamics of the pension funds' activities. The horizontal axis is the number of contributors and the vertical axis the volume of shareholders' equity. Here we can see the volume of money accumulated in these funds and it is possible to see that the small funds are in a difficult position. The figure also shows that one of the most realistic ways forward for those funds in the future is to merge with larger funds, because competition in the market is quite serious.

Figure Nº 3 explains the situation of the market for pension fund administration companies. As from this year we are calling them fund capital administration and investment organizations. The sum of the three largest funds represents two thirds of the market. The CPF of the Popular Bank of Kazakhstan is the only pension fund that carries out the control of its assets independently. As from this year, the pension funds are authorized to manage their money on their own account. This is the only fund that opted to do it in that way.

FIGURE № 1
Market structure of the CPF as regards social security assets and their movements in the year 2003



* CPF:Capitalization Pension Funds.

FIGURE № 2
Chart of three main indicators of the CPFs of Kazakhstan at the end of the year 2003

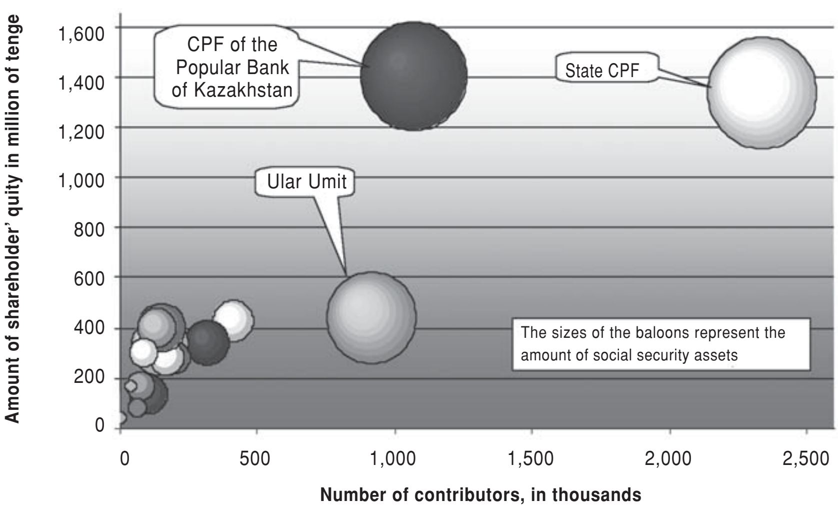
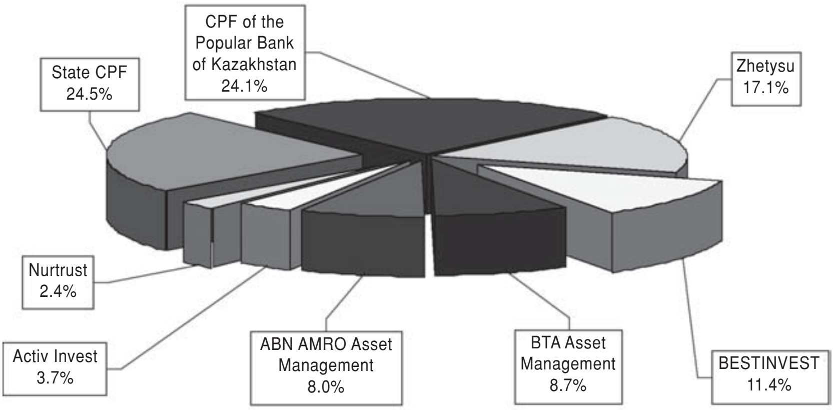


FIGURE Nº 3

Market structure for social security asset management as of 1st January 2004



In Table Nº 1 we can see the structure of the Kazakhstan pension market for the year 2004. It is possible to distinguish the pension funds, the supervision companies and the distribution of the market between them. The pension fund may have one supervision company but a supervision company may manage various pension funds.

In the table it is possible to see the number of branches of the funds in the country (one can see the leaders, which have branches in various regions), the number of contributors in the fund, the amount of accumulation and also the size of the obligatory reserve.

Table Nº 2 shows the consolidated investment portfolio of all the funds for the year 2004. State bonds account for slightly over half the funds. It is also possible to observe the existence of private bonds and the fact that approximately 37% correspond to bonds of foreign issuers. Today a proportion equivalent to 30% of the total portfolio may be invested in foreign securities or bonds.

Table Nº 3 shows how the pension funds are placed according to the amount of resources accumulated, while Table Nº 4 shows the number of contributors who are paying contributions, whether voluntary or mandatory, or both. The amount of money accumulated as of February 2004 amounted to approximately three thousand million dollars.

TABLE Nº 1

The structure of the Kazakhstan social security market for 1st January 2004 and the distribution of the professional participants in the social security market

Name of CPF	Name of custodial Bank	Name of Management Company	Number of regional divisions	Number of contributors	Amount of social security savings per person (tenge)	Amount of shareholders' assets (Thousand/millions of tenge)	Amount of paid-up capital (Thousand/millions of tenge)	Amount of reserve capital formed (Thousand/millions of tenge)
State CPF	National Bank	Own management	17	2,332,900	38,716	1,337,543	180,000	101,000
CPF of the Popular Bank of Kazakhstan	ATF Bank	Own management	17	1,068,609	83,239	1,408,110	630,100	154,254
Ular Umit	NSBK Bank	Zhetysú	15	911,543	69,154	440,711	440,000	68,190
Valiut Transit	Temirbank	Activ Invest	33	410,963	33,610	433,226	400,000	32,229
Curmet	Temirbank	BTA Asset management	16	313,025	49,805	341,284	459,000	0
Popular	NSBK Bank	Nurtrust	14	198,212	39,415	288,150	265,000	23,150
Neftegas - Dem	NSBK Bank	BESTINVEST	3	165,048	56,312	286,725	200,000	32,720
Senim	Banco Euroasiático	BESTINVEST	16	148,363	110,180	404,567	377,244	0
ABN AMRO - Caspio Munay Gas	DB HSBC Banco Kazakhstan	ABN AMRO Asset management	6	141,724	185,447	328,554	250,000	37,500
Kazakhstan	Kazkommerzbank	BTA Asset management	4	127,914	82,728	403,934	382,000	17,606
Kazajmys	NSBK Bank	BESTINVEST	-	99,559	107,037	141,858	100,000	30,000
Corgau	Banco Centr-kredit	BESTINVEST	2	83,907	66,514	301,964	288,672	12,000
OTAN	ATF Bank	BTA Asset management	2	69,588	83,450	175,151	265,000	0
Capital	ATF Bank	ABN AMRO Asset management	-	57,419	41,660	88,931	180,000	0
CPF D. Kunaev	ATF Bank	Nurtrust	-	34,284	30,310	169,664	180,000	0
Phillip Morris-Kazakhstan	Banco DB HSBC Kazakhstan	ABN AMRO Asset management	-	1,222	691,803	45,569	50,000	0
TOTAL:			145	6,164,280		6,595,941	4,647,016	508,649
Average market indicators			9	385,268	59,755	412,246	290,439	31,791

Source: Quarterly reports of the Capitalization Pension Funds and organizations that invested and managed social security assets for the 4th quarter of the year 2003).

TABLE № 2

Joint investment portfolio of all the CPFs in Kazakhstan as of 1st February 2004

Financial instruments	Millions of tenge	%
1 State securities including:	182,784.4	50.33
Eurobonds of the KR	24,079.9	6.63
Securities of the Ministry of Finance	69,394.4	19.11
Notes of the National Bank	88,580.9	24.39
Securities of local executive bodies	729.1	0.20
2 Deposits in second level banks	27,134.1	7.47
3 Securities of international financial institutions	9,308.2	2.56
4 State securities of foreign issuers	16,290.3	4.49
5 Non-state securities of issuers in the KR:	115,427.6	31.78
Shares	15,473.0	4.26
Bonds, including:	99,954.6	27.52
Expressed in US dollars	34,978.9	9.63
Expressed in tenge	64,975.7	17.89
6 Non-state securities of foreign issuers	12,227.4	3.37
Shares	10,571. 9	2.91
Bonds	1,655.5	0.46
TOTAL	363,171.9	100.0

Source: Information from the KR Regulation and Supervision Agency for the financial market and financial institutions.

TABLE № 3

Increase in social security savings in the period between 01.02.02 and 01.02.04

Date	Amount of social security savings	Increase in savings	% Increase in social security savings
1st February 2002	188,174.8		
1st February 2003	276,775.7	88,600.9	47.0
1st February 2004	369,405.8	92,630.1	33.0

Source: Information from the KR Regulation and Supervision Agency for the financial market and financial institutions.

TABLE Nº 4
Growth in contributors (beneficiaries) in the period between 01.02.03 and 01.02.04.

Contributors (beneficiaries) of:	As of 01.02.03	As of 01.02.04	Increase	% Increase
Mandatory social security contribution	5,459,165	6,223,812	764,647	14.0
Voluntary social security contribution	25,211	27,598	2,387	9.0

Source: Information from the KR Regulation and Supervision Agency for the financial market and financial institutions.

Today there are 6 million contributors (Figure Nº 4), representing 75% of the population capable of working in the country. It is also possible to see that voluntary contributions (Figure Nº 5), are not so popular among the population; the number of people paying such contributions is very low. This figure, 27,000, is less than half the percentage of all the contributors paying mandatory contributions.

FIGURE Nº 4
Number of contributors (of mandatory contributions)

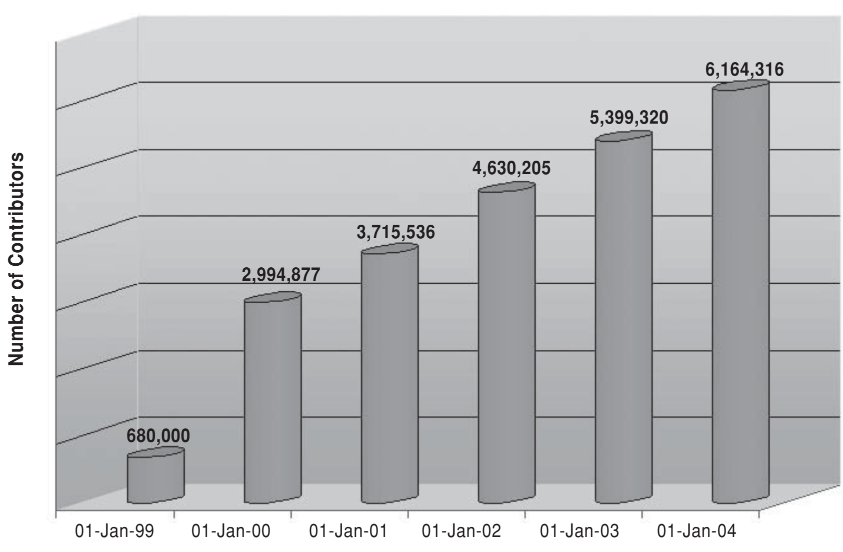
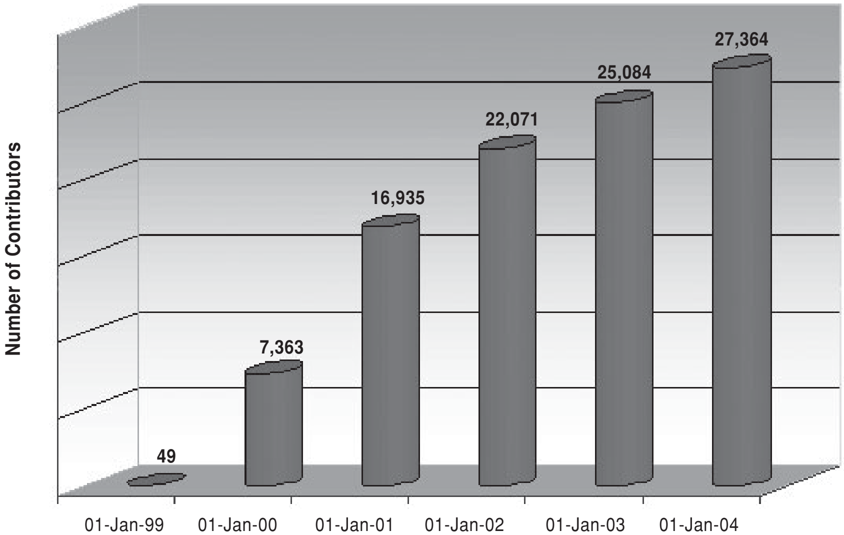


FIGURE Nº 5

Number of contributors (of voluntary contributions)



In Table Nº 5, it is possible to see the structure of the investment portfolio. The change that took place in 2003 is due to the fact that the return on the pension funds began to fall. In the table one can see that as from the middle of the following year, the dollar began to be less strong and the local currency became firmer. There was a very rapid process of redirecting funds towards bonds expressed in local currency. A fall of 10% can be seen which is the percentage removed from the funds in local currency. It is also possible to see another important figure of 13% which represents the return on the investment funds which began to fall last year. Thus the table shows that at the beginning of 2002, return constituted 5.83% and at the end of the year, return fell by 6%. This decrease still continues, meaning a negative value for growth.

It is worth mentioning that the individual capitalization system underwent serious changes in the year 2003. It was mentioned previously that the funds were authorized to control their accumulations on their own account. At the same time the State gave certain guarantees, and now retired people have the possibility of coming to an arrangement to obtain a life annuity with their pension funds. So far, this method has not begun to work, but there is an insurance company in existence which is licensed to make such arrangements, in order to grant a life annuity to the person participating in the reform. The possibilities and areas of competence of the tax authorities have also been extended to enable them to control the taxes to be paid by the funds.

Finally, it is worth underlining two unfinished tasks in our system of individual capitalization. In the first place, there is a sensation of shortfall or lack of financial instruments in the capital market, with a consequent absence of buoyancy there. At the same time, the coverage of the population is approximately 75% and the level of contribution collection is unsatisfactory because some people attempt to avoid payment.

A second pending challenge is the question of return. Naturally the position of the tengue affects this matter, together with the large sums of money devoted to the budget. The State has lost interest in the money coming from the pension funds, even though the funds themselves have no interest in buying bonds issued by the state, because it does not provide the necessary guarantees to respect maturity and redemption periods.

TABLE № 5
Structure of the aggregate investment portfolio of the CPFs in 2003

Financial instrument	Beginning 2003		
	Amount millions of tenge	**Amount millions of US$**	**Part, %**
1. State securities of the KR	**68,376.3**	**399.0**	**48.75**
Among these:			
1) local short-term (notes of BNRK, MEKKAM)	33,291.0		12.43
2) local medium and long-term, from the Ministry of Finance (MEOKAM, MEIKAM)	35,085.4		13.10
3) European bonds of the sovereign debt of the KR		391.1	22.76
4) municipal bonds MIO KR		7.9	0.46
2. Non-state financial instruments from Kazakhstani issuers, total	**32,032.2**	**431.0**	**37.04**
Including:			
1) shares of public limited companies of Kazakhstan	10,311.4		3.85
2) corporate bonds of Kazakhstan companies, expressed in tenge	26.8		0.01
3) corporate bonds of Kazakhstan companies, expressed in dollars		417.9	24.32
4) deposits and deposit certificates expressed in tenge	21,694.0		8.10
5) deposits and deposit certificates expressed in foreign currency		13.1	0.76
3. Securities of foreign issuers		**244.2**	**14.21**
Including:			
1) state securities of foreign states		63.9	3.72
2) shares of foreign issuers		19.8	1.15
3) non-state bonds of foreign issuers		48.8	2.84
4) MFO securities		111.7	6.50
TOTAL PORTFOLIO	**100,408.5**	**1,074.2**	**100.00**
Proportion between rates of foreign currency and tenge	**37.5%**	**62,5%**	

Source: IAFR “Irbus”, 20.01.03, 20.01.04.

End 2003			Modification (deviation) for the year 2003		
Amount millions of tenge	**Amount millions of US$**	**Part, %**	**Amount millions of tenge**	**Amount millions of US$**	**Part, %**
150,927.7	**318.8**	**53.64**	**+82,551.4**	**-80.2**	**+4.89**
90,102.5		24.58	+56,811.6		+12.15
60,825.2		16.59	+25,739.8		+3.49
	313.4	12.26		-77.7	-10.50
	5.4	0.21		-2,5	-0.25
96,325.4	**268.8**	**36.79**	**+64,293.3**	**-162.2**	**-0.25**
14,689.0		4.01	+4,377.6		+0.16
56,382.1		15.38	+56,355.3		+15.37
	268.8	10.51		-149.1	-13.81
25,254.3		6.89	+3,560.3		-1.21
	0.0	0.00		-13.1	-0.76
	244.9	**9.58**		**+0.7**	**-4.63**
	61.4	2.40		-2.5	-1,32
	76.7	3.00		+56.9	+1.85
	31.8	1.24		-17.0	-1.60
	75.0	2.93		-36.7	-3.57
247,253.1	**832.6**	**100.00**	**+146,844.6**	**-241.7**	
67.5%	**32.5%**		**+30.0%**	**-30.0%**	

7 Pension reform in Kosovo

Arieta Koshutova

Pension reform in Kosovo

Arieta Koshutova[1]

Kosovo is somewhat different from other places, in that it is not a sovereign state, and consequently it is governed by a dual government: United Nations Mission in Kosovo and the Kosovo Elected Government. Total number of inhabitants is over 2 million; there is neither stock exchange nor publicly traded securities.

The Kosovo Pension System is a three-tier system: The first tier, Basic Pension, provides benefits for every Kosovar who is 65 years of age or older. It is funded through the general revenues and is administered by the Ministry of Labour and Social Welfare.

The second tier is Individual Savings Pensions and it operates on the fully-funded basis. It is mandatory and covers all Kosovo employees. Contribution rate is set at 5% for each employee and has to be met by an additional 5% from the employer. The Kosovo Pension Savings Trust, the not-for-profit financial institution that I head, manages and administers the mandatory pension savings.

The third tier consists of Supplementary Pension Schemes. They can be established by any employer or financial institution in Kosovo

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Prior to her current position, Ms. Koshutova worked at the Pensions Division of William M. Mercer Ltd., where she assessed pensions and benefits projections, among other duties. She also worked at the Pensions Department of Jardine Lloyd Thompson UK (JLT) as Team Leader responsible for personnel organization and the analysis of diverse Pension cases.

provided they are licensed by the Banking and Payment Authority of Kosovo, which is Kosovo's Central Bank. See Diagram N° 1.

Diagram N° 1

Context: a three pillar system

Kosovo is an autonomous UN protectorate with a parallel Kosovar Government and UN Administration, population of around 2 million and no stock exchange or publicly traded securities.

1st Pillar: Basic Pension
Participants: Elderly over 65 **Financing:** General Budget Revenues
Provider: Ministry of Labour and Social Welfare

2nd Pillar: Individual Saving Pension
Participants: All employees **Financing:** 10% of Wages
Provider: Kosovo Pension Savings Trust

3rd Pillar: Supplementary Pension Schemes
Participants: No restriction **Financing:** Voluntary Contributions
Provider: Employers/Financial Institutions

The policy objectives (See Diagram N° 2) are a clear breaking from the past with the avoidance of recreation of the old pay-as-you-go pension system. The reform aimed at creating a financially sound and sustainable pension system in the long run, with universal coverage and benefit to all Kosovars.

Diagram N° 2

Policy Objetives

- Invest KPST assets for the benefit of participants
- Use international capital markets and foreign management experience when necessary for achieving objectives
- Avoid international record of poor financial performance of politically controlled public funds
- Avoid creation of a fiscally unsustainable PAYG system that reduces savings
- Provide universal coverage
- Basic Pension benefit is linked to food basket so system is fiscally sustainable

The investments of the KPST (Kosovo Pensions Savings Trust) assets have only one purpose: the benefit of the KPST participants, who are the sole proprietors of the assets. For various reasons, which include security, transparency, liquidity, the KPST invests in international capital markets. It also uses international experience in fund management, aiming at providing the best services for its participants.

To avoid the international record of poor financial performance of politically controlled pension funds, the KPST has been established as an independent institution, where the Governing Board has the autonomy in investment and other decision making.

1. Design of government arrangements

The portfolio of pension money is clearly defined and segregated from other assets of the KPST. It is managed by an independent body that aims at meeting the above-mentioned objectives with accountability.

Let me talk about "Defined and Segregated Portfolio". The KPST is a legal entity that is separate from the government. It is run by a Board of Governors, consisting of both international and local members. All the pension savings assets are property of each participant who contributes to the system.

The contributions are unitized. As soon as a contribution is paid into the KPST account, it is unitized, and becomes a share of the pooled fund, the pension savings fund. Using the units system is more transparent. Moreover it makes the allocation of investment return much easier and more precise.

All the liability that lies with KPST is from August 2002, when we started administering and managing collected contributions.

The Governing Board Members, as I said before, are both international and local. Their nomination is done by a committee, which is comprised of four people: The Auditor General, the Managing Director of the BPK (Central Bank), the Representative of the Ministry of Economy and Finance, and the Governing Boards Chairman.

There are three types of Governing Board members: Professional members, Representative members, and an UNMIK Representative. The professional members appointed for the first term of the Governing Board are all internationals, who brought the most necessary experience in both managing funds and administering pensions. The representative members are Kosovars with wide experience in representing Kosovar employers and employees. The position of the UNMIK Representative is currently vacant.

It is the Governing Board's responsibility exclusively to decide and define the investment policy and strategy. The Governing Board meets two to four times a year.

All the directions and principles of investment of the KPST assets are set out in the legislation, rather then by the government. Beside the security and reasonable return objectives that guide the KPST's prudent investments, there is another safeguarding mechanism that has been put in place by the legislation, and that is the prevention of a conflict of interest.

All members of the Board of Governors, as they make decisions on policy and strategy, are not to have any shares or family members in the institutions which we invest in.

The Board Remuneration is set at a level of an Executive or an Expert in a Financial Institution, and this is done to attract the best people.

2. The explicit objectives

I'll just read a quotation from the Regulations: "The Assets of the Kosovo Pension Savings Trust shall only be invested to maximize return, solely for the benefit of participants and beneficiaries. The goals of prudent investment of pension assets are the security of assets, diversification, and maximum return, consisting of the security of all its funds and also maintaining an adequate liquidity."

There are restrictions on types of assets; they have to be publicly traded. There can be bank deposits and/or portfolio investments but not direct investments

The decision to use passive rather then active investment management was reached by the Governing Board, simply because of the greater cost involved in active investments management.

3. Accountability

KPST is supervised by the BPK (Central Bank) and we report to the Central Bank on a quarterly basis and annually.

All this information is sent as a report to the Government and also to the Special Representative of the United Nations.

The KPST also publishes the audited annual financial statement. Ernst & Young was selected, through an international open tender, as the auditing company to audit both 2002 and 2003 KPST operations.

4. Statement of investment

Policies standards and procedures are all adopted by the KPST's Board and when the decisions are made, they are made open and available to the Public.

We the Board of Trustees and I, have to invest these assets in a prudent way, focusing only on the benefit of the KPST participants and their beneficiaries. Our legal integrity, when it comes to matters related to the investment of assets, is insured by fiduciary insurance.

We also report to our participants through the individual account statements, where they can see the amount of the contributions paid on their behalf, from both their salaries and from their employer, and the amount returned from assets investment. At the beginning of 2004 we issued the first account statements.

Ever since we have been established and functioning as a new institution, we have been focusing on raising awareness regarding the importance of pension savings. We have organized so far a number of public meetings, where the general public has had the chance to meet the Governing Board members, hear what they have to say and ask questions. We also hold periodical press conferences, and use other means of communication with the population and media, in order to inform the general public in a very transparent manner on where and how the assets are invested, how much money has been collected, and the issues that the KPST in general deals with.

5. Financial portfolio

During the start up phase, August 2002 to March 2003, all the assets were deposited in the KPST account with the BPK.

In 2003, there was an International Tender to select asset management companies that would manage the KPST assets, and ABN-AMRO and Vanguard were selected.

ABN-AMRO has been serving as a liquidity fund, where the assets are invested in a euro-denominated money market. Currently up to 75% of total assets are invested with ABN-AMRO. Vanguard will be managing assets of stock index fund, as the Governing Board has decided to invest up to 25% with Vanguard.

The Board has decided for such allocation right now, to gain trust among contributors.

The system is mandatory for all workers born in 1946 and younger, however people who are older than this are not excluded from the system, so everyone could contribute.

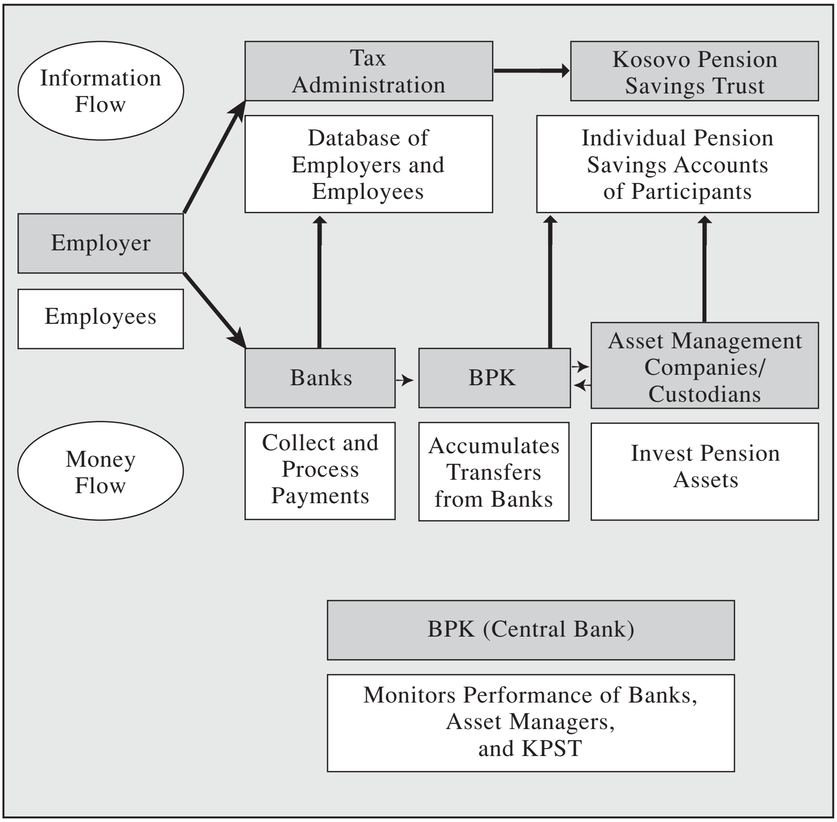
The KPST charges 1% gross of total assets, to cover financial and administrative costs and this includes the asset management fee changed by our asset management companies.

Initially since there were no assets, the KPST was given a lump sum grant from the Kosovo Budget.

The Kosovo Pension Savings Trust was established to administer and manage the mandatory pension savings contributions. On the other hand the collection process is the responsibility of Tax Administration, which is also responsible for reconciling payments and reports, and for the compliance issues. See Diagram N° 3.

The whole process consists of two major flows: money and information. The employer pays the contribution in the bank, and the bank reports to Tax Administration and at the same time the employer reports to the Tax Administration with all the documentation necessary on the amounts of contributions for employees.

DIAGRAM N° 3
Organizational Structure



The KPST holds a collection account with BPK, from which the assets are transferred to asset managers' accounts, and invested. The whole KPST structure is overseen and supervised by the BPK.

We have been and are facing some challenges on the unified collection and there are probably lessons to learn. Tax Administration sometimes doesn't take pensions as a priority. Their priority is collecting taxes. Yes, their task is to collect pension contributions too. Data quality requirements for reconciliation of pensions are much higher than for taxes, so that's an extra burden, a huge job, so the tax administration has come to the realization that maybe there is a resources issue to be resolved.

There's a need for more people to work on pension contributions collection. All this information needs to be complete and accurate so that we can allocate and track contributions to the individual accounts.

Another issue is the IT system. Our IT system has been developed from scratch, by a local company mainly, in collaboration with an International firm. We had anticipated that it would be a much shorter period to develop the IT system, but it's been a long, long road and we have had a lot of challenges, but we are getting there.

6. Major facts

We started in August 2002. The system was implemented in two phases. The first phase covered all the Public Sector, meaning Public and Social Enterprises. During the second phase, which was implemented after a year, the system became mandatory for all workers of Kosovo, including the self-employed.

Right now we have 160,000 participants, employed by more than 10.000 contributing employers.

"KPST" has only one office: in Pristina, the Capital of Kosovo, and there are 22 local staff.

In January 2004, we have generated and distributed the first accounts statements for 82,000 employees, and this was a big step but lots of challenges there as well. After only 18 months in operation we produced account statements. To follow up with these account statements we had to establish help lines where people could ring in with their questions and issues, maybe errors. In particular, we have identified a problem: employers who have been deducting from employees but never paid into their name. The employee has phoned in and asked where his money is, since his employer has deducted the sums of money. All these cases have been followed up jointly with Tax Administration, which is dealing with these companies.

There is another challenge that we are anticipating. Even though as I said earlier on, all workers who are 55 and younger are obliged to pay, we have people older than that voluntary paying contributions. They will retire in a couple of years' time but we still don't have an annuity market. This is something that we are trying to work on with Central Bank, to license life annuity companies in Kosovo. At the same time, at the present by the regulation, we can pay in a lump sum of up to 2,000 Euro (because 2,000 Euro doesn't buy much of annuity).

Finally, as the presenters were mentioning yesterday and this morning the importance of public awareness regarding the pension program, we are also working on Public Education. It is a huge job and this is our aim; to increase awareness in Kosovo about the pensions and the importance of them.

CHAPTER II

Reform Perspectives in Eastern Europe

1 The reform in the Slovak Republic

Marek Lendacky

The reform in the Slovak Republic

MAREK LENDACKY[1]

In this presentation, I will talk mainly about the situation in Slovakia before the pension reform and touch on the demographic environment in Slovakia, with a couple of words about implicit pension debt (IPD).

I will also be referring to some basic features of the first and second pillars and I will maybe touch, briefly on the implementation stage, which is now on the programme of the day in Slovakia and I will explain the reason why we chose a second pillar reform strategy and not maybe another reform strategy or the building of reserves for the first pillar.

As you can see in Diagram N° 1, during the transformation period the situation in Slovakia was similar to other transitional countries. It meant that the Pension system was completely financed from the resources of the state budget. The Slovak Republic together with the Czech Republic was caught by the revolution in 1989 and four years after this revolution, the Czech Republic and the Slovak Republic were divorced.

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1 He is doing his Ph.D. and Master in Economics, University of Economics, Bratislava. Pension systems expert and one of the authors of the Slovak Republic's guiding principles for pension laws.
Dr. Lendacky is currently Director General, Social Insurance and Pension Savings Division, Ministry of Labour, Social Affairs and Family in the Slovak Republic.
Prior to his current duties, Dr. Lendacky held diverse positions in the same Ministry: Economist and Social Security Analyst and Director of the Department of Social Security Savings.
Dr. Lendacky's publications include the chapter on Pension System Reform in the book "Economic Policy in Slovakia 2000-2001".

DIAGRAM N° 1
Pre Reform Period

- Transformation from planned to market economy
- Worsening of economic and demographic situation
- Social security financed completely from state budget
- Czech and Slovak Republic divorce (1993)
- Old social security law (1988) – covered all parts of social security
- PAYG-financing with very low reserves
- Big redistribution (very progressive formula)
- Preferential treatment (special working categories)
- High contribution rate (28% total)
- Low retirement age (M – 60Y, W – 53-57Y)

All the social system in the Slovak Republic was covered by one law - The Social Security Law commencing as from 1988. The for law was only abolished in January this year, in 2004. It means that for all 15 years of the transitional period from 1989 to 2004, the Social Security System was covered by this old law.

As you can see from this, it was very, very urgent to introduce reforms, not just in pensions, but in all the areas of Social Security.

Our Pension System had a very big distribution component within the system, a very progressive formula. The replacement rate for the poorest people was about 120% but for higher income people it was about 20%. As you can see, this progressive formula was very strict.

Then we had very preferential treatment for special categories of workers in the system, with high contribution rates and unequal retirement ages for men and women.

You can see in Table N° 1 that the demographic situation is getting worse. In 2001 the population of Slovakia stopped increasing and the prognosis for the next 50 years is not very good. I think it's an ageing problem in Slovakia, but it's the same in other European Countries, so it's not surprising.

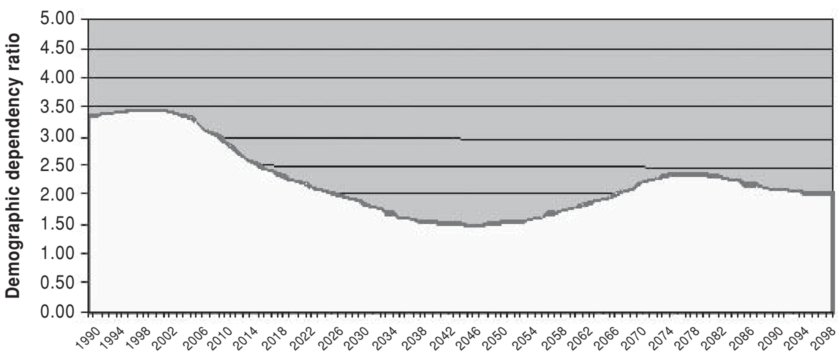
As I said before, future demographics don't show much growth, Figure N° 1.

TABLE N° 1
Past demographic environment

Year	Total population	Total population increase	Live births per 1,000 inhabitants	Deaths per 1,000 inhabitants	Total increase per 1,000 inhabitants
1950	3,463,446	45,595	28.8	11.5	17.3
1960	3,994,270	48,723	22.1	7.9	14.2
1970	4,528,459	33,969	17.8	9.3	8.5
1980	4,984,331	41,392	19.1	10.1	8.9
1985	5,161,789	34 399	17.5	10.2	7.3
1990	5,297,774	23,048	15.1	10.3	4.8
1995	5,363,638	11,583	11.5	9.8	2.2
1998	5,393,382	5,732	10.7	9.9	1.1
1999	5,398,657	5,275	10.4	9.7	1.0
2000	5,402,547	3,890	10.2	9.8	0.7
2001*	5,378,951	168	9.5	9.7	0.0

* According to population and housing census 2001.

FIGURE N° 1
Future demographic environment



Now let me talk about the Pension Reform in Slovakia. I think the demographic situation was not the real reason for Pension Reform, or not the only reason.

When we talked about Pension Reform, there were voices that said that "as regards demographics, this can only be done by Parametric Reform of the Pension System and the Demographic situation will be resolved".

But then we had a discussion in Slovakia about Implicit Pension Debt and the responsibilities for future generations and the commitment not to increase this Implicit Pension Debt.

Table N° 2 reflects our calculations for Slovakia. It was made by our ministry and, as you can see, in the year 2000 it was about 290% of our GDP (Gross Domestic Product). This is a very high number and was one of the main arguments as to whether to do a deep reform of Pensions or not. But this Implicit Pension Debt in Slovakia was very high and we didn't want to increase it any more.

TABLE N° 2
Implicit pension debt

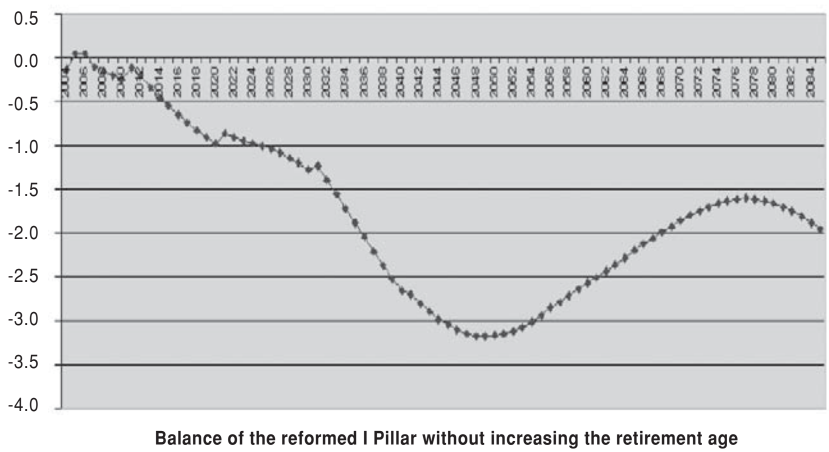
Inputs	**Men**	**Women**
Working (insurance) period	40	35
Real wage growth index	1.02	1.02
Real old age pension index	1.01	1.01
Replacement ratio (net/gross)	54.3	47.3
Real discount rate	1.03	1.03

Outputs	**Men**		**Women**	
	Bln. Sk	**% GDP**	**Bln. Sk**	**% GDP**
IPD old age	685	77	991	112
IPD old age pensioners	206	23	364	41
IPD active members	478	54	628	71

Outputs	**IPD Old Age**		**IPD (D+S)**		**Total IPD**	
	Bln. Sk	**% GDP**	**Bln. Sk**	**% GDP**	**Bln. Sk**	**% GDP**
IPD total	1,676	189	895	101	2,571	290
IPD pensioners	570	64	304	34	874	99
IPD active members	1,106	125	590	67	1,697	191

Figure N° 2 shows a balance of the system we felt you should see. It shows the deficit of the Social Insurance Fund which amounts to 3.5% of GDP for 2050, so it was also a very good argument at the time to do radical Pension Reform.

FIGURE N° 2
Explicit surpluses and deficit of the current pension system as a % of GDP



You can say that we started to talk about Social Insurance in 2000. Of course, as I mentioned, it was not only the reform of the Pension System, but the whole area of Social Security.

State Social Support, which is the system targeted to some groups of people, for example young families or young women on maternity leave. Also we went through a big reform of the Social Assistance System which was targeted to low income people.

And the third part of the Social Security System in Slovakia is Social Insurance.

The complete concept of Social Security Reform in the year 2000 had one very big area and it was the area of pensions.

We decided to go for a multi-pillar System as you see in Diagram N° 2: First Pillar, Second Pillar, Funded and Mandatory, and third Pillar.

DIAGRAM N° 2

The new Slovak three pillar pension system

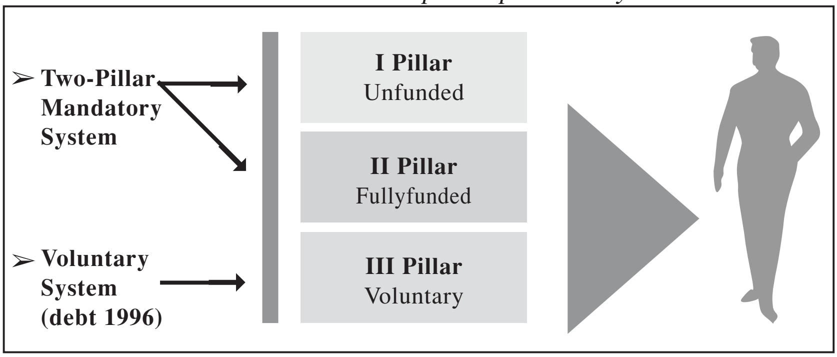


Table N° 3 shows the contributions rates planned as from January 2005.

As I mentioned; one of the reasons and one of the main arguments for Pension Reforms in the case of Slovakia were the high contribution rates.

We can see from this table that this is one of the aims of the Reform: to decrease the contribution rate and the burden for employers and employees. It was not achieved. Now we are doing a budget for 2005/2007, and it is clear from this exercise that the contributions will still be too high. It's due to transition costs which were also the question yesterday, and you see the transitional costs, in the case of Slovakia, on the line of the Special Transitory Reserve Fund, which was especially created for the transition to the second Pillar. We hope that this Special Reserve Fund will decrease to zero in the next ten to fifteen years.

As from January it will be 4.75%; so it's rather a heavy burden for people and employers who are paying into the system.

Concerning the first Pillar; for the people who pay, here you see the parametric changes in this system. There is a strictly neutral formula, new indexation. I won't talk about this because it is a typical parametric reform of the system and I will focus mainly on the second Pillar, Diagram N° 3.

TABLE N° 3
Contribution rates as from 1.1.2005 (%)

	Monopillar system		Duopillar system			
	I pillar		I pillar		II pillar	
	Employee	Employer	Employee	Employer	Employee	Employer
Sickness insurance	1.4	1.4	1.4	1.4	–	–
Old-age insurance	4	14	4	5	–	–
Old-age savings	–	–	–	–	–	9
Disability insurance	3	3	3	3	–	–
Reserve fund	–	4.75	–	4.75	–	–
Work injury insurance	–	0.8	–	0.8	–	–
Guarantee insurance	–	0.25	–	0.25	–	–
Unemployment insurance	1	1	1	1	–	–
Health insurance	4	10	4	10	–	–
Total	48.6		48.6			

Let me tell you something about the timing of the Reform. It was very essential, especially in the case of Slovakia, because it was thought that Pension Reform was a long process that went through a couple of governments; but as you see, in the case of Slovakia, luckily, it was quite quick.

I said that we had prepared the Basic Documents in 2000 and as you see, in 2003 a new government was elected with a strong appetite for reforms. We prepared the law rather quickly in 2003, and by the end of this year this law was adopted by the Parliament, so we opened this bottle of Champagne. Actually, we opened two bottles of Champagne, as our President returned this law to the Parliament, so it had to be passed again.

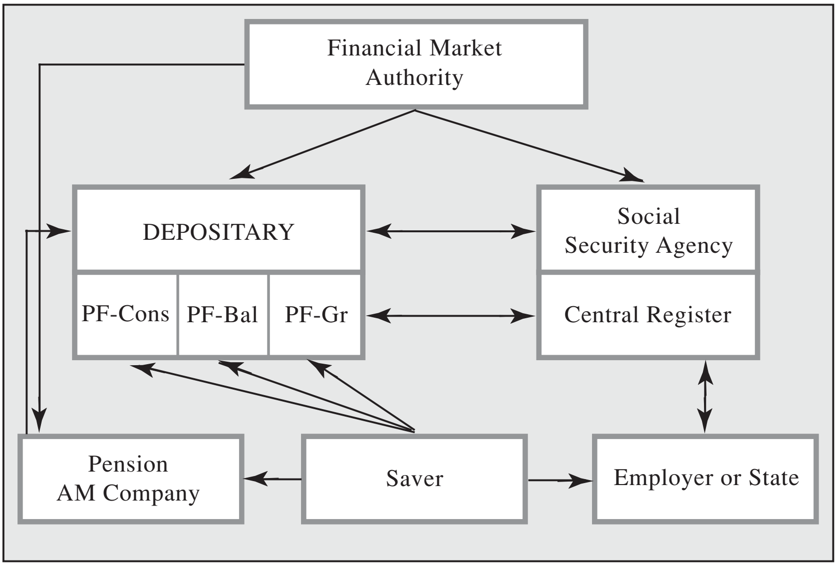
Diagram N° 3
Second Pillar introduction -
Law on old-age pension savings

- Mandatory for those who have never been insured by Social Security
- New single-purpose companies – Pension AM Companies, transfer through CR in Social Security Agency
- Contribution rate 9% paid solely by the employer
- 10 years minimum savings period requirement
- Special transitory reserve fund
- Saver's ownership of pension fund's money
- Annuities paid by life insurance companies, free disposal paid by Pension AM Companies

It appears that the strategy to implement this law as soon as possible was a very good idea in the case of Slovakia, because now this strongly reform oriented government has a minority in the Parliament; this government has low support from the public, so I think that if we had postponed the implementation of the law process and had tried to adopt this law not in 2003 but later in 2004, I think that no reform would have taken place in Slovakia, no substantial reform.

You see here, in Diagram N° 4, the main feature of the Second Pillar Law: it will be Mandatory for those who had never been insured in Social Security before. We created new single purpose companies: pension asset management companies which will receive money through the Social Security Agency which will hold a Central Register. So the flow of the money will be from the employer through our Central Register in the Social Insurance Agency to the Pension Funds.

DIAGRAM N° 4
Structure of the II pillar



The contribution rate is rather unique: you see 9% there, I think this contribution rate is amongst the highest in Central and Eastern Europe. I think Kazakhstan has 10% and then I think that we are the second highest contribution rate to the second pillar.

We imposed a minimum 10-year Savings Period. It means that the money will be blocked for 10 years. After 10 years, the saver can choose a retirement option. I mentioned that there is a transitory reserve fund. As far as for paying out benefits, we are far from this, but it was decided that the benefits from these funds would be paid out by Life Insurance Companies, the normal Life Insurance Companies in Slovakia which will have a license for paying out Life Insurance Products.

You see here the graphic structure of the Second Pillar. As you may have noticed from Table N° 3; the contribution rate of 9% is paid solely by the employer. This may be another unique feature of our system. It was also one of many arguments when implementing the reform, that money would suddenly appear in the accounts of the people, because it was money paid by the employer. People never saw this money, so when the reform is implemented, it was said that everyone would see the 9% in their account.

We created three Pension Funds: the Conservative Pension Fund, the Balance Pension Fund and the Growth Pension Fund, under each Pension Company. It means that from the beginning of the reform we wanted to emphasize that a Pension Fund is not a Pension Company. As I remember in Chile, they began with one Pension Fund under one Company and I think, from the point of view of educating people, it is very good to emphasize from the beginning that a Pension Company is not a Pension Fund. They are separate. A Pension Fund is only managed by a Pension Company, and I think that if we create three Pension Funds from the beginning, it will be easier to communicate to people that it's not the same, it's something completely different and that their money is completely separate from the managing entity.

1. What are we doing now?

This year, 2004, the so-called secondary regulation year, we are preparing a couple of secondary regulations together with our local and especially our foreign consultants.

We have to prepare around ten of them. A couple of them are done, a couple of them are on the way, so now we are working hard to prepare the Ministry of Finance and Financial Market Authority which will supervise all this system. We are also preparing the Social Insurance Agency because they are included in the system: they collect the money.

2. What do we expect from the system?

Slovakia is not a big market. We only have 5.4 million inhabitants. It means that the market work force is only around 2.2 million people.

We expect that half of the currrent workforce will join the second pillar. The actual market is about 1 million to 1.1 million people.

Assets under management; in the first year these will be about three hundred million dollars and each additional year about four hundred and fifty million dollars. So I think, that from the point of view of Slovakia, it's a substantial amount of money, and for local players, our market will be very, very interesting business.

3. Why did we use this reform strategy?

Maybe we could not have introduced a substantial second pillar but instead have built some reserves like Ireland or another country in the European Union. But we decided to go this way and I have tried to put here some aspects which emphasize the problems of the reform.

One of the main arguments was diversification of resources of financing. It meant that one part of the future benefit will come from the PAYG system and another part from a funded system.

At the time, we also wanted to use Privatization Resources. We now have about 8% of GDP special Privatization Revenue in a Special Account in the National Bank of Slovakia. Our politicians are now thinking what to do with this.

Giving money to politicians, is not a very good idea in any country. I think the use of these Privatization Resources is very, very good, especially for Pension Reform, and we will adopt a special constitutional law at the end of this year, about using these Privatization Resources just for pension reform.

Another argument was that one system will be defined benefit and the other will be defined contribution, because in the first pillar people wanted to see some sort of security, to have some sort of promise. In the second pillar, it's a matter of Responsibility. It's more about Depending on Yourself.

It was also argued that it was good to balance this system between a Defined Benefit System and a Defined Contribution System.

I mentioned that this Implicit Pension Debt was hardly discussed and that it was a very good argument, especially in connection with these Privatization Resources, to use this money especially for substantially reducing Implicit Pension Debt.

Of course there is discussion, and there was an argument that this reform was going to increase the pensions. I think this is good, it is a good argument, but I think that maybe on a political level, it was taken too simply: ”When we implement the funded pillar, we will have higher benefits”.

But as we are on the Expert Level at this conference we can say “Yes, they will be higher, probably”, but no one emphasizes the fact that if we didn’t do anything, the prognosis for the next 50 years would be that the pension replacement rate in a PAYG system would probably decrease from the current level of about 42% to 18%. So I think that the benefits under this system would be much higher. We have to just compare the situation in the year 2000 with the situation in the next fifty years.

Yesterday, there was a discussion about the education of people. I think introducing a second pillar is also very good from the point of view that people realize that their pension is not something virtual, which they will get from the state when they are older. But the pension system in the PAYG part and in the funded part, is driven by some underlying economic reasons. And in both the PAYG part and in the funded part there are some basic economic considerations. I think that with the combination of these two systems, people will be more aware of the two components that make up the whole pension system.

2 The reform in Macedonia

Zorica Apostolska

The reform in Macedonia

Zorica Apostolska[1]

The Republic of Macedonia is a country in transition. It was one of the six constitutional republics of the former Socialist Federal Republic of Yugoslavia. After the break up of the Federation, Macedonia declared independence on 8th September 1991. According to the new Constitution, adopted on 17th November 1991, the Republic of Macedonia is a parliamentary democracy.

Despite the challenges and difficulties during the transition period, the country has persevered on the path of political and economic reforms towards building a democratic society and open market economy. The result has been political and macroeconomic stability which allows opportunity for growth.

1. Reasons for the reform

The pension system in the Republic of Macedonia has a long historical development. It's been in existence for the last 50 years, gradually developing and upgrading over time. The social and economic changes in the past few years have left their mark on the

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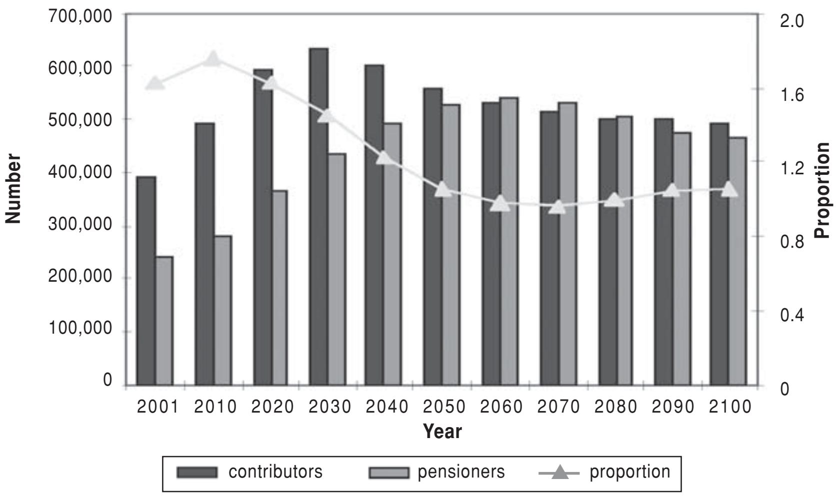
Prior to her current position, Ms. Apostolska was Finance and Utilities Department Director at Metalski Zavod Tito-Skopje Engineering. She also held several positions in the Ministry of Labor and Social Policy as Consultant and Assistant to the Minister, as Head of the Pension and Disability Insurance Department and as Director of the Pension Reform Technical Assistance Project - PERTAP.
Ms. Apostolska has published several articles, debates, analyses, and other works on pension systems and their reform and has also participated in several projects on social insurance.

pension system as well. The unfavorable economy at the beginning of the transition increased the number of loss-making companies, created labor force redundancies and caused many bankruptcies. These were the main reasons for the decreasing number of active contributors from one side and the increasing number of pensioners on the other side. See Figure N° 1.

FIGURE N° 1
Ratio contributors/pensioners



Like many other countries, Macedonia will face demographic changes that could have a negative influence on the system, such as decreasing birth rates and longer life expectancy. If nothing is done, this will lead the pension system to permanent insolvency and it won't be able to pay the legally determined pension benefits.

The system could maintain its fiscal balance by increasing the contribution rate or by reducing benefits. However, these solutions will only put the system back in balance in the short run, and will create other problems. The high contribution rate will hinder economic growth and will likely further increase tax evasion. On the other hand, decreasing pension benefits will lead to insufficient old age income. These solutions will also not avoid the long-term insolvency problem.

In order to overcome these problems, Macedonia decided to make broad structural changes to its pension system. This led to changes and amendments to the Law on Pension and Disability Insurance and introduction of a multi-pillar pension system in Macedonia.

2. Goals to be accomplished

The main goals of the pension reform are to:

– Provide security in acquiring rights to pension and disability insurance

– Assure the short and long term solvency of the Pension and Disability Insurance Fund of Macedonia

– Provide maximum security while minimizing risk

– Guarantee payment of pensions for all generations

– Strengthen the public's trust in the pension system.

3. Expected effects from the reform

The implementation and existence of a multi-pillar system, a combination of a PAYGO and a fully funded system, is expected to generate advantages for the individual as well as for the pension system and the economy as a whole.

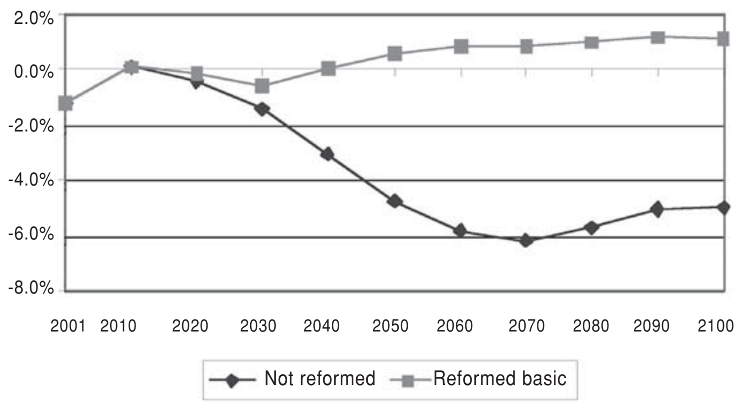
3.1 Advantages for the individual

From the individual's perspective this system should provide **better security** because pension benefits will not be financed from only one source, so **risks will be diversified**. Also, the introduction of individual accounts, for the purpose of investing the assets accumulated in these accounts, will provide an opportunity for higher old-age income. One of the important features of this system is the **transparency** in its operations, because the individual will have access to his or her account information at all times (accumulated assets, types of investments and returns on investments).

3.2 Advantages for the system

The existence of the multi-pillar structure will enable long-term solvency, which is one of the main goals of every State's social welfare policy. By cutting down the scope of the State-run pension system in favor of introducing the fully funded system, the long-term liabilities of the Budget will decrease, leading to a reduction in the Budget expenditures for pensions. See Figure N° 2. Unlike the PAYGO system, which does not stimulate savings due to the generational solidarity element, the fully funded system will **increase national savings**, in the long run. This, in turn, should help develop the financial markets and **increase the capital available for local investment**, eventually leading to **economic growth**. From a long-run perspective, the pension reform should also increase the efficiency of the Macedonian labor market. The gap between gross and net wages in Macedonia is very large due to the size of social contributions and person income tax. The pension and disability contribution alone is 21.2% of gross wages today. It is expected that, in the long-run, the pension reform will lead to a reduction in the contribution rate, and therefore, a reduction in total labor costs. This will make it more cost effective for employers to hire additional employees, leading to a reduction in the unemployment rate and switching of labor from the informal to the formal sector of the economy.

FIGURE N° 2
Comparison of income-expenditures



4. Structure of the pension system

The multi-pillar system is based on three types (pillars) of insurance:

4.1 The mandatory pension and disability insurance based on generational solidarity (first pillar), represents the current reformed pension system organized on the basis of pay-as-you-go financing, where the current employees pay for the current pensioners. This system will provide a portion of the old-age retirement benefits, all disability and survivor benefits, and will guarantee minimum pensions. Benefits are based on a formula that takes into account salary history and years of contributions, with a target old-age replacement rate of 30% for a full career. The balance of the old-age benefit will be provided from the fully funded pension system, with an expected replacement ratio of 35-40%. .The contribution to the solidarity system is 20% of the gross wage. Contributions are paid by employees, but employers are responsible for withholding contributions from the employees' gross wage and paying them to the Pension and Disability Insurance Fund (PDIF).

4.2 The mandatory fully funded pension insurance (second pillar) a new defined contribution system. Under this system, workers make contributions to their own individual accounts throughout their working careers in order to save for retirement. Under this system, workers' contributions finance their own benefits, rather than the benefits of current pensioners. This type of insurance is based on accumulation of assets in individual accounts, which are invested. The return on the assets, reduced for operational costs, is added to the individual account. The percentage of the overall contribution for pension and disability insurance that will be paid to the second pillar is 7.42% of the gross wage. Contributions are paid by employees, but employers are responsible for withholding contributions from the employees' gross wage and paying them to the Pension and Disability Insurance Fund.

4.3 The voluntary fully funded pension insurance (third pillar) is also included in the Macedonian pension system, though implementing legislation has not yet been written. This system will allow those who want to have higher old-age income and those who are not covered with the mandatory insurance (first and second pillar) to save additional money for their own retirement.

5. Who will enter the reformed system? (Range of contributors)

- Mandatory: All employees hired on or after January 1, 2003

- Right to choose: All other contributors, that have already entered the pension and disability insurance i.e. that were employed before January 1, 2003

- Switching decision:
  - Those who choose to join the new pension system will receive a maximum of 5 years of service credit under the current system for service prior to the date of election to join.

  - Software available for individuals to compare the benefits they would receive by remaining in the current system and by joining the new system.

6. Distribution of contributions in the two pillars

The total rate of contributions to the pension system amounts to 21.2% of the gross wage. This figure that is broken down as follows:

- First pillar: 65% of the contribution, equivalent to 13.78% (earmarked for financing old-age, disability and survivorship benefits and the minimum guarantee)

- Second pillar: 35% of the contribution, equivalent to 7.42% (earmarked exclusively for financing old-age, pensions)

The actual date planned for starting payment of contributions into the second pillar is estimated to be around the middle of the year 2005.

7. Conditions for acquiring the right to a pension benefit and expected benefits

- The conditions for acquiring the right to a pension benefit are the same for both pillars

- Retirement age: 64 for men, 62 for women, and at least 15 years of service

- The solidarity benefit includes payment of old-age, disability and survivors benefits and will be calculated by a determined formula

  Replacement ratios for men with 40 and women with 35 years of service
  - Non-switchers: decreasing from 80% to 72% of net salary (gradually over 40 years)
  - Switchers: 30% from solidarity for full service, plus benefit from mandatory accumulation system (total of 70-80% of average net salary expected)

- Pension benefit from the second pillar includes
  - Part of the old-age benefit and the members have the right to choose from:
    - Purchase of life-time annuity
    - Programmed withdrawals

8. Contribution collection and allocation process

The Pension and Disability Insurance Fund of Macedonia (PDIF) will collect the contributions in a unified procedure for both pillars, and it has the primary responsibility for controlling the contribution collection and their allocation to the pension funds.

The Agency for Supervision of Fully Funded Pension Insurance will receive daily information about the flow of contributions, including data about contributions collected and contributions allocated, by pension fund and by individual. The Agency uses this information in its processes of reconciliation of data received from the other institutions of the system (the Custodian) and for supervision and control of Pension Companies activities (investment and accounting processes).

Each day, the Pension and Disability Insurance Fund of Macedonia transfers contributions for allocated and special accounts to the Custodian of each Pension Fund. The Pension Company should check that the amount actually received by the Custodian is what was sent, according to the Pension and Disability Insurance Fund of Macedonia reports, and that the contribution amount is consistent with the individual data file. The Pension Company processes the individual data information into its internal record-keeping system, thereby allocating contributions to individual accounts.

9. Pension Companies for Managing Pension Funds

In the Republic of Macedonia in the first ten years of the implementation of the mandatory fully funded pension insurance only two licenses will be granted for managing pension funds.

9.1 Requirements for Pension Company founders

- Each founder must have minimum share capital of 20 million Euro
- At least three years of existence
- Uninterrupted solvency
- Permanent managerial team and competent employees
- Minimum investment-grade rating from reputable rating agencies

9.2 Shareholders and capital of the Pension Companies

- Shareholders – Domestic and foreign legal entities that meet the conditions
- Legal entity can only be a shareholder in one Pension Company
- 51% of share capital must be held by banks, insurance companies, or other financial institutions
- Each Pension Company manages one Pension Fund;
- Each member may choose only one Fund;
- Share capital not less than 1.5 million Euros;
- Additional 1 million Euro of share capital is required for every 100 million Euro increase in assets;
- Own capital must always exceed 50% of share capital;
- Share transactions require Agency’s consent;
- Pension Companies can’t merge, separate, or reorganize.

10. Revenues and expenditures of the Pension Companies

- Fees (Revenue)
  - Percent of contributions (determined through tender process)
  - Percent of assets (fixed at 0.05% per month)
  - Fee for members who transfer (in limited circumstances)
- Expenditures
  - Own operations
  - Fees to PDIF and the Agency
  - Custodian
- Brokerage costs and fee as a percent of assets are not expenditure of Pension Companies but paid directly from Pension Funds

11. Investment limits of Pension Companies

- Foreign investments (EU, Japan, USA)– 20%
- Securities guaranteed by Government of the Republic of Macedonia or the National Bank – 80%
- Macedonian bank deposits and securities– 60%
- Macedonian corporate bonds and paper- 40%
- Macedonian equities – 30%
- Macedonian mutual funds – 20%
- Other restriction prescribed by the Law

12. Investment prohibitions of Pension Companies

- The Law prohibits investing in:
  - shares, bonds and other securities that are either unlisted or not publicly traded, real estate etc.
- Pension Companies are not allowed:
  - to invest Pension Fund assets in securities issued by: any Pension Company shareholder, the Pension Fund Custodian, Foreign Asset Manager and any Affiliated Person.
  - to approve loans and guarantees from Pension Fund assets
  - to use Pension Fund assets as collateral

13. Institutional infrastructure of the fully funded pension system – key institutions

13.1 Ministry of Labor and Social Policy

The social security of the citizens is a constitutional obligation of the State, and the pension and disability insurance is the key component of the social insurance system.

The Ministry of Labor and Social Policy is responsible for creating the pension and disability insurance policy as well as for the supervision and control of the implementation of the new pension system. The Ministry's goal is to assure that the pension and disability insurance system is secure and stable, and provides equitable benefits to current and future pensioners. The institutions through which the pension and disability insurance is implemented, and for which the Ministry is responsible, are the Pension and Disability Insurance Fund (first pillar) and the Agency for Supervision of Fully Funded Pension Insurance (second pillar).

13.2 Agency for Supervision of Fully Funded Pension Insurance

The Agency for Supervision of Fully Funded Pension Insurance protects the interests of pension fund members. It is a legal entity and reports to the Government of the Republic of Macedonia. The Agency is responsible for organizing the tender and for granting and withdrawing licenses of the Pension Companies for managing pension funds. The Agency performs off-site and on-site supervision of the Pension Companies and Pension Funds, the Custodian, and Foreign Asset Managers. The Agency co-operates with the Pension and Disability Insurance Fund, the Ministry of Finance, the National Bank of the Republic of Macedonia, the Securities Exchange Commission and other relevant institutions in order to ensure effective supervision of the fully funded pension insurance. In order to provide transparency, the Agency is required to submit an Annual Report to the Government and Parliament. The Agency also publishes an annual statistical report and other information on the development of the fully funded pension insurance system.

13.3 Pension and Disability Insurance Fund of Macedonia

The Pension and Disability Insurance Fund of Macedonia is responsible for the implementation of the pension and disability insurance. In the reformed pension system the Fund also has some responsibilities for the fully funded pension insurance:

- Collection of contributions for pension and disability insurance and the fully funded pension insurance
- Monthly reconciliation of paid contributions and received data
- Transfer of contributions to the individual accounts in the members' pension funds
- Delivery of information to the Pension Companies on transfer of contributions.

In order to perform these functions, the Fund maintains a data base of members and their choices of pension funds. The Fund provides employers with free software that allows them to submit monthly data electronically.

13.4 The National Bank of the Republic of Macedonia - The Custodian of Pension Fund Assets

The pension funds assets will be kept by the Custodian. At the beginning of the new system, i.e. in the first five years, the Custodian will be the National Bank of the Republic of Macedonia. The custodian is responsible for the safe keeping of pension funds assets. The Custodian monitors the investment orders of the Pension Company to ensure they are in compliance with the Law.

TABLE N° 1
Expected developments

Event	**Date**
Tender issued	12 July 2004
Pre-qualification decision	End-October 2004
Final licensing decision	Mid-December 2004
Incorporate Pension Companies	End-March 2005
Begin marketing	May 2005
Begin contributions	September/October 2005

Table Nº 1 shows the estimated timing for implementing the reformed pension system in Macedonia.

Table Nº 2 shows the projections up to the year 2014 for the main variables in the pension system: contributors, contributions and the size of the fund.

TABLE N° 2
Financial projections
(100,000 switchers, medium economic growth)

Year	Contributors (thousands)	Contributions (million Euro)	Total assets (million Euro)
2005	100,891	26.7	26.7
2006	115,657	32.3	55.3
2007	132,328	39.0	95.6
2008	150,082	46.7	146.6
2009	166,841	54.8	209.6
2010	186,090	64.1	286.8
2011	205,905	74.9	381.0
2012	226,614	87.0	494.9
2013	248,220	100.6	631.6
2014	270,333	115.7	794.7

CHAPTER III

Challenges for Implementing the Reforms

1 Regulation and supervision of pension fund investments

Effects of the regulatory framework on investments: Augusto Iglesias

The portfolio managers' view: Gianluca Renzini

Comments: Tibor Parniczky

Effects of the regulatory framework on investments

AUGUSTO IGLESIAS[1]

I want to thank FIAP and Arcada Bank for the invitation to take part in this seminar. Analysing and discussing the reform experiences of different countries is of invaluable assistance in the task of regulation improvement, so this type of conference is particularly useful for those of us involved in the debate on the reforms and in the design of new social security systems.

I shall be dividing my lecture into four parts: in the first place I shall argue that the investment of mandatory pension funds must be regulated and emphasize the importance of appropriate regulation; secondly I shall give a brief description of two regulation models – "quantitative limits" and "prudential regulation" –; thirdly I shall be referring to certain criticisms that can be levelled at both models; and finally, in conclusion, I shall try to identify some lessons from experience.

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Mr. Iglesias is currently a Partner and Director of PrimAmérica Consultores.
Mr. Iglesias has been an Economics Professor at the Pontificia Universidad Católica de Chile, Universidad de Chile, Universidad Gabriela Mistral, Universidad Adolfo Ibáñez, Universidad de Los Andes and Universidad del Desarrollo.
Mr. Iglesias has published several articles and books on economics and pension funds. Some of them are: "Economía: Principios y Problemas *(Economics: Principles and Problems)*", with H. Cortés and A. Holuigue; "El Sistema de Pensiones: 7 Años de Historia *(The Pensions System: 7 Years of History)*", with Rodrigo Acuña and Sergio Sepúlveda, edited by A.F.P. Habitat; "Chile: Experiencia con un Régimen de Capitalización 1981-1991 *(Chile: Experience with a Capitalization Regime 1981-1991)*", with R. Acuña, edited by CEPAL (Chile); "Managing Public Pension Reserves", with R. Palacios (Social Protection Discussion Paper Nº 0129, The World Bank; and "Payout choices by retirees in Chile: what are they and why", whit E. James and G. Martínez (June 2004).

1. Why is it necessary to regulate pension fund investment?

The investment of mandatory pension funds should be regulated for two main reasons. First, when the State imposes the obligation to pay social security contributions, it makes itself at least partially responsible for the pension system. Secondly, as a result of agency problems and asymmetrical information, there are certain investment risks that may prevent the system from fulfilling its objectives.

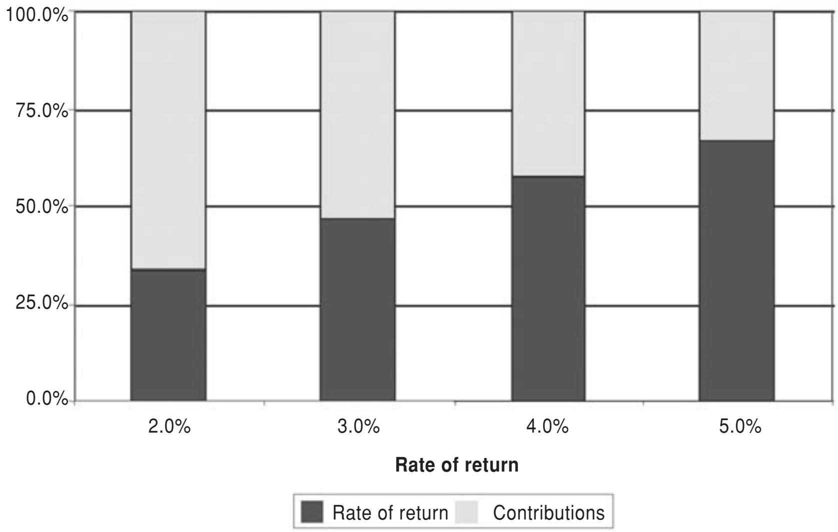
It is therefore necessary to regulate investments in order to minimize the risk that the pension (or the ratio of pension to salary) will be less than some objective level defined in advance; to minimize supervision costs; to minimize information costs; to minimize variance in rates of return and to minimize the possibility of fraud.

Of course, regulating in itself is not enough; the quality of pension fund investment must also be appropriate, because this will have a decisive effect on the result of the capitalization systems. In particular, ceteris-paribus, the potential return of the funds will be greater or less depending on the characteristics of the regulation and pensions will consequently be better or worse. Furthermore, different regulations can stimulate or limit the impact of the accumulation of funds on the development of the capital market and thereby on economic growth.

The relation between fund returns and pension levels is illustrated in the first two figures. Figure Nº 1 shows us the total balance in a worker's individual account at the end of his/her working life, assuming that he/she has paid contributions for 30 years. It can be seen that with an average return of 2% per year, 30% of the final balance has its origin in returns and 70% in contributions. However, if the rate of return is 5%, almost 65% of the total balance will have its origin in the returns of the investments and less than 30% in contributions paid.

In Figure Nº 2 we can see the impact of different rates of return on the absolute level of balances in the worker's individual account after 30 years of work and contributions. It may be observed, for example, that with a rate of return of 5%, the worker will accumulate double the amount of savings that he/she would obtain with a performance of 2%.

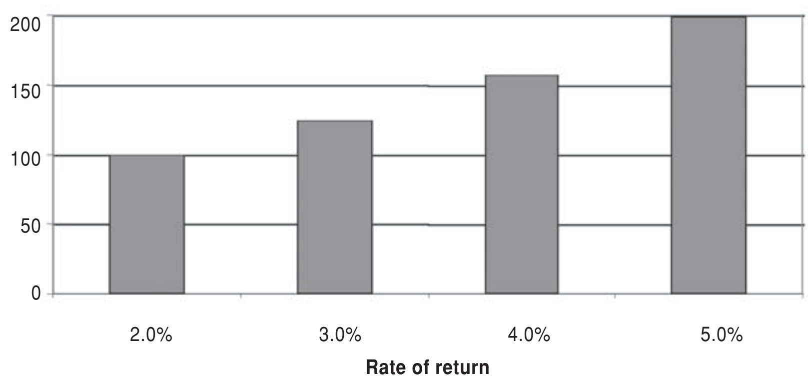
FIGURE N° 1
Composition of total final balance



Source: PrimAmérica Consultores.

On the other hand, investment regulations can potentiate or limit the impact of funds' accumulation on the development of the capital market and, consequently, on economic growth.

FIGURE N° 2
Impact of differences in rates of return of funds' accumulation



Source: PrimAmérica Consultores.

For example, a recent study made by two economists for the Chilean case (Corbo, Schmidt-Hebbel, 2003) shows that, in appropriate conditions, the impact of pension reform on the development of the capital market and consequently on the economic growth of the country can be significant. As we were saying, one of these conditions refers precisely to the quality of investment regulation.

Table Nº 1

Impact of pension reform on economic growth: the Chilean case (average 1980-2001, %)

Scenarios	Minimum	Average	Maximum
Average growth rate	4.63	4.63	4.63
Contribution of pension reform	0.21	0.48	0.74
Savings-investment	0.03	0.18	0.32
Labour markets	0.05	0.10	0.15
Development of the capital market	0.13	0.20	0.27

Source: Corbo, Schmidt-Hebbel (2003).

According to the results found by these authors (in their "average" scenario), Table Nº 1, approximately 10% of Chile's economic growth in the period 1980-2001 is explained by the pension reform (0.48% per year of an average growth of 4.63% per year). At the same time, of the 10%, almost half is explained by the positive effect of the reform on the development of capital markets. In other words, approximately 5% of the country's growth in the period 1980-2001 may be explained by the positive impact of the pension reform on the development of the capital market.

In consequence, the investment of mandatory pension funds must be regulated. However, the quality of that regulation is also important. Efficient and effective regulations contribute towards maximizing the long-term returns of the pension funds (and therefore the pensions) and allow the process of fund accumulation to really become an element that stimulates the development of the capital markets.

2. Regulation models: quantitative limits and the prudent man rule

How should one regulate? The best-known investment regulation models combine in different ways a series of restrictions on the types of instrument that are eligible for investment purposes and on portfolio composition with other criteria and guidelines for conduct which have to be obeyed by the fund managers. In order to facilitate the analysis of the different positions, I am going to refer to two typical models which, according to normal custom, we will call "Prudential regulation" and "Portfolio limits" (or "Quantitative regulation").

The "Prudential regulation" model is characterized by a set of regulations which include: fiduciary responsibility of the manager; obligation on the part of the fund-manager to take out a special license in order to operate; obligatory custody of financial assets by an institution that is independent of the fund managers; criteria for asset valuation (generally based on market prices); provisions to control possible conflicts of interest; accounting criteria (both for the pension fund and for the fund manager); prohibitions against investment in certain asset classes; and obligations regarding reporting on transactions and portfolio composition.

The "Quantitative regulations" model on the other hand includes the rules of the "Prudential regulation" model, plus a set of limits referring to the composition of the investment portfolio and, sometimes, certain minimum yield requirements. In particular, in addition to the rules already mentioned, it imposes the obligation to invest only in instruments that have been specifically authorized. It also fixes maximum and minimum limits for investments in each instrument (and in families of instruments) as a proportion of the pension fund and, occasionally, obliges each manager to generate a yield similar to that of a benchmark chosen for this purpose.

3. Criticisms of investment regulation

There are five main objections to the "Quantitative regulations" model. In the first place, it is argued that investment limits prevent the fund-managers from choosing portfolios that are on the "efficient frontier" of investment opportunities. In the second place, it is also argued that investment limits are not the most efficient way of restricting risks for the participants in the pension funds. The third criticism is that restrictions in the composition of the investment portfolios may limit expected performances quite disproportionately. In the fourth place it is argued that quantitative regulations do not allow fund-managers to offer a sufficient variety of portfolios to suit the preferences of all individuals. Finally, quantitative regulations are criticized using the argument that they encourage fund-managers to imitate each other's respective investment strategies ("herd effect").

On the other hand, the success of "Prudential regulation" depends in the first instance on its ability to prevent bad fund management and secondly on its ability to penalize those who commit fraud or fail to act with due diligence. However, in many countries the legal system does not provide an efficient mechanism to penalize or punish people who do not fulfil their fiduciary responsibilities. Furthermore, particularly where fund-managers are relatively young companies in the market, without a reputation to protect, or where they operate with a small capital base compared with the funds they are managing, the expected profits from fraud may be far higher than the expected costs of the punishment (if they are found out), which creates "incentives" for actions that are at variance with the interest of the members of the pension fund.

The "Prudential regulation" model is also open to other criticisms. In the first place, if members are to be able to check effectively that the fund-managers are fulfilling their fiduciary role, the costs of information need to be low while the level of financial education among participants must be high. However, in practice it is difficult to find these two conditions. In the second place, it is argued, partly because of the circumstances already described, that prudential regulation models imply particularly high supervision costs. Finally, it is also emphasized that there are potential conflicts of interest associated with the management of third-party funds which can only be resolved by imposing certain investment limits and/or prohibitions, so that in practice it is impossible for there to be a "pure" prudential regulation model.

Most countries that have adopted mandatory pension programs based on individual capitalization have also decided in favour of a "quantitative regulation" model for investing the pension funds. Although we have no way of knowing what the results would have been if these countries had opted for the “Prudential regulation” model, it is interesting to confirm that the returns of the pension funds obtained under “Quantitative regulation” schemes have, at least so far, been satisfactory. So, for example, the Table N° 2, compares rates of return for the pension funds with growth of salaries and GDP in eight Latin American countries. It can be seen that the performance of the pension funds has far exceeded the other two references in all the countries in the sample. Evidence would therefore suggest that the countries which have adopted quantitative regulations have at least been able to avoid the more obvious potential costs associated with this model of regulation.

TABLE N° 2
Rates of return of the pension funds

	Real rate of return since outset %	Real rise in wages %	Differential of return/ wage growth %	Real growth of per capita income %	Differential of return/ per capita growth %
Argentina	11.7	-0.8	12.5	-0.4	12.1
Bolivia	16.2	8.8	7.6	0.4	15.8
Colombia	11.8	1.4	10.4	-0.3	12.1
Chile	10.5	1.8	8.7	4.5	6.0
El Salvador	11.3	0.2	11.5	0.5	10.8
Mexico	10.6	0.0	10.6	2.8	7.8
Peru	5.7	1.8	3.9	2.4	3.3
Paraguay	9.5	3.6	5.9	-0.3	9.8

Source: Palacios (2003).

4. Final remarks

The practical experience of “reformist” countries suggests that, in the context of mandatory pension systems, imposing some restrictions in the formation of pension fund investment portfolios is inevitable. Particularly where capital markets are not highly developed, where there is weak political support for the reform and where the population does not have much financial knowledge, "Prudential regulation" is not sufficient to limit the risks facing the system and portfolio limitations are necessary.

In any case, "Quantitative regulation" systems must obviously be designed in such a way as to interfere as little as possible with the decisions of the portfolio managers. In this sense it is very important to look at the experience of countries that use this type of regulation and identify best practices.

It is also possible to conclude that portfolio limitations should be made gradually more flexible as time goes on, as capital markets develop and as both industry and supervisors gain experience. In fact, most of the reasons that can be given to justify the need for portfolio limitations depend on the specific conditions of each market, which evolve over time. To avoid these limitations imposing significant costs in terms of lower returns, it is necessary for them to change together with the conditions of the market. From this point of view the question is not whether to adopt a quantitative regulation model, but what the characteristics of that model should be and how these should change as time goes on.

What, then, are the main challenges facing the quantitative regulation model? In the first place, the challenge of balancing the need for portfolio limitations with the possible costs of these limitations. In order to find an appropriate solution for this challenge, the possibility of diversifying the portfolio among different asset classes and issuers should always be kept open. Furthermore, it is important that fund-managers are not obliged to invest in specific asset types.

In the second place, the challenge of avoiding the risk of regulators (or those with power to establish these limits) using the limits to further specific economic activities or other aims of social policy which are different from those of a pension system. To achieve this, as in the previous case, it is important to avoid obligatory investments. It is also advisable to limit investment in non-financial assets and at the same time to stimulate investment in assets that are usually traded in the financial markets. The funds' protection against these "political risks" is also increased when transactions take place in formal markets and where portfolio managers have a strong, well-defined fiduciary responsibility. Finally, having independent, professional supervision is a necessary condition to ensure a regulation which is directed solely towards promoting the aims of the pension system.

In the third place, the challenge of avoiding the encouragement of “herd” behaviour among fund-managers. Experience shows that this challenge may be met by authorizing portfolio managers to offer different portfolios to their members and by avoiding obligatory yield requirements that force fund-managers to duplicate the structure of the reference portfolio. (For this reason results should not be measured over very short periods and the return of the portfolio should be allowed to move around the return on the reference portfolio.)

Finally, the challenge of designing a set of regulations which is consistent with the situation of the country’s economy and capital market.

The choice of the most appropriate regulation model for pension fund investment is a critical decision for the success of pension reforms. However, the ability of legislators and supervisors to adjust the regulations according to the results of the system and to ensure that they are constantly being adapted to the conditions of the environment may be even more important. For this reason, there is no single, unvarying set of “best regulations” for pension fund investment. On the contrary, investment regulation is an instrument that must be under constant review, in the light of the specific characteristics of each economy and each market.

The portfolio managers' view[1]

Gianluca Renzini[2]

The Italian experience is a series of stories, not all of which end in great successes, but what I would like to do is provide a little information about how the system has developed over the past ten years.

Following on from Mr Iglesias' remarks, we will see if I can add a little more information, and I am going to do this with a few ideas. In the first place, I believe that it is possible to take advantage of this international experience in the development of these systems, talking about the second and third pillars in Eastern Europe.

From the point of view of the legal framework, the results obtained reflect the knowledge of the professionals involved and the regulator must provide the experts with the possibility of acquiring international products, this to be carried out under certain conditions. However, this scenario ought to include other elements: we have to remember that such access to international

1 The presentation of this subject at the Seminar was made by Mr. Renzini, in representation of Mr. Marco Mazzucchelli.

2 Graduated in Economics at the University of Ancona. After an MBA (Master in Business Administration) at the Bocconi University of Milan, Gianluca joined Banca Nazionale del Lavoro managing various bank branches all around Italy.
He continued his career in General Electric Oil & Gas as Business Development Manager and then as Managing Director of a GE Oil & Gas company in Spain.
In 2000 Gianluca started to work at Sanpaolo Wealth Management, one of the European leaders in mutual fund and life insurance management, where today he is the Head of International Sales.
Gianluca was recently nominated Italy Country Head of Allfunds Bank. Allfunds Bank, a joint venture between the Spanish Santander Central Hispano and the Italian Sanpaolo IMI financial groups, is a platform that offers products and services in the "open architecture" context to financials institutions and pensions fund managers.

markets must also provide a series of control factors. That is how we have explained it in Italy.

Let us talk for a little about Italy. We are still based on the first pillar and are seeing demographic changes which mean that the gap in pensions is growing. We are trying, therefore, to increase the presence of the second and third pillar to cover this gap (understood as a time-lag in fund accumulation). It is a supplementary system which is still small, but it is growing.

If we look at what Mr Iglesias was saying, we can see that in Italy the legislators are working within an environment of limitations. We believe that this limitation is a tool which ensures the stability of the market to some extent.

Then, if we analyse this scheme, we can infer that some good results and a certain stability have been achieved, even though there have been some blows, both Italian and international. This is because various countries are taking advantage of the knowledge of other more important markets, such as the Italian market with a wide range of products that allows for good portfolio diversity.

The approach of the Italian regulator is as follows: in the first place, to do as much as possible to reduce public debt. We started with the reforms in 1992, continuing in 1993 and 1995 and all these reforms have to some extent given rise to this widening of the pensions gap that we are suffering from today. So in 1999 we began with this new law, which seeks to bridge that gap by making use of this voluntary pension system.

The structure that we are using in Italy is the following: we felt that we needed to have a regulatory authority to supervise all the structures: it makes sure that there is compliance and carries out a follow-up as regards the transparency of the transactions. Then there are the fund sponsors: elected by the managers, in a process governed by the indications of that authority. The portfolio managers, especially in the case of these closed funds, must be independent. They are companies which must be independent and can make use of a wide range of products that express a differentiation. In that way we can see that there is diversity and an opportunity for participants to work with these funds in order to achieve the best results. This scheme is closed by the custodian bank, which manages the assets, assumes responsibility for performances and must keep a check on the resources received by the portfolio managers.

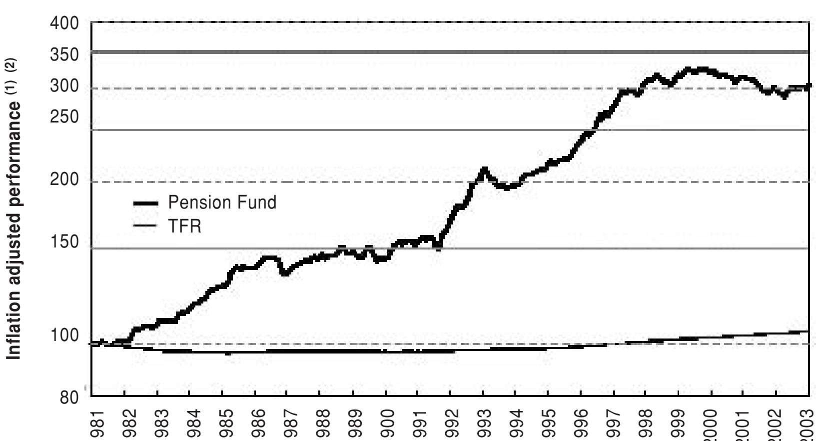
So, seeing the elements to which they are subjected, development shows an upward trend as far as the assets being managed are concerned, and this could continue in the same direction if parliament approves the proposal, the draft law, which includes a series of important tax advantages for the end client.

As far as results are concerned, what we see in Diagram N° 1, is that there is a series of advantages and that there are better results than under the old scheme, which was adjusted to the adjustment –if you will excuse the redundancy– at the moment of retirement. If we compare ourselves with the old evaluation, which proposed 3.2, we have a comparison between 5.7 and 3.2. As I say, we had to resort to this law to cover that gap.

DIAGRAM N° 1

Nominal Performance[1]	Open-ended pension funds performance in 2003	5.7%
	Close-ended pension funds performance in 2003	5.0%
	Gross TFR Revaluation	3.2%

TFR Revaluation and backtested pension fund performance



1 Net of all expenses and taxes.
2 Semilogarithmic scale: base 100 as May 31st, 1982.
Source: *Covip, Annual Report 2003*.

Well, we need to underline the importance of the concept that, although we have managed to draft these guidelines about diversification, attention to conflicts of interest and having the authority to supervise the smooth running of the system, the clear aim of the regulator in limiting investments is, as I see it, to attempt to establish a mechanism that protects the end client. I therefore believe that we are getting close to a position of stability in Italy.

There is an interesting case, that of Parmalat. I do not know if you know what has been happening in Italy with Parmalat, but it is a company that has had many problems and the end clients, the banks that invested directly in Parmalat bonds, have lost over 60% of the capital invested. However, the pension system is almost totally absent from these portfolios and holds no Parmalat assets, due to the high associated risk which prevents the pension fund system from participating.

Another important point is the following: this activity is close to asset management. It is similar, the agents are similar and the points of reference are also very similar. This is what has been subject to regulation from the very beginning. It was a case of saying that a small business cannot take on the minimum level of assets needed to obtain good results and to have an interesting activity, so although this has limited access to the market, I believe that the limit is interesting.

The portfolio managers have the possibility of investing up to 50% in mutual funds issued by countries of the Confedem. We can say that when the regulator defines limits, even if, as Mr Iglesias says, they are later made less severe, I am sure you realize that they may have a negative effect on the Italian economic system, from the domestic point of view as well. But I believe that the decision has been the most appropriate one, given the possibilities that existed. And, as you can see in Diagram N° 2, regulation has not had a negative effect on the financial system.

In conclusion, we can say that, given the proposals of this panel, I believe that the Italian pension system's constant process of adjustment – both from the point of view of access to international markets, competition, responsibilities and the opportunities granted to the manager and from the point of view of portfolio diversification, with the strict process and approach to risk management, thinking always in terms of transparency and with the professional code also in mind, is achieving positive results both from the internal and external points of view. Thank you very much.

DIAGRAM N° 2

Access to foreingn markets	<50% of securities issued by OECD countries but not traded in regulated markets(1) <5% of securities issued by non-OECD and traded in regulated markets Securities issued by non-OECD countries not traded in regulated markets are forbidden	
Currency matching	The fund is obliged to invest at least 1/3 of its assets in Euro	
Concentration limits	<5% in any single unlisted company <10% in any single listed company Individual issuer <15% of pension fund assets	
Investment limits in relates parties	<20% of pension fund assets in a single related company Total allocation for related companies <30% of pension fund assets	
Other quantitative limits	Liquidity	<20% of fund assets
	Shares of private equity and closed investment funds	<20% of fund assets <25% of investment fund value

Source: Treasury Ministery, Decree November 21st, 1996, n. 703 art. 4 and 5.

1 Within such limits, the fund investments in equity cannot exceed 10% of the fund's total assets and the total amount of debt and equity securities issued by non-OECD countries cannot exceed 20% of the fund's total assets.

Comments

TIBOR PARNICZKY[1]

I have to start with saying that I could not agree more with the previous speakers on the importance, procedures and methods of pension fund investment. I would like to say a few words about these matters from another point of view, that of the regulator and supervisor, to enable us to reach certain conclusions.

Augusto Iglesias's presentation has been very interesting. It seems to me that there is a convergence of two philosophies, the (conservative) prudent person approach and quantitative limitations. This is what we see in most of the countries in the EU, in Central and Eastern Europe and in Latin America. I found the Italian example interesting, especially the comments on how investment activities and funds are governed. My presentation will perhaps illustrate these principles a little more.

However, I am not here only to bring you good news; sometimes the point of view of the supervisor or regulator makes it necessary to give bad news to market players. It will be similar to the situation, when the reporter asks the victim following a road

1 Software Designer and a Mathematics university graduate.
Mr. Parniczky is currently the Regional Coordinator of the International Network of Pension Supervisors and Regulators (INPRS), a member of the Hungarian Society of Actuaries and Government Consultant on the regulation and supervision of Private Pension Systems, particularly in Central and Oriental Europe. He is one of the sponsors of Hungarian private pension funds.
Mr. Parniczky's prior positions are, among others: Senior Expert at Human Risk Management Ltd. and Counselor to the Minister of Finance. He has held several posts in the State Superintendence of Private Fund Management Companies of Hungary: General Vice-President and Chief Counselor. He also worked for the Organisation for Economic Co-operation and Development (OECD) as Chairman of the Outreach Taskforce of the OECD Working Party on Private Pensions and was one of the founders of the International Network of Pension Supervisors and Regulators (INPRS).

accident “How are you?” and the answer is “Fine”. But journalists do not like one-word answers and the reporter insists, “But could you tell us more?” and the poor victim says “Well, not so fine at all”. Sometimes we must have a closer look at the figures to get an idea of what these experiences may possibly mean.

The pension systems in Eastern and Central European and Latin American countries are based on a different approach, compared with traditional private pension systems. This affects even the functions of investment. Pension fund management companies' main function is administration and asset management, so they do not consider outsourcing these activities. From our point of discussion this is a fact that I would underline as perhaps one of the most important experiences in our countries. And as it has also been remarked in the previous presentations, the prudent investment rules are interpreted by quantitative limits, with some references to qualitative regulation (or prudential approach).

If we would like to assess the successes of investment activities, we have to look at the two facets of the activity: on the one hand, the returns on investment – which is obvious; but on the other hand we have to take into account the costs of the activities. We are going to see some examples that may illustrate the point for us.

Normally, managers deduct commissions, operational costs, etc. from contributions, and these charges, the deducted amounts, are not invested. What rate of return must be achieved in order to offset the deduction, i.e. the difference between the total amount contributed and what is invested? Of course, that will depend on the length of time the person remains in the system. See Figure Nº 1.

Let us imagine, for example, a person who is 40 years old when he starts to contribute and remains in the system for only twenty years. For example, a 10% reduction of the contributions, over the course of 20 years, represents over 1.0% of the total amount[2]. There should be compensation for that. So if we talk of net contributions and net returns, we have to be aware of the fact that the first 1.0% should be counted as compensation only for the front loaded charges. As we can see, these figures are higher during a short stay, Figure N° 2.

[2] Parameters of baseline scenario: rate of return = 5%
wage growth = 3%
length of period = 20, 30, and 40 years

FIGURE N° 1
Charges and returns

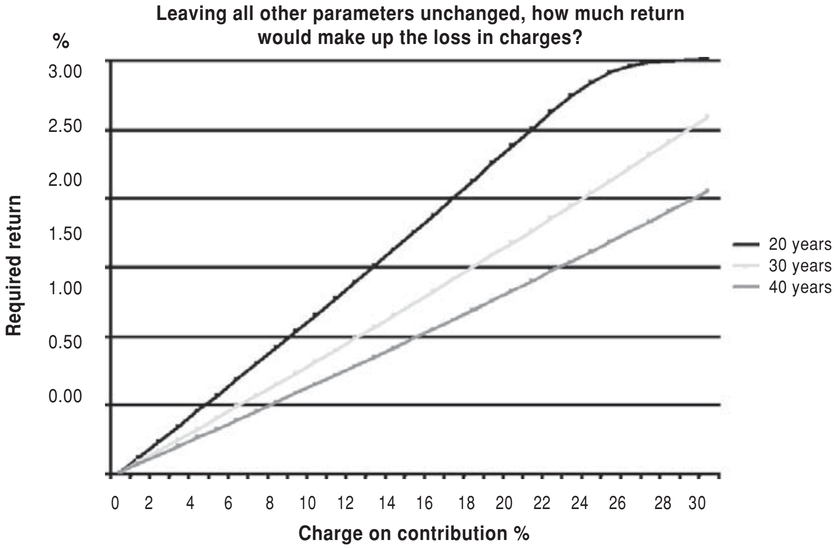
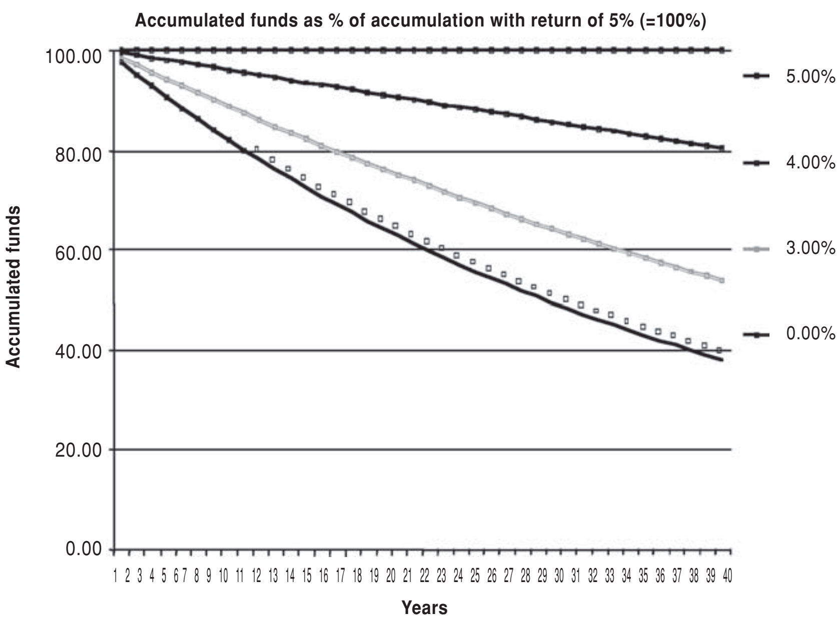


FIGURE N° 2
Returns and accumulated funds



Now we can make similar calculations for the management fees which are deducted from total assets, or for the situation of less than expected returns. Let us imagine a long-term average return of 5% as baseline scenario, and let the total amount of saving with this return be 100% at retirement. Another person, represented by the other line, achieves 1% less yield over the same 40 years. His final amount, which will be converted into a pension annuity, is 20 percentage points lower. Thus investment is very important. In terms of costs this means that with 1% dedicated to asset management the savings will be 20% less. This underlines once again the importance of low-cost, high-yield investments. Table N° 1

TABLE N° 1

Market structure of the private pension funds in Hungary

Type of founder	Number of funds established		Number of funds in 2002		Probability of survival %		Average size in 2002 (members/fund)	
	Manda-tory	Volun-tary	Manda-tory	Volun-tary	Manda-tory	Volun-tary	Manda-tory	Volun-tary
Financial institution	17	21	11	11	64.7	52.4	164,045	76,204
Employer	24	161	5	51	20.8	31.7	9,117	5,289
Other	19	96	2	20	10.5	20.8	6,806	1,941
Total or Average	60	278	18	82	30.0	29.0	96,981	13,985

I have collected a series of example from Hungary[3]. The period runs from 1998 to 2002, which have not been the best years for investments. There was a global investment crisis, and that of course also affected the Hungarian markets. What I would emphasize here is the aspect of difference in governance. In our pension fund market we identified some groups of pension funds. They are linked with financial institutions or employers' pension

3 Based on calculations of MATITS A, and the study by AUGUSZTINOVICS, M., GAL, R.I., MATITS, A., MATE, L., SIMONOVITS, A., and STAHL, J. 'The Hungarian Pension System Before and After the 1998 Reform' in: Elaine Fultz (ed), Pension Reform in Central and Eastern Europe, Volume 1, Restructuring with Privatization: Case Studies of Hungary and Poland. Budapest, International Labour Office, 2002.

funds (Table N° 1), or from another aspect we may call them small or large according to membership, or assets under management (Table N° 2); in organising their investment activities they use an internal asset manager, or a single (non-competitive) external asset manager, or competitive external asset managers (Table N° 3). This enables us to a certain extent to understand the structure of the system.

TABLE N° 2
Voluntary funds, 2002

Name	Size	Funds		Members		Assets	
		Nº	%	Nº	%	(bln HUF)	%
Micro	-500	26	32	6,027	1	5.58	2
Small	500-5,000	30	37	52,770	5	26.65	8
Medium	5,000-50,000	19	23	365,695	32	134.33	38
Large	50,000+	7	9	722,305	63	184.62	53
Total		82	100	1,146,797	100	351.19	100

Table N° 3 illustrates the different results of the activities of the small, medium and large pension funds. In the last part you will see the operational and asset management costs, and finally the total expenses, of the funds by categories. At the bottom you see the small funds, and moving upwards the larger ones. We can see that the very small ones do not reach levels of efficiency and therefore have slightly higher costs. There are some medium-sized ones which could be, so to speak, the reference point in Hungary. But, surprisingly, the large administrators do not achieve the possible savings through economy of scale.

Figure N° 3 and Table N° 4 demonstrate similar information from another angle. Here we compared in-house asset management and outsourced asset management. We can see the result of outsourcing: in the last column we see average returns according to management structure. And we see that the funds that take charge of their own management obtain better results. Table N° 5 shows the same variables for mandatory pension funds:

TABLE N° 3

Voluntary funds, 2003

		Group averages								
Group of membership	Number of funds	Members*	Assets HUF mln	Operation cost		Cost of asset management		Total cost	
				HUF[1]	%	HUF[1]	%	HUF[1]	%
+100,000	2	148,612	32,105	2,995	1.3	2,198	1.0	5,194	2.3
50,000-100,000	4	83,447	17,398	3,001	1.4	2,522	1.3	5,523	2.8
10,000-50,000	14	26,813	8,105	3,643	1.2	2,070	0.8	5,713	2.0
1,000-10,000	24	3,444	1,534	4,479	1.1	2,447	0.6	6,926	1.7
-1,000	34	393	221	12,480	1.4	4,485	0.6	16,925	2.0
Total or Average	78			3,324	1.3	2,494	0.9	5,818	2.2

* At the beginning of the year.

1 Per member, per year

FIGURE N° 3

Charges in proportion to the assets in the voluntary funds in Hungary

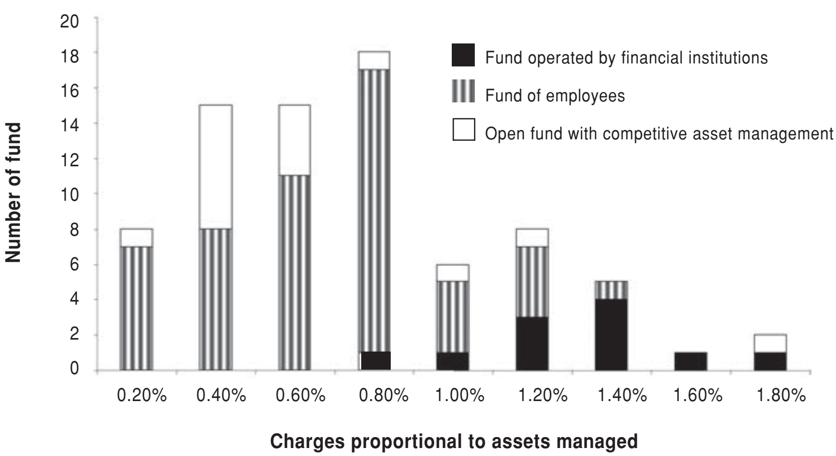


TABLE N° 4
Voluntary funds, 2002

Mode of asset management	Number of funds	Assets under management		Number of members		Average rate of return
		HUF bln	%	N°	%	%
In-house asset management	15	76	22	209	18	**3.4**
Competitive outsourcing	56	97	28	262	23	**2.2**
Non-competitive outsourcing	11	178	51	676	59	**1.2**
Total	82	351	100	1,147	100	**2.3**

TABLE N° 5
Mandatory pension funds

	Number of funds	Share of assets	Rate of return		Costs as percentage of	
		%	Gross %	Net %	Assets %	Gross return %
In-house asset management	13	96	9.2	7.8	1.4	15.2
Competitive asset management	8	5	9.0	8.6	0.4	4.2
Total or average	21	100	9.1	8.1	1.0	10.9

Finally we have included Table N° 6 showing real values. When we talk about investment, we must also consider inflation. As a minimum, an investment should maintain the purchasing value of the contributions, also taking deductions into account.

TABLE N° 6
Average rates of return

	2001 %	2000-2001 %	1999-2001 %	1998-2001 %
Inflation	6.8	8.3	8.9	10.2
Net rate of return	8.1	8.0	10.8	12.0
Real rate of return	1.3	-0.3	1.9	1.8

Table N° 7 and Table N° 8 summarise the approach to investment regulation of international bodies, the OECD/IOPS and the European Union. These guidelines and regulations have to be followed by the member countries. The principle of prudence is at the very heart of these regulations. However it is also true that they envisage a few quantitative limits where they are prudentially justifiable. So, in a broad context, these standard-setting bodies address the basic principles of prudent investment (the objective of investment, diversification, dispersion, matching, governance structure and procedures, accountability and suitability, conflicts of interest, risk management). They acknowledge the application of quantitative limits in certain prudentially justifiable cases, but not for foreign investment. Regulation also covers issues such as disclosure of information and supervision.

TABLE N° 7
European Union investment standards

The prudent person rule is defined in the Pension Directive

- Member states apply restrictions on a prudential basis, but even in this case the 70% limit may be applied to shares and other securities traded on regulated markets; 30% in non-matching currencies; for risk-capital: the prudent person concept; dispersion of 5% in the same issuer and 10% at group level
- In case of cross-border activity, stricter rules may be applied with respect to regulated or non-regulated markets, and guaranteed investments

Statement of Investment Principles

Information Disclosure

Adequate supervision

TABLE N° 8
Investment principles - OECD and INPRS

Investment regulation should be based on the prudential objectives of the pension fund investment function, taking into account security and profitability, and implemented using concepts of diversification, dispersion, maturity and currency matching, and risk management. Pension fund investment and governance are regulated by same concept.	
In a pension fund, investment management is the responsibility of the governing body	– *The governing body may delegate this duty to advisors and other professionals* – *The duty to accept and approve the investment policy of the pension fund remains with the governing body*
The governing body defines	– *The process of investment activities, including the establishment of the statement of investment policy* – *Appropriate internal controls and procedures to implement and monitor the investment management process*
Accountability and suitability rules for persons performing investment management are stated	
Quantitative investment limit rules (maximum) might be derived from prudential principles	*It is therefore recommended:* – *To use lists of admitted or recommended assets, diversification, dispersion, and maturity and risk management, and also regulated and standarized products, and investment abroad* – *Quantitative limits should be regularly assessed and amended if necessary.*
Pension fund assets should be valued for accounting, reporting and actuarial purposes with consistent rules	

From the above we may conclude that governance and market structure matter. International organisations underline the importance of disclosure but it should be balanced: to show investment performance together with all related information, e.g. costs, risks, and prospects for pension annuities.

Well, I think these are the lessons that we must include in our thinking when preparing possible regulations.

2 International Organizations' View on Regulation

The AIOS view (International Association of Pension Fund Supervisory Authorities): Guillermo Larraín

The OECD view (Organization for Economic Cooperation and Development): Juan Yermo

Comments: Ángel Martínez-Aldama

The AIOS view

Guillermo Larraín[1]

Regulatory and supervisory principles are undoubtedly a very broad subject area. We can broach it from different points of view, of course. We can speak about the role of the executives, the management of private accounts, the definition of benefits, individual and international portability and the post-retirement accumulation stage, among other topics. I will try to concentrate my presentation on two of the most important points concerning the supervision of those systems where compliance is compulsory, sketching in the difference between mandatory and non-mandatory plans, since the latter are most prevalent in many countries of the OECD.

I will start by stating that there are indeed points in common between the principles of the AIOS and OECD. Incidentally, I should explain that AIOS is an international organization which basically includes Latin American countries and Poland, so that is where the non-American feature comes from. We have borrowed many of our so-called "best practices" from the OECD

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Mr. Larraín is currently the Superintendent of Pension Funds Administrators in Chile and Chairman of the Risk Classification Commission. He also heads the International Association of Pension Funds Supervisory Authorities (AIOS).
Prior to his current position, Mr. Larraín was Chief Economist at BBVA Bank, Chile and Economic Policy Coordinator and Chief Economist, Ministry of Finance, Government of Chile; and Research Associate, OECD Development Centre, Paris, France.
Mr. Larraín's numerous publications on economic and pension funds issues include: "El Ahorro Previsional Chileno: Desafíos de las Bajas Densidades de Cotizaciones y sus Determinantes", with Solange Berstein and Francisco Pino; "From Economic Miracle to Sluggish Performance: Employment, Unemployment and Growth in the Chilean Economy", with Andrés Solimano for the International Labour Organization and "Human capital, Trade Reform and Growth: The Experience of Chile", with David Bravo and José de Gregorio, working paper for the OECD, Paris, France, among others.

Regulations, especially with regard to objectives and everything to do with prudential aspects. On our website, www.aios.cp.org you will find a document with the set of “best practices” which was approved by the General Meeting of Supervisory Authorities in October 2003 in the city of Santiago.

We have worked together with the OECD and signed a letter of understanding in April of this year. We thought about continuing to work together to develop those codes of best practices for compulsory compliance pension schemes such as those existing in Europe and Latin America. And, of course, I believe that we must work more closely with Eastern European countries.

1. Regulation in a mandatory system

The fact is that our systems are mandatory and this is a point which marks a great difference with other systems, such as those that are most prevalent in the OECD countries. As I see it, our reforms are young and we therefore need to comment, talk and reflect on our systems and how to improve these regulations so that we really get the best from the reforms. The aim is to improve pensions, but in the meantime we also have to think about financial development and other related topics.

In Latin America this sector belongs to some extent to the social security system. And this second pillar, that of capitalization, is the most important. In some ways our systems are the soul of the social security system: while they are mandatory savings, it is a mandate that involves the whole population. When we say that it covers the whole population this is very important, because in our countries people have different levels of financial knowledge. There are people who are familiar with integrated markets, of course, but the vast majority of the population really has no access to financial markets, so their knowledge in this area is frankly negligible. This is reflected in the enormous asymmetries in levels of information of our economies, which is an important difference compared with the OECD countries.

Another aspect in which they differ are the state guarantees which occur in many countries. Our experience shows that there is a danger of moral risk and other related matters which do not appear in the OECD countries.

Finally, we have different management methods and different resources and there are also conflicts of interest, so what we have here is an enormous menu of good economic reasons why these mandatory systems must be submitted to regulation. And it is probably stricter regulation than in other sectors. Those are the broad guidelines which explain the rule-making and regulating.

2. The client and his/her needs

I am going to refer to the client, because here too there is a difference. We are considering mandatory savings which compete with other needs that may be more urgent. Many people in our economies are subject to liquidity restrictions and a variety of pressures; a situation different from that of the OECD countries. There the savings going into the pension funds are not mandatory and their citizens are under less pressure from the liquidity point of view than those in Latin America.

At the same time, the competition for managing the savings varies according to the age of the savers: we have the feeling that competitions is fiercer for younger savers.

Then there is another element that marks a difference between our clients and those of the OECD countries and it is that there is an inherent difficulty in valuing lifetime risks; in other words, people do not know what their needs are likely to be in terms of income at a future age. This means that people are not willing, spontaneously, to evaluate what their future needs will be. What is more, most of the Latin American population does not look further than one year ahead; that is their limit. In other words, the contributions to the funds, which in principle are savings that belong to them by law (stipulated in those terms in an official document which they receive regularly), are seen by them as a tax, because they cannot lay hands on that money to finance their more urgent needs.

All this means that the demand curve that we can see for this product, the pension, in curiously inelastic to prices. Furthermore, it is similarly inelastic to the yield of the funds but very elastic in relation to anything that makes it possible to spend in advance.

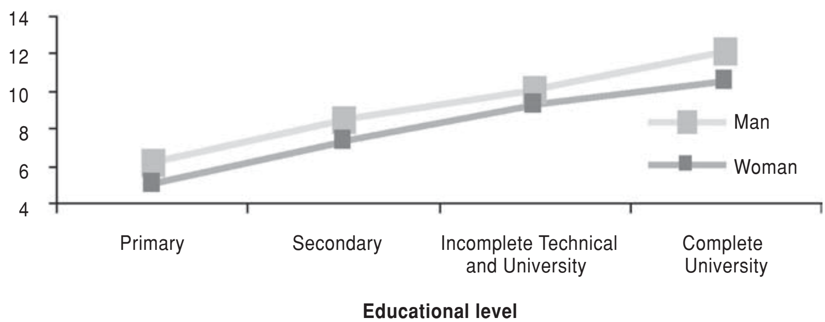
3. The Chilean case

What is described above is no exaggeration. In order to understand this phenomenon better, I am going to analyse some examples from the Chilean case.

A Survey entitled "Work History and Social Security" (HLSS) carried out in 2000 by the University of Chile made it possible to create an index of people's knowledge of the social security system in general and the individual capitalization system in particular.

FIGURE Nº 1

Index of knowledge according to educational level

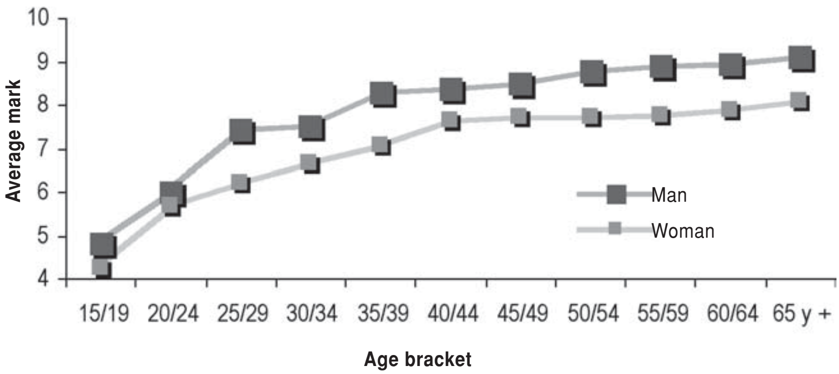


Source: HLSS, 2000.

In Figure Nº 1 it is possible to see that there is a strong correlation between people's knowledge and educational levels. In other words, people who have only been to primary school know less than those who have completed their secondary studies and they in turn know less that those with university education.

The same thing happens with age, as seen in Figure Nº 2. We already know that we learn a lot with age and that is also valid for the pension system: as we get older we get to know the system better. This is very important because when we are young we have less knowledge and the poor have even less, and that is where a large portion of the population of our countries is concentrated. We all know that the impact of the composition of interest over time is very important in accumulating resources, that young people should contribute. However, together with the most disadvantaged, they are the ones with least knowledge of the system.

FIGURE Nº 2
Index of knowledge according to age



Source: HLSS 2000.

Apart from all this, people are not consistent with regard to their expectations and, as we have seen, they are not well-equipped to foretell the future. In the HLSS Survey one of the questions was "How many years do you expect to live?" On average, young people underestimated their real life expectancy by 15 to 20 years, while the population approaching retiring age tended to estimate its life expectancy more accurately. In short, during the course of its working life the population does not know what its real life expectancy is. This is a very important aspect in getting to know our potential client; clients who accumulate resources throughout their working lives but who have no idea of what their life expectancy is until they retire.

These people realise too late that their life expectancies are longer than they thought. If we ask people in Chile the age at which they would like to retire, the general reply is five years earlier than the official age. In other words, people want to retire earlier but suddenly realise when they are 60 that they are going to live longer than they had anticipated. This does not square with the demand for higher pensions.

These features summarise the type of clients that we have. This culture of improvidence is really a determining factor when we are looking at the type of regulation and legislation in mandatory systems, which are an essential pillar if we compare them with voluntary systems that are not part of social security.

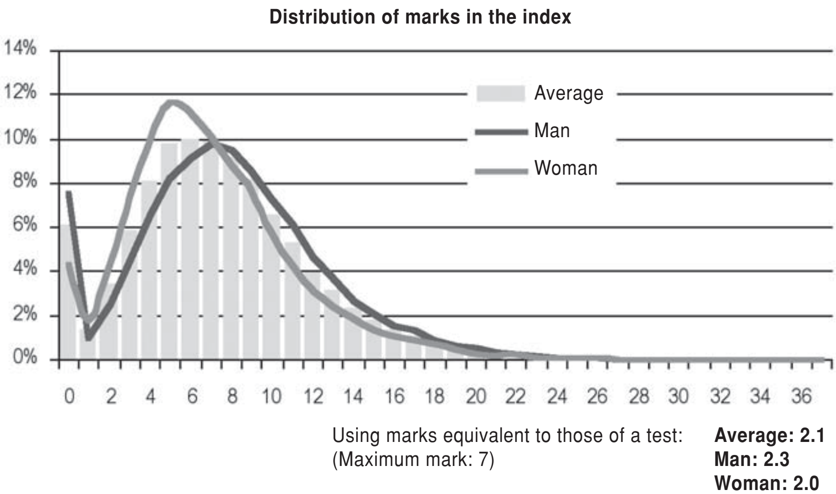
4. Foundations of good supervision

The principle is well-known, it is absolutely standard information. We need to create an objective choice of directives to improve competition, in other words the information of the directives must be true, clear and must arrive at the correct time.

Information about accounts must be available at all times. These are principles approved by the AIOS. The supervisory agencies must give systematic information about the system and its directives and advertising must not be misleading.

I would re-emphasize that there are three basic elements in the sector. In a mandatory system what we want is maximum transparency, where the funds are invested, etc. But if people are incapable of understanding the information they have, or receive too much information, the result is very bad. We have already seen that a glut of information swamps the client; he/she cannot digest it. So we have to provide somewhat less information, but it must be more useful, so that the client can take the best possible decision. It is very difficult to achieve this balance.

FIGURE Nº 3
Index of system knowledge

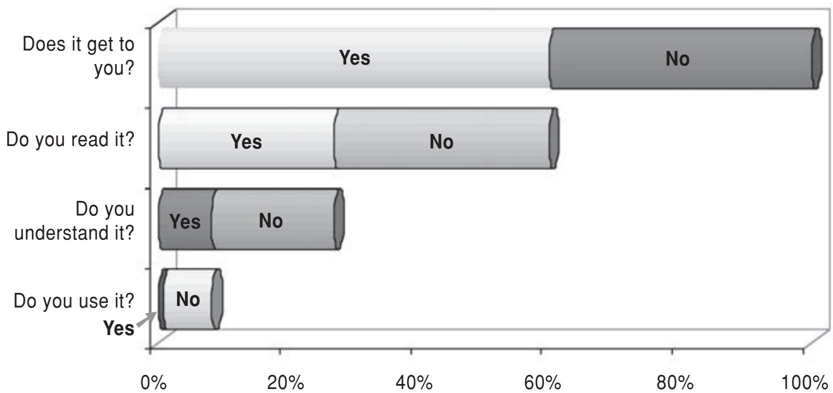


Source: HLSS 2000.

In Chile's case, according to the HLSS Survey, those who were consulted failed the examination on their knowledge of the system. Out of 37 questions, Figure Nº 3, the average number of correct answers was six. So even after 23 years of reform, many people still lack complete information.

The same survey revealed to us that many people do not receive the information which is sent out systematically, Figure Nº 4. Others receive it but do not read it. Some of those who do read it say that they do not understand it, and of those who say they have understood it, a minute proportion really use the information.

FIGURE Nº 4
How useful is the statement?



Source: HLSS 2000.

This information is very important in a capitalization system. It is fundamental information in our case, more so than in non-mandatory systems. Why? Because these capitalized systems are built on the idea of personal responsibility and one cannot call people to account if they have no information. So, in these capitalization systems, information is an essential part of the story.

5. The art of de-regulating

The second idea that I want to emphasize has to do with investments Table Nº 1. The aim is to have an effective allocation of investment and a management of risks. Basically, in AIOS, we maintain that the supervisory agency must have a structure to minimize risk, encourage competition between fund administrators, seek legislation that supports effective portfolios and achieve a fair classification for all the assets.

We say that rules are necessary because it is a mandatory system, but what we have to do is de-regulate in order to improve competition. In other words, liberalization is important and it is an art. When is there most insistence on legislation? When the systems are immature, when we are starting off, then there must be plenty of legislation. But then it is necessary to learn how to de-regulate. That is a real art, but it must be done and we will have to do it.

Of course, it is also essential for transactions to be carried out in appropriate markets with their supervision and their information. Investments must be considered with these issuers, and here again there must be a balance. There are many companies without histories in our countries which may not have this classification, so I have a few questions here. I do not know whether we should perhaps give a greater degree of flexibility to the investors, so that they may have some way of investing in these unclassified securities.

TABLE Nº 1

Portfolio of pension funds in Latin America, December, 2003

Country	Total MM US$	State	Financial institutions	Non financial institutions	Equity	Mutual funds and investment funds	Investment abroad	Other
		Share with respect to total National Fund (%)						
Argentina	16,139	68.9	3.6	1.5	11.8	2.8	9.7	1.7
Bolivia	1,493	64.1	7.3	16.7	8.6		1.7	1.5
Chile	49,690	24.7	26.3	7.7	14.5	2.9	23.7	0.1
Costa Rica	305	79.5	13.8	5.7		1.0		
El Salvador	1,572	82.3	13.2	4.2	0.3			
Mexico	35,743	82.3	4.5	13.2				
Peru	6,311	19.5	21.4	12.1	35.5	1.0	8.8	1.7
Uruguay	1,232	69.6	22.9	5.8				1.8
Total	**112,487**	**51.0**	**15.3**	**8.9**	**10.2**	**1.7**	**12.4**	**0.4**

Source: AIOS.

When looking at the results since December 2003, I must emphasize three points. First, over half the resources that have been entered in our funds today are in Government bonds. I think this is excessive and believe that we should move towards less dependence on these bonds. In the second place, we have too few non-financial institutions; we know that we need to create more instruments so that the funds can invest in them. And the third point is that investment abroad is generally very low and prohibited in some countries. I believe that we must increase the exposure of our funds to foreign investment in order to improve diversification.

Obviously competition must be an objective, but not competition in itself: there are features of the client which have to be borne in mind. To be very practical, competition must be designed so that commissions are reduced because we want to increase net returns. We have already spoken about gross returns, but we also have to achieve an increase in net returns.

As regards dissemination, we need a research group that includes government officials who can provide information and fund managers who can also contribute their knowledge. Self-regulation must also be encouraged: there is agreement on this in the sector. This agreement must be made public, of course, and the supervisory agency must be able to carry out a follow-up. If we achieve this, I believe that competition will be better, and pensions too.

The OECD view

Juan Yermo[1]

Population ageing and fiscal considerations have led to a world-wide focus on the role of private pensions in pension provision. Yet their scope and main features are by no means homogeneous across the OECD area. Some countries have gone the route of mandating private pension provision, while others prefer to encourage private pensions through tax incentives. Some rely largely on occupational pension arrangements, while others prefer personal pension plans administered directly by financial entities without the involvement of employers. Some plans are defined benefit, others are defined contribution, and yet others are a blend of these two types, a hybrid form that attempts to share risks between sponsoring employers and plan members.

Given this diversity, it is surprising that an agreement could be reached between policymakers to identify best practices in pension regulation and supervision. Such a feat has been made possible by the consistency of policy goals that aim at protecting the rights of beneficiaries and ensuring the financial security of pension plans and pension funds.

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1 He is an Oxford University Economist and a Cambridge University graduate.
Mr. Yermo is currently with the Organisation for Economic Co-operation and Development (OECD) as Administrator of its Financial Affairs Division and he is also the Secretary of the Working Party on Private Pensions. In addition, he is a member of the Secretariat for the International Network of Pension Regulators and Supervisors (INPRS) and manages a broad research program on various issues related to the operation, regulation, and supervision of pension plans and pension funds.
Prior to his current position, Mr. Yermo was a consultant for the World Bank Group on pension reform projects in Latin America.

The OECD, through its Working Party on Private Pensions, has been for the last few years encouraging countries to review and strengthen their regulatory and supervisory frameworks for private pensions. As a first step, the OECD Working Party on Private Pensions approved 15 Basic Principles for the Regulation of Private Occupational Pension Schemes. These Principles cover regulations governing the establishment of pension plans and funds, the governance of these plans and funds, the funding and actuarial valuation of pension liabilities, the investment regime, as well as standards of disclosure towards plan members. This work received the support of the OECD Ministers during their annual meeting in 2001 and was extended to include detailed guidelines for each of the 15 principles.

In April 2004, the OECD Council approved these fifteen principles (condensed into seven core principles) and their related guidelines. In addition, the OECD helped to establish an International Network of Pension Regulators and Supervisors, which became a fully-fledged International Organisation of Pension Supervisors (IOPS) in July 2004. The IOPS will extend the OECD's work in the development of principles and best practices for pension supervision and will provide a unique international forum for the discussion of policy issues and the dissemination of information.

In all their work, the OECD and the IOPS aim at establishing a regular policy dialogue between regulators supervisors and policymakers in the area of private pension provision. Annual international gatherings have been organised since 1999, at which representatives from the different authorities discuss issues and put forward recommendations. This work is expected to gain momentum as other countries join the IOPS and pension reform efforts lead to an enhancement of the role of private pensions in retirement income provision.

1. Key ingredients for effective regulation

Pension regulation should be designed with a single goal in mind: that of promoting the security of retirement income in an efficient and economically sound manner. Security and efficiency, however, do not always go hand in hand. Sometimes governments attempt to protect retirement benefits by introducing guarantees that are not properly priced and end up breeding moral hazard, dependency and distortion of capital allocation decisions. Other times, governments attempt to improve pension benefits by promoting certain investments and imposing administrative structures on the private pension system. These policies sometimes backfire, raising undue risks and stifling competition, respectively.

A cost-benefit evaluation is needed when designing any regulation. In the case of pension regulation, such evaluations are an essential ingredient of diligent policymaking. These evaluations should focus on both short and long-term effects and take into account the reality of the population and market to whom the regulations will be applied. The regulations chosen in a developing country with limited liquid financial instruments and understaffed supervisory authorities will clearly not be identical to those chosen in a rich country with a highly sophisticated financial system and well-manned supervisory bodies.

Regulations should also be transparent and involve simple implementation of their requirements. Complex rules that are not easily translated into action by market players can create more harm than good and end up hampering the image of the private pension system. Pension providers are likely to be driven away by cumbersome regulatory systems, while plan participants will seek alternative ways to provide for their retirement, even if it entails a loss of tax advantages.

Ensuring the transparency of regulations is no easy matter. Achieving the right style is likely to require consultations of draft rules with market participants and reference to international and historical best practice. Ease of implementation is also critical for a smooth functioning of the private pension system. Regulatory red tape such as long and dense regulatory forms can handicap even the best managed private pension systems.

Regulatory frameworks should also be injected with a good dose of stability in order to allow the consolidation of good practices in the industry and allow market players to establish a long term orientation to their strategies. Volatile regulatory systems pass on their instability to the markets they regulate. At the same time, regulations should be kept up with the times. Policymakers should steer them in line with the development of new financial products and the evolution of socioeconomic conditions and plan features.

Furthermore, policymakers should not be afraid to make radical exemptions or adjustments to the regulatory framework when the continuity of the private pension system is at stake. Emergency times call for emergency measures.

2. Promoting benefit security in the defined contribution schemes of Central and Eastern Europe

In the countries of Central and Eastern Europe, personal plans have been given preference over occupational ones, mandatory membership has been chosen over voluntary provision and defined contribution is the norm. The funded pension systems that have emerged call for a specific regulatory framework that addresses the specific risks of these plans. In addition to the effective regulation of the pension fund administrators, the following policies may be considered as prerequisite good practices to ensure that the regulatory framework evolves in a direction that promotes benefit security:

– Regular monitoring of the operational costs of the fund administration industry, the commissions paid by members and their sensitivity to them.

– An evaluation of the ability of plan members to understand the choices they face during both the accumulation and the retirement stage and their wish to make those choices.

– An assessment of the role of the fund administrators and other market players in providing long term saving advice to the plan members, including the choice of fund portfolios and retirement instruments.

– An evaluation of the quality of the information provided by the supervisory authority and market players

These policy assessments are necessary to ensure the development of any private pension system based on defined contribution formulas. They are absolutely essential in the early stages of a new system, when regulatory development is partly a trial and error exercise.

Unfortunately, policymakers are sometimes more concerned with writing what they consider to be good regulations than with checking whether such regulations actually help plan members to make better choices and market players to provide better pensions. Through a regular assessment of regulations and their market impact policymakers can ensure that the basic goals of private pension arrangements will be more easily fulfilled.

Comments

ÁNGEL MARTÍNEZ-ALDAMA[1]

In the first place, I would like to talk about the market of the assets managed by the pensions funds in the world and what is going on there, the recent scandals (in the assets market), the consequences and reactions, not only from the point of view of Governments, in other words the Institutions, but also from the point of view of companies or private institutions.

Let us look at assets. Obviously the industry is active in North America, representing almost 60% of the total assets that are managed in the sector; Europe represents approximately 25% and the rest of the world, 15%. Basically I am going to concentrate for a little on the European situation.

If you look at the different countries of Europe, there is obviously great diversity. Of course these are not countries where the coverage of the private system is mandatory, but in many countries, such as the United Kingdom, the Netherlands and Switzerland, the levels of benefits in the public system are so low

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Mr. Martínez - Aldama is now the General Director of the Spanish Association of Investment and Pension Funds (INVERCO) and a Vice-President and a Board Member of the European Federation for the Provision of Retirement Pensions (EFRP). He is also a Board Member of the International Federation of Pension Fund Administrators (FIAP), among other positions.
Mr. Martínez - Aldama's prior positions include his active membership in the European Federation of Investment Companies and Funds (FEFSI); the application of his vast experience in the Comisión Nacional del Mercado de Valores *(National Securities Market Commission)* (CNMV), in its Issuers and Prudential Supervision Divisions, and his work in the Tax and Accounting Consolidation Department of UNILEVER's Spanish organization.

that it is obviously necessary to take part in a private pension plan. It is not mandatory, but the workers themselves realize that supplementing their pension is to their advantage.

As regards their relation with GDP, assets under management and also the relation with the levels of development of the economy, we can see the differences. In the first place, in Table N° 1 you can see the 11 countries belonging to the European Union; a second group made up of Switzerland, Norway and countries which are not in the Union and then three countries which are outside Europe.

Let us look at the assets. Remarks have already been made during the morning about the case of the Netherlands and the need, or rather the desire, on the part of certain Eastern European countries to reproduce or achieve this percentage at some point. Clearly, in the United Kingdom, the Netherlands and Denmark, they represent a very high volume, compared with the GDP. Look at Switzerland, over 100% of GDP; look at the United States, Canada, Japan, which are clearly extraordinary examples, Table N° 2.

What has happened, then? What are these scandals? Everyone knows what has happened in certain companies in the United States and, more recently, in Europe. Obviously the reactions have been devastating, without the slightest doubt. Not only public institutions have published codes. The private sector has also made statements and issued self-regulation standards, plus the risk-rating firms.

We are now going to look at a few examples. As from May 1999 the principles of corporate governance of the OECD; then the NAPF (British Association of Pension Funds) published a document in the United Kingdom; OECD, guidelines for the governance of pension funds; the Winter Report, prepared by the European Commission with regard to corporate governance as an initial reaction after the Enron scandals in the United States; the European Commission's own communication on the subject. More examples regarding the different reactions are the OECD guidelines and the revised OECD principles.

So we can see that this affair has attracted enormous attention, not only in public institutions, but also in Governments and the private sector. Everyone has been affected and everyone has reacted.

TABLE N° 1
Pension funds assets (in billions of US dollars)

Countries	1991	1996	2003 (E)	2006 (E)
U.S.A.	2,823	4,352	8,563	9,913
Canada	214	306	439	514
Total North America	**3,037**	**4,658**	**9,002**	**10,427**
United Kingdom	669	1,058	1,931	2,235
Netherlands	242	350	562	650
Switzerland	185	257	381	441
Germany	113	131	176	204
Sweden	90	109	160	185
Denmark	43	63	116	134
France	22	74	108	125
Italy	53	80	99	114
Ireland	11	32	75	87
Spain	8	22	55	73
Finland			53	61
Belgium	8	11	21	24
Rest	22	46	53	94
Total Europe	**1,466**	**2,233**	**3,790**	**4,427**
Japan	699	1,142	1,676	1,940
Australia	65	127	279	323
Singapore			95	110
Malaysia			66	77
Hong Kong	12	20	44	51
Rest	34	63	134	172
Total Pacific	**810**	**1,352**	**2,294**	**2,673**
Brazil			93	124
Chile	10	28	50	67
Mexico			36	48
Argentina			16	21
Rest	19	86	17	22
Total Latin America	**29**	**113**	**212**	**282**
South Africa	39	99	55	73
Rest	13	56	38	51
Total Africa and Asia	**52**	**155**	**93**	**124**
World total	**5,394**	**8,511**	**15,391**	**17,933**

(E): Estimated.

TABLE Nº 2

Pension fund assets / GDP (%)

Countries	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
Netherlands	78.3	80.0	87.0	88.6	98.7	114.0	111.7	107.1	96.8	99.6
United Kingdom	58.9	76.2	91.9	90.8	91.9	98.9	91.6	83.0	71.8	79.1
Denmark	28.9	33.1	35.2	38.2	37.7	48.1	47.5	48.2	46.3	47.7
Sweden	31.1	33.8	42.7	41.5	40.6	42.8	40.0	38.1	37.4	40.4
Ireland	-	-	-	-	50.5	53.2	44.2	44.4	38.3	39.3
Finland	-	-	-	-	23.5	29.4	22.3	20.5	17.9	19.6
Portugal	-	-	-	-	9.8	10.4	11.6	11.2	10.5	11.3
Spain	1.1	2.9	3.8	4.5	5.2	5.6	6.2	6.7	6.9	7.5
Italy	5.0	5.4	6.7	6.1	5.2	6.3	5.2	6.4	6.0	5.9
Belgium	3.3	3.6	4.2	4.7	5.3	6.4	6.1	5.5	5.2	5.5
Germany	6.6	5.6	5.6	5.8	5.6	7.0	6.5	5.0	4.7	5.0
France	1.7	4.7	4.9	4.7	4.6	5.2	4.3	4.4	4.3	4.5
Austria	-	0.8	0.9	1.5	1.8	3.6	2.1	3.8	3.8	3.9
Switzerland	74.1	88.8	88.7	85.8	105.0	123.4	134.5	122.8	115.1	124.0
Norway	4.8	6.1	9.1	8.7	8.4	6.7	7.0	6.6	6.4	6.9
U.S.A.	47.3	58.6	56.8	67.0	75.4	86.7	73.1	70.8	61.9	66.3
Canada	39.5	43.3	51.2	52.4	50.0	55.3	59.8	55.3	52.1	54.3
Japan	18.3	23.2	24.9	26.7	28.2	37.4	31.7	29.7	29.2	32.0

Let's talk a little about the IORP (European Pension Fund), the IORP Directive on pension plans, published in September last year after a long gestation period. After multiple drafts and redrafts, this Directive has finally seen the light of day but, as I said, it was first drafted in 1988 and enacted in 2003. In other words it has taken 15 years to get approval for this European regulation. Perhaps it is not a good example of how to do things, but in any case we have to bear in mind that there are different approaches, as we have seen. The European countries have their points of view, their rules, their guidelines, their decisions, those that support investment, those that support the quantitative or qualitative approach. It is very difficult to reach a consensus, but we finally have our Directive. Maybe it is not the best one possible, but it is better than nothing.

From the European Federation there was work with the European Commission and also with the Parliament, to enable this Directive to see the light of day. As we have heard before, the different European countries will now have to transpose it into their national legislation. There will be two more years before these principles are fully approved, so that in two years' time, in September 2005, it will be a regulation with which all countries belonging to the European Union will be obliged to comply.

There is a whole series of matters related with the principles included in the Directive. In the first place we will talk about the conditions under which it will operate. We have decided to look at eight principles: the legal separation between the fund itself and the sponsoring company; the IORP or pension plan must be registered on a national list; the funds must be managed by persons of good repute, with due qualifications and experience; the rules and how they function; technical provisions and stipulations must be certified by an actuary; participants must have adequate information; the Member States suggest that certain options regarding the guaranteeing of benefits should be offered to members; Member States may entrust the management of these funds to other bodies or other companies.

What can we say here about the information to be supplied to participants? The pension funds must prepare and approve annual reports about their plans. Participants and beneficiaries must receive information punctually. Guillermo has already mentioned that participants do not receive information; some do not understand it, others do not use it. That is correct, but maybe we should think of sending it only on request, where it might be more useful. Information must also be provided about any changes that may have occurred.

Participants and beneficiaries must also receive detailed information on request about benefits and services, about the range of investment options, depending on the schemes, and everything to do with the transfer of consolidated rights.

The matter of portability is, frankly, a problem throughout the European Union. A Directive was approved in 1998 to allow those workers who had moved to a receiving country to pay contributions in their country of origin. This was a very important step but it is obviously not enough. The European Commission has been working during the past two years and has finally decided to publish a draft Directive in September on portability, which is a new step. A third, very important point is that of the rules laid down by the European Court of Justice, which stipulate that any worker may claim personal tax allowances in his/her receiving country in view of the pension contributions paid in his/her country of origin. This has been achieved in a short space of time, let us hope that it will not take another 15 years. These are very important steps and make it possible to think in terms of truly trans-national European funds.

The participants will also receive due information about the different options, and a written paper about the principles will be prepared and made available every three years.

This information must, of course, be given to the authorities. They must provide information about whatever they are asked, supervising relations between the various companies to obtain information about principles, annual accounts and reports, and to carry out on-site inspections.

There must be an adequate internal auditing function, the authorities must be able to take appropriate administrative or financial measures to detect irregularities, they must take internal measures into account – they may restrict the activities of a pension fund – there must be a limit on liabilities and an actuary must be present to sign these limits, ceilings and thresholds every year.

The pension funds must invest in accordance with prudential guidelines. The European Parliament preferred more realistic rules for a period of five years, but the debates in the European Council between the different European governments have left this as a general idea, as a guiding principle. However, some Member States prefer prudential ideas and do not fulfil the other guidelines.

Investments must guarantee the quality and liquidity of the portfolio. Investment in derivative instruments is possible but there must be adequate diversification. Member States are not obliged to invest in a specific class of assets – this varies considerably from one country to another in the European Union, and there are certain margins for some asset classes.

3 The fiscal impact of pension reform: economic effects and strategies

Theoretical aspects:
Luis Fernando Alarcón

Experience in Poland: Ewa Lewicka

Theoretical aspects

LUIS FERNANDO ALARCÓN[1]

I am going to speak to you about the fiscal impact of pension reforms, seeking to produce a conceptualisation of the problem and at the end attempting to identify what, in my opinion, are the main obstacles for pension reforms.

Let us start by understanding which problem we are talking about. Pension systems with defined benefits become financially unsustainable in the course of time and begin to require very large injections of funds from central budgets. The reasons why this occurs have to do with design problems in the original systems, demographic changes, institutional and legal restrictions, political pressures, etc. That fiscal pressure on public finances, together with considerations regarding the inter-generational and intra-generational fairness of such systems, have given rise to the reforms. In consequence, systems of defined contributions or individual capitalization have been introduced, which are financially balanced by definition. However, and this sounds paradoxical, even though the main motivation for making the reforms is fiscal in origin, the so-called fiscal impact or cost of the

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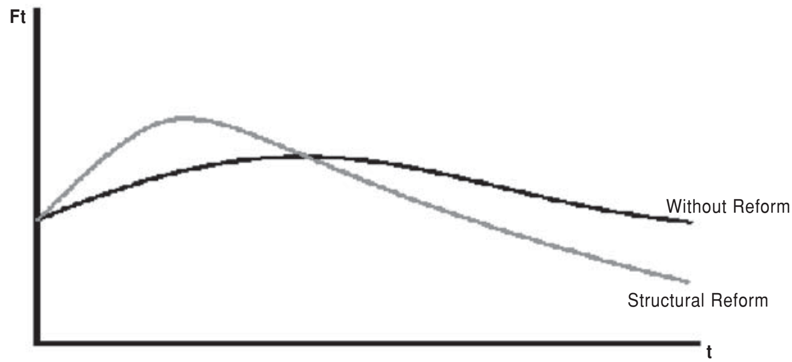
Mr. Alarcón is currently the President of Colombian Association of Pension and Unemployment Fund Administrators, ASOFONDOS, and a member of several Company Boards such as the Banco de Bogotá, the Colombian Stock Exchange, Interconexión Eléctrica S.A. (ISA), Internexa, San Ignacio Hospital and Petrocolombia S.A. He is also participates in the Board of Trustees of the Universidad de los Andes in Colombia.
Mr. Alarcón was Minister of Finance and Executive Director of the Inter-American Development Bank (IDB).

"transition", once the reforms have been made, has become at the same time their main obstacle. Let us look at the problem using Figure N° 1.

FIGURE Nº 1
Impact on cash flow



* Ft: Transfers from the Central Budget to the Pension System in period t.

Let us analyse the cash flow impact on public finances. If we call the transfers required by the pension system during the corresponding period Ft, on the vertical axis, the black curve corresponds to the scenario in which there is no structural reform, (in other words, when the defined contribution system is not introduced) while the grey line shows the transfers required when that reform is introduced. Clearly, what can be seen is that at the beginning, when the reform is first brought in, greater transfers are required for very simple reasons: it is necessary to continue paying pensions to those who are already retired, new contributions are paid into the recently created capitalization system and recognition bonds, where such bonds exist – as in the case of the Latin American reforms -, must be paid in their entirety when people retire. For those reasons, at the beginning there will be greater cash-flow pressures on the central budget. Of course this trend reverses later on, as can be seen on the graph.

Now, the relevant question is which of the two curves implies a lower present value in the associated cash-flow, which in principle depends largely on the discount rate that is used. This should be that of government bonds, to the extent that it is necessary to issue debt in order to fund these needs in the margin. But it will also depend on other assumptions, as happens with all projections: growth in wages, coverage, demographics, the extent to which the defined benefits system will be actuarially unbalanced in the future, the time scale being used, etc.

There is obviously no definitive answer. In principle anything may happen in terms of present value, and the result will depend on how the future is seen with regard to the aspects mentioned above. However, the one certain thing is that there is greater fiscal pressure at the beginning when pension reform is carried out. This is unquestionable. As a result the incremental cash needs are going to require a combination of greater fiscal adjustment and greater issuance of public debt. It is important to bear in mind, however, that there are new sources for the increased debt which would not have existed but for the reform, corresponding to the savings collected by the new defined contributions system.

When looked at in that way, the short-term scenario for the economy as a whole is very similar in both cases. But of course, from the government's point of view the situation is quite different, because if there is no structural reform it collects contributions through an implicit financing mechanism and what is more, according to existing accounting practices, that income goes into the public coffers as current income – equivalent to tax income – while in the case of a reform the income has to be collected as explicit debt, issuing securities in the market. That makes a great difference. For that reason, it can be affirmed that the accounting practices contained in the International Monetary Fund's Manual of Public Finances are strongly biased against pension reforms.

Here I am quoting Robert Holzmann[2] and his associates, of the World Bank, who say quite clearly in a recent document that "current accounting systems unjustly penalize countries which introduce reforms, where multilateral institutions, particularly the International Monetary Fund, concentrate on current deficit and conventional debt objectives".

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2 Robert Holzmann, Robert Palacios and Asta Zviniene (2001), "Implicit Pension Debt Issues, Measurement and Scope in International Perspective".

Here there is a problem of deep conceptual content, leading on to a discussion of the treatment of so-called "implicit pension debt". This may be defined as the present value of the pensions to be paid in the future, based on rights that have already been acquired. There are various definitions, but this seems to be the most widely accepted and most useful for analysis. The complicated part is that according to current accounting practices, accepted by the international organizations, implicit pension debt is not recorded on the balance sheet of the public sector, despite the fact that it is usually much higher than conventional debt.

TABLE N° 1

Public debt, pension spending and implicit pension debt

Country	%GDP		
	Public debt 1999/2000	**Pension spending**	**IPD (4%)**
Brazil	33	9	330
Slovenia	25	11	298
Romania	18	6	256
Poland	43	12	261
Ukraine	59	9	257
Hungary	59	9	203
Argentina	53	5	85
Mexico	19	1	65
Colombia	24	2	56
Chile	9	7	60

Source: Robert Holzmann, Robert Palacios y Asta Zviniene. "Implicit Pension Debt: Issues, Measurement and Scope in International Perspective", The World Bank, 2004.

Table N° 1, taken from Holzmann's document mentioned above, shows in the last column how implicit pension debt is several times higher than conventional debt in the majority of countries. To give one example, in Brazil, at the top of the list, it was 10 times higher in the year 1999/2000. The figures may be open to question, they may or not be exact, but the fact is that in terms of magnitude, they are in that range.

Given the complexity of the subject, there is a very interesting debate going on at present inside the IMF, where a discussion group has been formed[3], which is open to the academic community and interested members of the public, precisely in order to discuss this subject: The nature of pension debts and how to record them. The central point is that according to the IMF's Manual of Public Finances, social security debt is not a contractual liability of governments and it should not therefore appear in the accounts. The defence of the status quo in this matter, as expressed by one of those taking part in the discussion, Henry Aaron, is based on the fact that pension obligations are not debt because they can be changed at any time and, in that way, the accounts can be balanced whenever required.

In my opinion, that is a fairly superficial approach to the problem, which fails to take into account the different characteristics and the legal and contractual implications existing in different countries with regard to this subject. For example, in Colombia, which is the case I know best, when a person fulfils the requirements for receiving a pension under the old system of defined benefits, he or she acquires a right which is protected by the constitution. This means that if the government or Ministry of Finance were to decide not to pay the exact amount of those pensions, that person would simply turn to what is known in Colombia as the "derecho de tutela" and in other places as the "derecho de amparo" (action for protection of constitutional rights) and a judge would order payment to be made without delay. If the Minister were to ignore that injunction, he would undoubtedly receive a warrant of arrest. This means that in a case such as that of Colombia, default on government bonds is easier, and would certainly happen first, rather than default on pension payments that have already been decreed and acquired. What is more, also in Colombia, where parametric adjustments are made to the defined benefits system, those changes operate a long way into the future, based also on arguments about acquired constitutional rights. To sum up, the obligations grow with each day that passes, as also the part of the implicit pension debt that is protected by the constitution and therefore cannot be adjusted at the discretion of the Government or by the Congress of the Republic.

I think that a study on the real legal nature of pension obligations in different countries is essential, because there will certainly be

3 The Treatment of Pension Schemes in Macroeconomic Statistics – an Electronic Discussion Group.

some, like Colombia, where the nature of these debts is very powerful. This is possibly not the case in other places.

To conclude, allow me to draw a few conclusions of economic policy on what this all means. In the first place, introducing pension reforms in developing countries is becoming more difficult every day and there are strong pressures to reverse those that have already been introduced. And this is because, for these countries, the fact of having programmed agreements with the International Monetary Fund is absolutely indispensable. In practice, it is a matter of life or death because it means having, or not having, access to financial markets and means higher or lower spreads for their debt.

However, the current practices of public accounting, which I have already mentioned, imply that the best way to close countries' economic programs and be able to reach agreements with the international organizations, especially the IMF, is to stick with the old system of defined benefits. The priority of the reforms in that context consists in improving the short-term cash flow of the pension system. The ideal way to do this is to increase contributions or, in countries where a structural reform has been made, to return to the Defined Benefits system. This return to the past would be a magnificent way of improving the fiscal position, in a manner that is clearly artificial. Imagine what it would mean for a hard-pressed government to be able to incorporate the savings and contributions of the defined contributions system into its accounts, these being paid into the public finances as current income. This in turn would mean not having to make the real adjustments to the fiscal budget and pension system which are in fact needed.

I could draw many more conclusions on this subject, but time is short. I conclude by saying, in summary, that the way of accounting for defined benefit pension systems, especially implicit pension debt and collection, is becoming a major obstacle for bringing in pension reforms and a great incentive for governments and congresses to reverse some of those that have already been introduced.

Experience in Poland

Ewa Lewicka[1]

With regard to the fiscal impact of pension reform I wanted to look specifically at the example of Poland. While considering the financial consequences of pension reforms, one may distinguish between the long-term and the short and medium-term ones. The long-term consequences are the reduction of the "implicit pension debt", i.e. the long-term pension system liabilities. The short and medium outcomes manifest themselves in an increase or decrease of the "explicit pension debt", i.e. the public finance deficit caused by pension related expenditures.

What do we mean by the implicit debt of the system? This debt is a measure of the liabilities assumed by the pension system. In industrial countries this debt is increasing very rapidly since the number of retired people continues to grow.

The way the implicit debt develops is a very important factor for the reforms because making the debt explicit allows the real obligations for future generations to be measured and also shows the level of the cash-flows needed to meet those obligations. Also, when these liabilities have to be paid, implicit debt becomes explicit. So, in order to prevent break-downs in state finance a surplus is necessary to cover the debt that has been generated.

It is worth starting with an analysis of the size of the implicit debt (IPD, Figure N° 1). In most of the countries, the IPD is much

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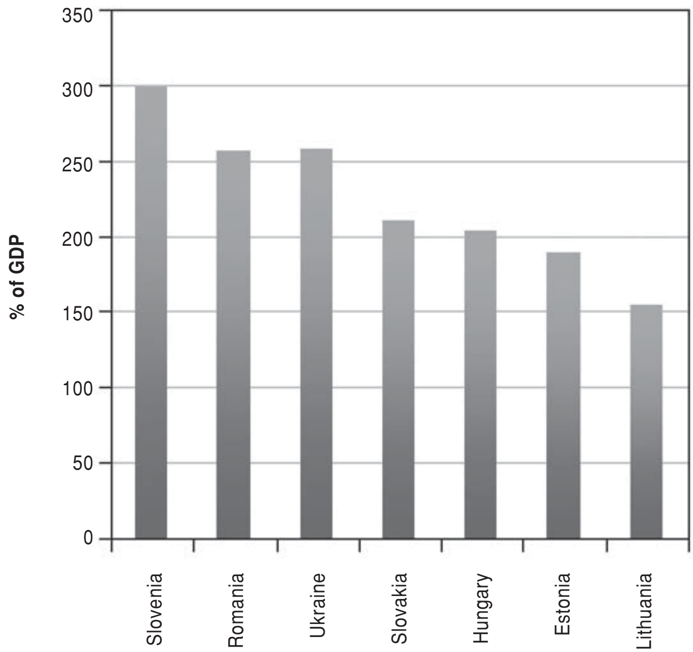
Ms. Lewicka was Secretary of State at the Ministry of Labour and Social Policy and Deputy Chairperson in the Regional Board of "Solidarity" Trade Union, where she made vital contributions to Social Insurance Reform. She was also a Research Associate at the Warsaw School of Economics.

higher than the explicit public debt. According to estimates: IPD exceeds 200% of GDP in France and Italy, and it is above 150% in the UK and Germany.

FIGURE N° 1
Implicit pension debt in transition economies in 2002

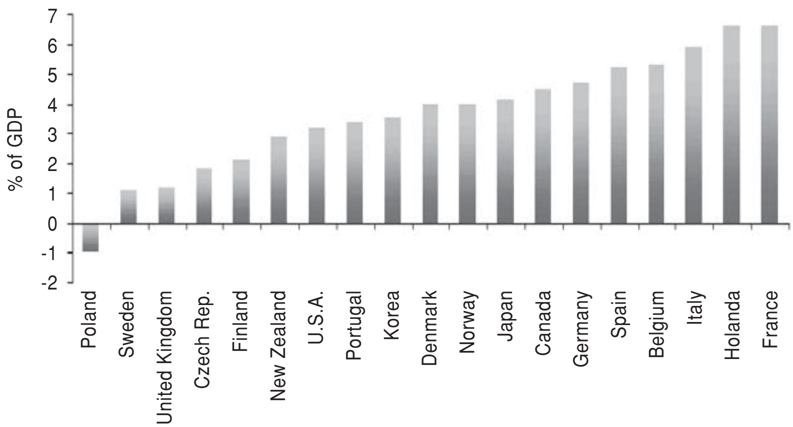


Note: Assuming 4% discount rate.
Source: Holzmann *et al*. (2001).

Now we are going to see what level of primary balance we need to offset the impact of ageing in society. Here we see examples for various countries (Figure N° 2).

This figure shows the development of the primary balance that would allow public debt to be reduced to zero by the year 2050. In OECD member countries necessary surplus is around 4 percentage points of GDP. It may be said that the need for low primary balances is characteristic for the countries that have reformed their pension systems, such as Poland and Sweden, and also countries with a well-balanced system, like Great Britain. After the pension reform, Poland has become the only country that does not need to generate a primary balance.

FIGURE N° 2
Primary balance needed to offset the impact of ageing



Source: OECD.

From the point of view of the medium and long term, one should also investigate the transition costs. The cost of transition in systems with various pillars, where the contributions are transferred to the pension funds and the benefits have to be financed, generates the deficit. How can this deficit be covered? That is difficult. There are tax contributions, for example, or we may receive proceeds from the privatisation process, savings related with social insurance policies and also increase explicit debt.

There are certain misunderstandings in assessing the cost of the reform. The transfer of a portion of the contribution to a funded pension scheme is not a cost. It costs practically nothing because it merely reduces future financing, however in the short-run, there are indeed severe problems with financing this gap. It is also possible to offset this cost by improving the functioning of the pension funds. The investment of the funds in equities also helps to solve this problem.

What might be the short and medium-term consequences of the reform? In order to improve funding in the short and medium-term it is possible to do the following actions: raise contribution levels, reduce liabilities by changing the principles for paying the benefits, increase the age of retirement. Thanks to this type of measure it is possible to improve the situation in the short term.

The savings and costs of the pension system should not increase the pressure on the population which is going to retire. A portion of this cost must be transferred onto future generations.

While planning the reform it is important to compare effects, knowing how some reforms affected other countries. Now I am going to show the effects of the pension reform in Poland.

What are the characteristic features of the Polish system? It is a system with defined contributions. The retirement account for each member of the system consists of two types: the financial (FDC account – *funded defined contribution*) and the non-financial accounts (NDC account – *notional defined contribution*). The rate of return in the FDC depends on the financial market returns, while in the NDC part it depends on the wage fund growth.

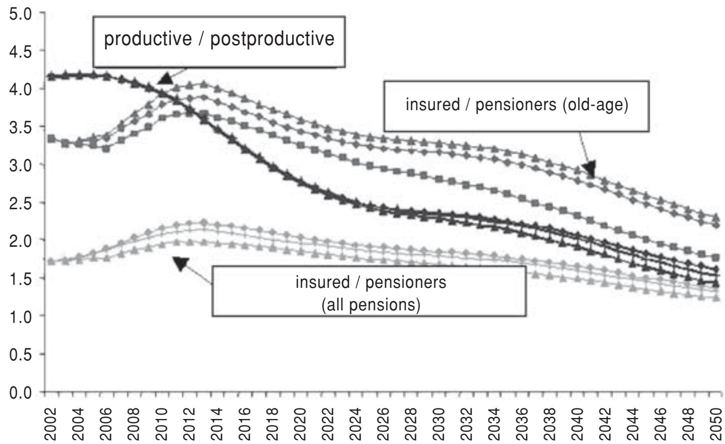
People who on 1st of January 1999 were below 30 were provided with both types (NDC and FDC) of accounts. Those who were aged between 30 and 50 had a choice to have either one (NDC) or both (NFD and FDC) accounts. In Poland, 53% of them chose to have both accounts. People aged 50 years or above were left with the old system. By the year 2023 we plan that both men and women will have the same retirement age. Thanks to our efforts, the initial capital for each insured person was formed and the accounting is also done in the same way as in typical pension funds.

What are the state guarantees? There is the minimum level of the pension in the NDC and FDC accounts and the State has become the main guarantor of pension payments from these accounts.

How can we assess the long-term effects of the reform in Poland? Before the reform, the estimate of the volume of internal debt until the year 2050, as a percentage of GDP, was expected to be 462% and it is clear now that this debt will fall by 268%. The process of reduction of the long-term pension debt can be analysed in three main areas: the demographic structure, the process of replacing the old system with the new one and the financial situation of the pension system.

Concerning the rate of dependency of Poland's demographic indexes, it can be said that in Poland, as in other countries, the number of people of productive age is falling while the number of older people is growing (Figure N° 3). By the year 2014 this correlation will be negative.

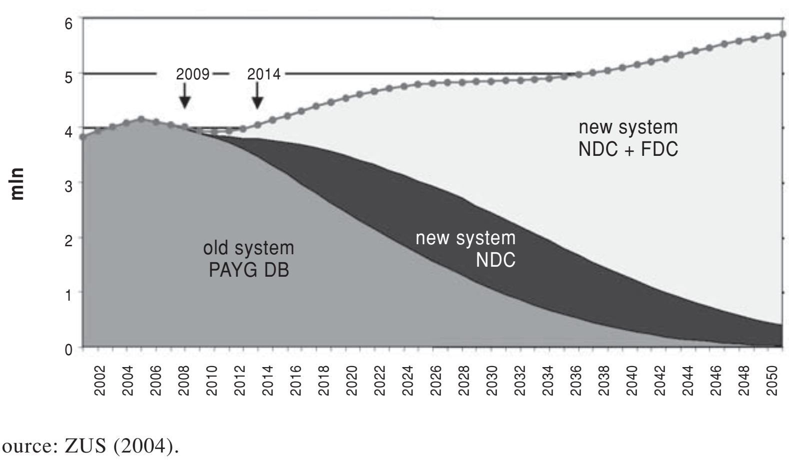
FIGURE N° 3
Demographic and system dependency rates



Note: Projection for three various demographic scenarios (including baseline, higher fertility and lower mortality.
Source: ZUS (2004).

Let us look now at the distribution of those who have retired, by type of pension system (Figure N° 4).

FIGURE N° 4
Pensioners by type of the pension system



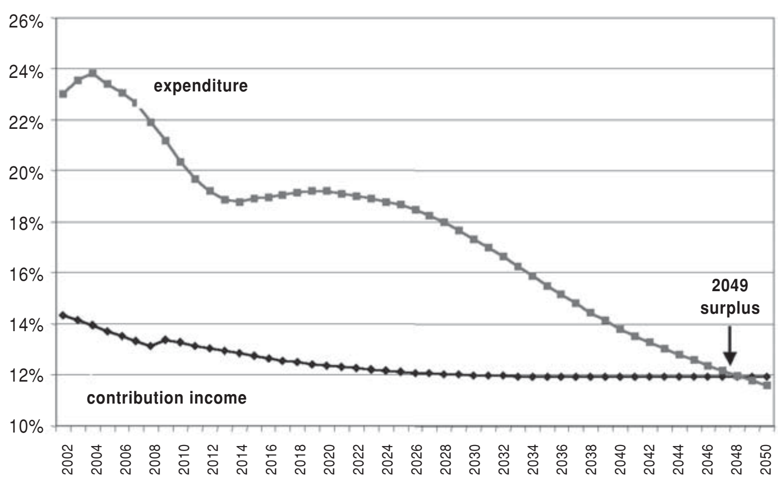
Source: ZUS (2004).

It is forecast that the number of retired people from the old system will fall. The new system will start in the year 2009, paying out retirement benefits, but, as we can see, the new system of DC is only a part of a wider area. I have already said that about 53% of citizens who were allowed to choose decided to enrol in the pension funds.

Now, let us consider the revenue and expenditure of the pension system both in medium and long-term aspects (Figure N° 5). According to the forecast, till 2014 expenditure will decrease rapidly. After the year 2014, for a short time, the expenses will rise because the society will be getting older, but not significantly. Later, up till the year 2049 expenditure will decrease constantly because the population will be using benefits paid from the individual capitalization portion. So for that certain period we shall have extra assets and also around that time the deficit in the pension system will become smaller.

FIGURE N° 5

Expenditure and revenue of the pension system



Note: Expenditure of the pension system covers both the old pension system and the NDC pensions.
Source: ZUS (2004).

Let us look at the effect of the reform in the medium term. The full transition to the new system will take several decades. According to the calculations, the deficit of the system will be reduced and after a transition period, stabilised. Some further improvements may also be expected due to the changes proposed in 2004 as regards the indexing of pensions and retirement age. It was also decided to create a buffer fund, called the demographic reserve fund. In 2003 the assets of these funds represented 0.4% of GDP, mainly invested in government bonds.

In conclusion, it may be said that before planning a reform it is necessary to assess the implicit debt and to inform the population about the level of pension obligations. It is also important to ensure that the financial consequences of the reform, both negative and positive, do not fall on one generation alone.

The systems with various pillars enable public debt to be reduced more quickly and also generate a higher level of pensions, in comparison with parametric changes in a pay-as-you-go system. The sooner we can balance the system, the sooner we will be able to reduce the burden placed on the working population. It is also necessary to create a financial market infrastructure.

4 Pension reform: the conditions of success

Elements involved in a successful reform: Michal Rutkowski

Comments: Guillermo Arthur

Elements involved in a successful reform

MICHAL RUTKOWSKI[1]

This is an extraordinary event in Kiev. I was getting tired of the fact that three or four years ago everybody was talking about the reforms in Latin America and no-one mentioned the reforms in Central and Eastern Europe. Even today The Economist devotes itself to describing the reforms in Latin America only. Obviously there are good reasons for this, because the reform began there, but I believe that this congress clearly underlines the fact that it is no longer Latin America alone.

It is a pleasure to hear Spanish spoken in this city. Let us see whether we can speak Ukrainian at the next congress in Santiago, Chile, as a part of a global learning about pension reforms.

I am here today to speak about subjects that are not very weighty or popular. In fact I am not going to talk about economic subjects but about the conditions that are necessary if pension system reforms are to be successful.

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Dr. Rutkowski is currently the World Bank's Sector Director, Human Development, Middle East and North Africa Region. He is a member of the European Economic Association, the American Association for Comparative Economic Studies and the European Association of Labor Economists.
Dr. Rutkowski has published extensively on health, social protection and pension funds. For example: “”Labor Markets and Social Policy in Central and Eastern Europe” at Oxford University; “Workers in an Integrating World” for the 1995 World Development Report and “Security Through Diversity”, which was implemented later by the Polish Government.

So, I am going to talk about the successful introduction of the reform and not the success of the reform itself, because the jury has not yet reached a verdict on that, even in Chile. We hope that it is a success and there are many secondary proofs showing that it may be, but we shall only see the proof after a lengthy period of payments and disbursements and we shall never know what would have happened under the old system. However, we can say something intelligent, even though it may not be entirely accurate or, of course, proof against mistakes.

Before getting down to the marrow of the matter, I would like to try to answer the questions pending after the last panel. I liked the fact that implicit debt was recognized to be something just as important as explicit debt: I think this is a big problem for reforms all over the world. Many institutions do not recognize implicit debt correctly, in other words, by accounting for it in the government's actions and balance sheet. Only government expenditure and the inter-annual budget are mentioned and it is a fact that governments concentrate only on expenditure and the budget deficit, for example.

The Maastricht criteria established a ceiling for new members as regards budget deficit, but it is more difficult to introduce reforms in this way because the change of system makes everything easier. I ask myself what will happen with the Maastricht criteria if France introduces a pension reform that reduces the budget deficit by three points; it cannot be used without a reform, but with a reform the criteria might come down a little, and I do not know if the mechanism exists.

I also have to say that these debates are the debates that we have with the IMF, because from the point of view of those of us in the Bank, as members of the panel, we give a lot of importance to implicit debt – e.g. Robert Holzman's publication recognized this several years ago – and we also attempt to include concepts of implicit debt in public finance. We would like to have even more collaboration from the IMF's Department of Fiscal Affairs, because it seems to me that they think a bit too much about pension reforms that have costs in the short term without fully recognizing the fiscal benefits in the long term, due to the reduction in implicit debt. For that reason I liked the session very much, because it has left everything quite clear and up-to-the-minute.

Personally I often meet economists who say: we can't do much with the subject of implicit (debt), because if pensions are an implicit debt, everything is, including the maintenance of a motorway. I believe that there is a very fine dividing line, which has to do with a legal basis for implicit debts. They are the responsibility of the government, and if the government does not pay it has a problem similar to the problem of not paying an explicit debt, so I do not understand the conceptual problem in calculating the implicit debt and treating it in the same way as the explicit debt. Maintaining a motorway is not the same thing. Maybe you do not do the maintenance, but even so you have not broken a law with which you were obliged to comply. So, we need to talk about more than just expenditure or implicit deficit, and take implicit debt into account as well.

After this introduction, I am going to pass on to something lighter and share a few thoughts with you about the conditions needed for the success of the reform.

In the first place, I am going to say that the technical contents of the pension reform package is not all that relevant to successful implementation. I have seen reforms that are not good but have been very well implemented, and excellent reforms that have still not been implemented. A country with an excellent, technically faultless reform was Slovenia. The technical concept of the reform, the calculation of the dynamics of implicit and explicit debt, the level of benefits in real terms, different macro-economic scenarios, and so on, they calculated it all, over and over again. A very competent government, the current Prime Minister was then Minister of Labour, then began to take interest in the reform, and it was a classic case of doing everything right: they respected the order, took the impact into account, calculated the impact, talked about the processes with the parties involved, all correct – but the reform has not taken place.

Therefore, I would like to say that the technical contents are important in the long term, but they are less important for the successful implementation of the reform. What matters are policies, programs and practices. The trick is being able to move from policies to programs and practices. Policies are a concept and not a decision about the new structure – many countries have gone in this direction - and moving on to programs is a very significant step. It means that there are arrangements for implementation, it is clear what can and cannot be done, or when. We know examples of reforms with programs that were not good, and they had to be postponed. Mexico is one example and Croatia another. We have examples of reforms with programs, but bad programs. Poland is an example, with collective contributions being initially mishandled by the social security institution.

And practices are another matter: they occur when the pension reform is already rooted in the society and people learn new behaviour patters in response to the new pension system. I believe that the practices in Poland are not good with regard to the first pillar because, in general terms, those participating in the system do not know the structure of the first pillar and there has been no change in behaviour. This is true for many other countries too. But there comes a very important moment when policies and programs are converted into the practices of employers, employees, governments. Very often we have reforms with policies and programs but no change in practice.

Here I have some phases of pension reform – the work of a colleague of mine, Mitch Orenstein. He divides the process into three phases: commitment-building; coalition-building, and implementation You have to distinguish and create a commitment before getting a credible commitment from the government. Building coalitions because there is already something on the table and the government has to obtain support from the public.

Now let us pass to the pension revolution in Eastern Europe. I don't need to talk about it. Here we have the different phases yet again and the only thing that I want to say is that when implementation is beginning, the phases are very long. Kazakhstan is slightly out of this, because the reform began with a technocratic concept, but normally various years of commitment and coalition-building are involved. I get the impression that the commitment is a long-term commitment, lasting longer than the term of office of one government. I am not going to talk about each of those points but I would like to emphasize a few aspects.

The initial stage of the process, commitment-building, is basically the stage in which one can encourage the participation of groups and organizations, the more the better. That is the way things are. This is the stage in which a number of concepts will be put to the test, and where opinions will be sought in order to have an authentic, open conversation. Also, at this stage it is good if a radical reform is proposed, as the paradigm is shifted that way and the ultimate government proposal may seem moderate by comparison. At this stage the proposals can be excessively radical but society should have the chance to discuss them. At some point a concept will be presented and this, as I understand, changes the dynamics of the debate, because from then on it is no longer the time to talk about everything: it is more a question of deciding on the correct approach within the stipulated framework. This is a coalition-building phase, that consists of (i) concept, (ii) concept presentation, (iii) concept dissemination, feedback and consensus building, (iv) working on new legislation, and (v) passage of laws. I will not talk about all the sub-phases, I will only highlight a few points.

First, I would like to underline the appropriate use of opinion polls, because it is important that the pension reform concept is presented and viewed as a real response to a legitimate concern of the population.

In the stage of concept presentation I would underline point number two, the present or current net value of current pensions. This is important. If we look at the reforms in various countries, the participation of young people in the market is going to be absolutely essential if this reform is going to reach harbour safely. The reason for this is that they are the groups that will benefit more than others as a result of this reform, more than the older workers. But, at the same time, they are the groups that are least interested in taking part in this public debate, precisely because for them the moment of truth seems so far away. So we are going to see what the participation is, and see if we can individualize the presentation in such a way as to meet their needs. This is very important.

Another aspect which seems to me to be very useful is that employees in the financial sector tend typically, at least in Central and Eastern Europe, to be younger than employees in other sectors of the economy, and when we talk about the reforms that give rise to the funded pillar, that is already in itself a formula to activate the younger groups, to link them not only with the funded pillar but with the whole concept of the reform.

If the young people involved do not believe in the pension system, a vicious circle is created with the final result that they are not interested in contributing, see Diagram Nº 1. The result, therefore, is that the present system becomes less credible. It is a vicious circle, as I said, a genuine syndrome which may not necessarily be negative, because one of the factors that helps the introduction of the reform is that people do not like the present system. The higher the level of dissatisfaction, the easier it will be to introduce the reform. This is probably why, when we are talking about Central European countries that have so far not introduced big reforms, such as Slovenia and the Czech Republic, they are countries where there was not much dissatisfaction at a given moment because the people liked the present system, even though they are countries with great administrative ability. In other words, the start of this vicious circle did not occur there, because the administrative control is good and it is difficult not to contribute.

Let us look now at feed-back, and consensus-building. These are concepts that I put essentially to underline two concepts. In the first place, and here I think there is a difference between Europe and Latin America, these groups are made up of lawyers who specialize in social security. All reforms are to some extent a violation of the present scheme and Central European tradition is often based on the tradition of Bismarck, with great concentration on the rights of those involved. The lawyer therefore interprets the reform as something that violates those acquired rights. So, in many countries, this group has been totally critical of the reforms, and it has been necessary to overcame the resistance in some way, because otherwise reform would simply not go forward.

Here we will be referring to a series of examples. If I remember correctly, the Constitutional Tribunal in Croatia decided to return the amounts that the pensioners should have received because the change in indexing was perceived as a violation of acquired rights. I believe that this problem does not exist to the same extent in Latin America, perhaps because the traditions of those systems are based on other elements and the role of social security lawyers in the early stage is less critical. That is the first comment I wanted to make.

Diagram N° 1

Vicious circle, virtuous circle

In a PAYG DB monopoly, under existing demographic scenarios, an individual worker will always have an advantage in not complying with payroll tax or moving to the informal sector, and an individual pensioner will always have an advantage in bargaining over higher pensions. The bargaining spiral, however, is against the interest of all workers and pensioners together since the taxed output goes down and the tax rate has to go up to finance pension benefits. The situation resembles "the tragedy of the common people". The more successful pensioners are in bargaining over current pensions:

– the more unsustainable the system becomes,
– the higher the future necessary payroll tax rate becomes,
– the less current workers expect to receive back in the future in the form of pensions because their expected net present value of future pensions to be obtained from paying a dollar in current taxes goes down.

Solutions

– bringing the net present value of future payments close to the level of current contributions paid, by introducing defined contribution systems, funded or notional; making young workers expect that the state will honor its future obligations;
– activating young workers in the pension debate, turning the debate explicitly into an intergenerational discussion;
– relying on organized workers, pensioners, financial sectors representatives, etc., since the more organized the actors are, the more likely they also are to take into account macroeconomic externalities of the bargaining process.

I cannot resist saying that the last point has to do with international obligations. The costs structure of the reform, even when there are these cash-flow problems when future commitments are brought up, leaves room for international organizations to provide support, and we have received support – loans, technical support – in most of the Central and Eastern European countries, even those which aim to cover these transition costs when they transfer from a single pillar system to one with a number of pillars.

There are others groups that are critical for the passage of laws. We have spoken of the lawyers, the group to which we must give special attention, but obviously the trade unions and members of parliament, which are absolutely critical, but I do not need to go into details because you are experts. I spoke about the lawyers because we often forget to take the importance of this group of professionals into account.

When the laws are passed, you should have a celebration. Here is when we can be really happy, neither before nor afterwards: but just when the law is passed. Not before, because the work is not yet finished, nor afterwards, because the work will be very difficult. So to those countries where legislation has not yet been passed, I tell you, on the day the legislation goes through, celebrate, and celebrate thoroughly, because afterwards the occasion for celebration will be lost. I am sure that Ms Lewicka will agree with me. In Poland at this very moment they are absolutely concentrated on implementation and I, fortunately, am not in Poland to see all the difficulties involve in the execution.

Execution or implementation again. There are six topics that speak to us of the different aspects: quality of institutions, administration, communication, “holding the fort”, enemies and dissidents and the timeline. I am going to concentrate on a few; first, communication. It is important to have constant communication and this is so because, contrary to what is believed at this moment, when the legislation is passed there is not a great deal of knowledge. The knowledge among those affected by the legislation – in other words: lawyers, trade unionists and others – is considerable, but the general public knows very little and people are very interested in having information, of course. There must be continuous public communication.

The worst that can happen is that communication points us towards the participants in the private sector. Often, in fact, it is the most important (sector) because of the money factor; those companies have a lot of money to invest. It is not that there is a conflict of messages, no, but it is very important that the message to the public is always the same.

And then, when there are problems with the reform, it is surprising to see how the friends of the reform suddenly change sides and criticise it. So, dealing with enemies is a very, very important aspect.

Second, the timeline. I believe that I would emphasize again here, basing ourselves not on this representative sample but on a sample from various countries that, when possible, it is good and advisable to postpone execution until there is sufficient administrative program available. Thus it is better to start a little later than to start with huge problems, because those problems undermine the credibility of the reform. Of course this is not always possible; sometimes postponing something is equivalent to not initiating the reform at all. In general, there is an excess of optimism, and this in turn means that even when it cannot be solved, the timeline and moment of execution should be reviewed, in order to avoid the implementation overwhelming the inherent capabilities of the system.

The essential message that I would leave with you here as regards achieving successful reform consists basically of two points. First, not everything can be done in every country, we have to think of the different models. In Central and Eastern Europe all the reforms leave the first pillar as a dominant pillar and I believe that there was no alternative. These countries simply did not have the option of doing what has been done in some Latin American countries, because of the size of the inheritance and also because of social attitudes. So basically this legacy, this inheritance, has been an absolutely determining factor.

In the second place, the organization of the reform process itself, the role of this designated office, is absolutely essential. Here we would separate the process of day-by-day management of the system from the process of introducing the reform package. The people who do the best job from the point of view of daily activity and daily management are not necessarily the best equipped emotionally to work on the reform, though obviously this is no reflection on their intellectual ability.

There is another message to be borne in mind, and that is that at any point in the process, during both preparation and execution, there must be a public message as to where we are, where we are going and why. It is better to get the message wrong than to give no message at all. If we say something wrong, we can correct it, but failure to provide information is very damaging.

There is another series of concepts that are important. You have this documentation available to you so we will not go into details now, but I would underline one additional concept and it is, once again, to stress the importance of concentrating on young workers They play an absolutely vital role. As I said, the perceived present value is really critical.

There is a myth, or maybe a confusion in Western Europe, in the Mediterranean zone, that the trade unions are *always* against pension reform. This message surprises me; my reply is that they have no reason to be enemies of this reform. And I am referring to a number of instances in which the unions have made an important contribution. Of course we must avoid the risk of turning them into a trade union position, but it is important to know that this is the way things are.

Finally, we have to notice, a couple of fundamental ideas that we must insist on. First, the ability to execute is always, always being overestimated, so we must be realistic. Not pessimistic, but very realistic. And then, as regards the execution phase, the ability to introduce secondary legislation, corrected and adjusted, whenever necessary. It is true that there are reforms that have gone very slowly because the governments have not known how to be creative when making readjustments after four years. Of course we are not talking about instantaneous readjustment, which is neither practical nor necessary, but the possibility of suggesting some variation after two, three or four years, because that allows us to understand what the subject and the margin are, and sometimes these adjustments are absolutely essential from the point of view of enabling members to understand the system and the satisfactions deriving from it. It is exactly what I meant when I mentioned arriving at the good practices.

The policies are important, the programs are important, but moving from the programs to the practical part means concentrating on execution in such as way as to review some of the elements of the execution process in a creative manner. That should be done with a group of experts, knowledgeable people who will take charge of the reform once implementation begins, because otherwise the reform will not, as we said, reach safe harbour.

Comments

GUILLERMO ARTHUR[1]

Michal Rutkowski said that even in Chile the jury was not in a position to give its verdict. It is true that after 23 years we still do not have pensioners in Chile who have done all their saving within the reformed system. For this reason we have to make use of ideas that give us some view of what the result might be, so I will make an analysis from three angles. First, the impact on pensions; for which I will be using a paper prepared by Robert Palacios, in which he compares the real rate of return of social security savings under the reformed systems with the real growth in wages that has taken place during the same period. This comparison is made because the growth of wages was the basis for calculating pensions under the pay-as-you-go system and it therefore gives us a measure and view of the trend of reformed social security systems over the pay-as-you-go systems, as far as improvement in pensions is concerned. In fact the yield of the funds has far exceeded growth in earnings, in all the countries.

It is also important to refer to the results that the system has had on the economy of the countries. There are qualitative results: by pooling the investments of many workers, better diversification is

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He is a former Minister of Labour and Social Security and author of "Régimen Legal del Nuevo Sistema de Pensiones" (The Legal Scheme of the New Pension System), published by the Editorial Jurídica de Chile, 1999.

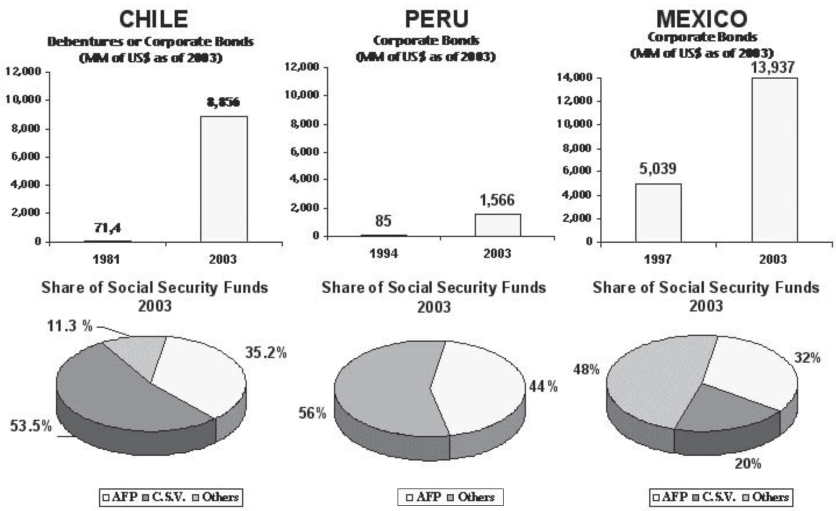
offered and a better risk/return combination. It also reduces the intermediation costs of investments and makes way for the creation of innovative, long-term financial instruments. Many of our economies had shallow capital markets with few instruments and the arrival of this mass of financial investments made it necessary to create highly innovative long-term instruments. It has also improved transparency and corporate governance by introducing these very demanding institutional investors into the investment processes. Furthermore, it provides incentives for the securities custody and risk-rating industries, etc.

With regard to this, I would like to give a few examples of what the introduction of the reform has meant in some countries. As is shown in Figure Nº 1, in Chile there were 71 million dollars in corporate bonds; today there are almost 9,000 million dollars, of which 35% has been acquired by the AFPs and 53% by the life insurance companies, which also, as you know, have their origin in social security, because they correspond to investments that have been transferred to buy life annuities. In the case of Peru, from 1994 to 2003 there was growth from 85 million dollars to over 1,500 million dollars, with the AFPs' share accounting for almost half. In the case of Mexico, from 1997 to 2003 this increase went from 5,000 to 14,000 million dollars, with the AFPs and insurance companies having a share of over 50%.

Other examples of long-term securities are mortgage-backed securities and bank bonds. In Chile these have grown from 500 million dollars to 10,300 million dollars between 1981 and 2003, which has made it possible to finance a housing stock of over 500 thousand with low, long-term interest rates.

When making an evaluation of the system, I believe it is also necessary to refer to the impact that it produces within the political economy. I believe that one of the dramas experienced by the pay-as-you-go systems was the influence of different sectors, trade union and others, which allowed and exerted both fiscal and re-distributive pressures on the systems, which eroded their finances and made them non-viable. It is obvious that a capitalization system presents greater resistance to these pressures, in the sense that any change has to be enacted on the stock rather than made on the future flow, and this makes these changes far more visible. The other resistance to these pressures is the fact that the assets belong to the workers, who therefore have property rights over them.

FIGURE Nº 1
Examples of corporate bonds



Note for Chile: Average life to maturity of bonds in the first half of the 1990s: between 10 and 15 years. Currently between 15 and 20 years. Some have been issued at 30 years.

To conclude, I would like to draw a few lessons from what should be basic elements in the success of the system. The first are some basic conditions in design.

1. It must be based on individual savings accounts over which the workers have indisputable property rights, meaning that no minimum limits for investment can be introduced and even less can those savings be diverted by the government towards other sectors or objectives.

2. It must be based on de-centralized, competitive management.

3. There must be adequate diversification of the investment portfolios. This means broadening the margins to allow investment in equities and broadening the margins to permit investment abroad, especially in those countries where the capital markets do not provide all the diversification possibilities and therefore entail an enormous risk for their performance.

4. It should also be based on members' freedom of choice, not only as regards choosing an administrator but also, preferably, the actual characteristics of the fund in which their resources will be invested. In this sense, I believe that the introduction of multifunds is the best answer.

5. It should have professional supervision which looks after the development of the system in such a way as to maximize workers' pensions, without any other consideration, however valuable it might be from the public point of view.

6. The other lesson is that one must not give in to second-rate technical solutions, however insignificant they may appear. They are mistakes that may seem very minor in the original design, but in the long term they affect the consistency of the system. Such, for example, as when the obligation to invest in public securities is set up in order to cover the fiscal deficit produced by the reform.

7. Together with this reform the State should also proceed to introduce other reforms, apart from social security reforms, to create an appropriate environment for their success. I am referring principally to the regulation of the capital markets, the regulations of taxation systems and labour systems.

8. It seems to me that the social security system is called to produce results in the very long term and therefore the persistence and coherence of these policies are fundamental. They can not be exposed to any change of government that also means a change in the rules of the game.

9. It is also important to respect the rights acquired under the previous system, in order to generate support for the new system.

10. The other lesson involves generating education among the general public and the workers, which means creating an awareness that the contribution they are paying is to build up their pension and is not a tax. Surveys showing the negative view that workers have of the social security system are often used as a weapon to criticize that system and I believe that before making such a survey, it would be a good idea to ask if people are in agreement with making a contribution to social

security systems. The answer to that survey would probably also be negative: These systems are mandatory for a reason, because people are naturally improvident, but I believe that it is essential to create social security culture in the public, to make systematic saving for pension improvement a possibility.

Finally, together with those lessons there are also some challenges which we need to bear in mind.

A first challenge is that of extending coverage. It is true that coverage is not in itself a responsibility of the social security systems, but a consequence of the characteristics of the labour markets themselves. In countries which have an informal element and unemployment, the social security system will obviously have lower coverage that in those which are formal and with a higher level of employment.

Bringing down operational costs is another challenge, involving an improvement in efficiency in all the processes.

Diversifying the investment portfolio is a permanent challenge. I have already mentioned that it is essential to create spaces for investment, avoiding the concentration of investments in particular instruments putting the security of those investments at risk. From that point of view, it is important to broaden investment margins in equities, to introduce multifunds if possible and definitely to invest in foreign instruments, especially in the case of countries where we have small local capital markets.

I will not enlarge any further on social security culture, which is an ongoing challenge aimed at helping the worker to become aware of the fact that it is necessary to build his pension day by day, quite apart from the legal obligation.

CLOSING REMARKS

Kostyantyn Palyvoda

Closing remarks from the President of Arkada Bank, Ukraine

Kostyantyn Palyvoda

Ladies and Gentlemen,

It has so happened that the person who will be talking to you about the state of the social security system in the Ukraine is myself. As we have only a short time I will be brief, and it must also be recognized that there is not much to tell. We, the Ukrainians, are very careful and prudent, so we are in no hurry with our social security reform. We watch what others do, see their mistakes and achievements; we think, reach conclusions, discuss and evaluate. Within this frame of reference, we decided that we should have a three-tier social security system, consisting of the old pay-as-you-go solidarity system, the system of mandatory social security saving and the voluntary system. We believe that a single state social security savings fund should be set up, which will hand over its resources to be managed by different private administration companies.

As I mentioned, the third tier will be the voluntary system. On this point we had great discussions. What should the voluntary social security system be like? Why? Because, as we see it, it is precisely within the framework of the voluntary social security system that we will create institutions and identify ways of operating that can be later applied to the mandatory system.

It was defined that a large number of institutions should work in this area. Our legislation stipulates that pension funds with legal status, insurance companies, corporate pension funds and banks entitled to manage the so-called social security deposits, will be the bodies involved in the framework of voluntary social security.

In addition, a special law created Pension Funds managed by banks. This is a very similar model to the Chilean pension funds, in other words, a sum of money is handed over to a trustworthy body –the bank– for administration purposes[1].

The most heated discussions revolve around the way of regulating the institutions that provide social security services. Some say that there should be regulations from the point of view of the "prudent man" while others insist that there should be a draconian system of limits. Our discussions are very irate. The point is that the capital market in the Ukraine is practically undeveloped, there are very few instruments. At the same time, the Ukraine has already lived through a series of breakdowns in corporate organizations and we, I in particular, very much fear that if these breakdowns also affect the social security organizations, they will mean that the population will cease to believe in social security reform and in the private organizations acting in this area, and we shall have grave problems with the pension system reform. That is why I, for example, in our conditions, am in favour of draconian measures.

How are these opinions manifested in practice? We have two laws on voluntary non-state social security systems. The first law, "the prudent man rule" states that limits should be imposed per types of instrument. But it does not add anything on the subject of rating or risks, except in the case of investment abroad. The law stipulates that investments can only be made through the capital market and are restricted to instruments with AAA risk rating. However, there is no risk rating for the instruments of the Ukrainian domestic market. This is one direction. On the other hand there is a pilot law, under which our bank is working. This defines an extremely draconian system of limits. It allows only one type of instrument, mortgage-backed securities, and not mortgage-backed securities in general, but only those guaranteed by the housing built by a single building firm in the Ukraine. This is because the authors of this idea picked out the most well-known and respected building firm, in view of the fact that some companies in this country build housing that is not of the highest quality.

As may be seen, there are two extremes. The pilot plan is developing fairly well, the law on non-state pension funds will

[1] Editor's note: in Chile the pension funds are managed by institutions with an exclusive corporate purpose called Pension Fund Administrators (AFP).

come into effect as from 1st January this year; the pension funds, insurance companies and other organizations which will manage the non-state social security are still putting their names down, but they have not yet started work. I hope that they will start operating next year. Then we will have some practice, some experience and some sort of lessons learned, so that in the next annual general meeting of the FIAP I will be able to share my observations as to how we are doing.

To close, a few final words. I am very pleased and very grateful. In the first place, with regard to our Latin American friends who took the trouble to make such a long and, may I say it, difficult journey and despite everything, arrived here in our country, not only to see each other and talk among themselves, but also to tell us about the successes of the social security systems in Latin America. For a variety of reasons, many representatives of the countries in our region have no possibility of travelling to Latin America to learn what you have done in your countries, and thanks to the fact that you decided to hold FIAP's Annual General Meeting here, they have had a unique opportunity to receive information at first hand about the undoubted successes achieved by the social security systems in your region. I am also grateful to the representatives of the countries in our region, not all of whom had the chance to speak: for example, our colleagues who came from Azerbaidzhan, a country in the Caucasus, who were not on the platform, plus many others.

I think that we must continue this exchange of experiences on the subjects of social security reform between the countries of Central and Eastern Europe on the one hand and the countries of Latin America on the other. Because we have things to discuss, things to say to one another. This is especially important for us and for social security reform in Europe, because I believe we are some way behind, compared with the countries of Latin America.

Last of all, my thanks to everyone for listening to me so patiently.

Currency exchange values

EXCHANGE RATE
(against the U.S. dollar)
(31.05.2004)

Country	**Unit of currency**	**1 US$**
Bulgaria	Lev (BGL)	1.60
Croatia	Kuna (HRK)	6.63
Hungary	Forint (HUF)	205.08
Kazakhstan	Tenge (KZT)	137.34
Kosovo	Marco Alemán (DEM)	1.60
Poland	Zloty (PLN)	3.80
Slovakia	Koruna (SK)	32.70
Macedonia	Denar (MKD)	n.a.
Europe	Euro (EUR)	0.82

n.a.: not available.

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CHAPTER II
REFORM PERSPECTIVES IN EASTERN EUROPE

Chapter III
CHALLENGES FOR IMPLEMENTING THE REFORMS

C O U N T R I E S   W I T H   R E F O R M S

● LATIN AMERICA ● CENTRAL AND EASTERN EUROPE ● ASIA

Latin America		Central and Eastern Europe		Asia	
Argentina	1994	Bulgaria	2002	Kazahstan	1998
Bolivia	1997	Croatia	2002		
Colombia	1994	Estonia	2002		
Costa Rica	2000	Hungary	1998		
Chile	1981	Kosovo	2002		
Ecuador	(*)	Latvia	2001		
El Salvador	1998	Lithuania	(*)		
Mexico	1997	Macedonia	2005		
Nicaragua	(*)	Poland	1999		
Peru	1993	Russian Federation	2003		
Dominican Republic	2003	Slovak Republic	2005		
Uruguay	1995	Ukraine	(*)		

MOLDOVA

The year given correspond in each case to the beginning of operations of the mandatory pension system.

* Reform in process of implementation.

Izmayil

INTERNATIONAL FEDERATION OF PENSION FUND ADMINISTRATORS

RUMANIA

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