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Evolution of supplementary old-age pension systems in selected CEE countries

Introduction

Old-age pension systems of Central and Eastern Europe have been intensely reformed since the end of the twentieth century. The parametric or systemic changes in retirement provision were highly necessary due to aging population and huge budget burdens caused by rising pension expenditures. Having adopted the World Bank old-age pension model [*Averting the Old Age Crisis*, 1994, p. 15–16], multi-pillar pension systems were introduced with both mandatory and voluntary elements of retirement provision. The former ones were substantially corrected by reducing the generosity of PAYG systems and introducing the funded financing while the latter were created from scratch to supply future pensioners with additional old-age income.

Despite that CEE countries implemented rather modern pension mechanisms in mandatory part of their pension systems, the literature regarding the shape and development of CEE pension systems is rather scarce. Only some international bodies (OECD, World Bank) make an effort every two or three years to collect some data and present them in more or less comparative analysis [*Pensions at a Glance 2015. OECD and G20 Indicators*, 2015; *OECD Pension Outlook 2014*, 2014; Holzmann & Guven, 2009]. Detailed and comparable data on supplementary pension systems are hardly available mainly due to different structure of old-age pension systems and various pension taxonomy employed. Even when supplementary pension systems are covered by the conducted analysis, they are usually put together with mandatory funded elements of retirement provision that belong to the basic part of pension systems [*OECD Private Pensions Outlook 2008*, 2008, p. 31–41].

The aim of the article is to analyse the supplementary old-age pension system's landscape in selected countries of Central and Eastern Europe, namely: Bulgaria, Czech Republic, Poland, Romania and Slovakia.

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Starting with the origins and the general architecture of supplementary parts of pension systems in CEE, information on their coverage, financial vehicles, tax incentives, fees and forms of benefits will be presented in detail. This comparative description will create a kind of a map encompassing variety of third pillar pension plans in that part of Europe. Finally, some problems and challenges facing the systems will be discussed bringing about some proposals for further amendments to CEE supplementary old-age pension systems. While preparing this article the following research methods were employed: literature method, descriptive method and comparative analysis method based on available statistical data.

1. Architecture of supplementary old-age pension systems in CEE countries

Old-age pension systems of Bulgaria, Czech Republic, Poland, Romania and Slovakia consist of three pillars according to the first multi-pillar pension model proposed by the World Bank [*Averting the Old Age Crisis*, 1994, p. 15–16]. The first pillar is a PAYG system based on defined benefit or defined contribution formula. The second one was[1] mandatory, funded and consisting of pension funds managed by pension societies. Finally, the third element embraces occupational and individual pension plans that are voluntary and funded.

The introduction of supplementary old-age pension provision resulted from decreasing adequacy of basic pensions offered from statutory pension systems. After reforms conducted at the end of the 20th century in the Czech Republic, Slovakia and Poland, the retired may expect benefits that replace only 49%, 61,2% and 43,1%[2] of their previous income respectively [*Pensions at a Glance 2015*, 2015, p. 139]. The systemic and parametric reforms in basic retirement provision reduced the redistribution transfers and increased exposure of the insured to old-age risk. Participants of the new (reformed) systems were given more power to act on the pension market, both mandatory and supplementary, but for the price of higher risk exposure and larger responsibility for retirement decisions.

The first country from CEE that implemented supplementary elements of old-age pension system was the Czech Republic (1994). Few

[1] Almost all countries of the CEE region retreated from mandatory funded pension systems and made them voluntary but still connected with mandatory contribution. The insured can partially opt-out form PAYG system by transferring part of the mandatory contribution to a pension fund (f.ex. in Poland).

[2] Gross replacement rates for an individual earning 100% of an average wage.

years later it was followed by Slovakia (1996), Poland (1999), Bulgaria (2002) and Romania (2007). In case of Poland, the third pillar was substantially broadened twice in 2004 and 2012 (Table 1).

Table 1. Elements of supplementary old-age pension systems in Bulgaria, Czech Republic, Poland, Romania and Slovakia

Country	Year of Introduction	Main features of the system
Bulgaria	2002	Voluntary supplementary pension funds Voluntary professional pension funds
Czech Republic	1994 2013	Supplementary Pension Savings and Insurance Transformed Funds Supplementary Pension Savings Schemes
Poland	1999 2004 2012	Occupational pension programmes (PPE) Individual Retirement Accounts (IKE) Individual Retirement Savings Accounts (IKZE)
Romania	2007	Voluntary private pensions
Slovakia	1996	Voluntary private pensions

Source: Own collaboration based on [Allgayer et al., 2016, p. 79–86, 249, 276, 301; Betty and Hailichova, 2012, p. 227; *Report on Financial Market Developments in 2015*, 2016, p. 64].

Old-age provision offering additional income at retirement, operates in form of a voluntary occupational pension fund (Bulgaria, Poland) or a voluntary individual pension plan (Bulgaria, Czech Republic, Poland, Romania and Slovakia). Depending on the type of a plan, the contribution may be paid in by an employee, an employer or by both parties. To curb the operating costs there are some minimum levels of participants (Slovakia) and maximum levels of contribution implied in pension law.

Governments often encourage individuals and their employers to participate in the third pillar by tax incentives at the stage of paying contributions or benefit withdrawal (Table 2). In the analysed systems, payments made by employers are usually deducted from the tax base of the company and reduce corporate income tax (CIT).[3] Contributions paid by employers are generally free of income tax for employees (except for Poland) and thus bring about double fiscal benefit. Employee's contributions

[3] Deductions are limited, if there is a cap on employer's contribution.

up to a certain amount are exempt from tax (except for PPE and IKE in Poland). Limits may be expressed in fixed quota (a quota limit) or represent the percentage of an employee's annual wages. Both types are equally popular in analysed countries.

Table 2. Fiscal incentives implemented in supplementary pension plans in selected CEE countries

Country	Tax Regime	Main features of the incentives
Bulgaria	EEE	Contribution up to 10% of annual salary is tax free, Investment gains and pay-outs are not subject to tax
Czech Republic	EEE	Individual and/or employer's contribution deducted from tax base up to a quota limit, state matching contribution (subsidy), pay-outs free of income tax
Poland	TEE (PPE&IKE) EEpT (IKZE)	IKE&PPE – no capital gains tax IKZE – contribution deducted from tax base up to a quota limit (120% of average monthly wage – the quota limit is the same for all savers), no capital gains tax and reduced income tax when paying benefits
Romania	EET	Contributions are exempt from tax up to the quota limit (15% of annual salary, max. € 400) Employer can deduct from the tax base contribution paid for an employee up to € 400 Investments are free of capital gains tax Benefits are subject to personal income tax
Slovakia	EEpT	Supplementary pensions – contributions are tax free up to € 180 annually (employee's contribution) and 6% of employee's wage (employer contribution), capital gains are exempt from tax at investment stage while pay-outs are partly subject to taxation (deferred capital gains tax)

Source: Own collaboration based on [Allgayer et al., 2016, p. 88–89, 289–290, 312–315; Batty & Hailichova, 2012, p. 228; Rutecka, 2014, p. 18–35].

CEE countries implemented tax regimes that are very generous for the participants and their employers. Almost all of the analysed countries allow contribution deduction from tax base and two of them (Bulgaria and the Czech Republic) do not deduct any tax from pension savings at any moment of participation in the system. Poland (in IKZE) offers reduced tax rate at the pay-out phase, while Slovakia charges only deferred capital gains tax. One country (The Czech Republic) implemented subsidies (state matching contribution) to individual contributions. That makes Czech system the most generous as far as tax regime in CEE supplementary old-age security is concerned, whereas Poland stands at the other end.

2. Pension vehicles and coverage

Financial products used to collect old-age savings are mainly pension funds, both occupational and individual ones (Table 3). In some countries (Czech Republic, Poland and Romania) the significant part of supplementary pension market is covered by life insurance contracts, while in Bulgaria they do not play any important role.

Table 3. Pension vehicles in third pension pillar in CEE countries

Country	Main features of the system
Bulgaria	Pension funds managed by pension insurance companies, Voluntary occupational pension schemes managed by pension fund managers
Czech Republic	Supplementary pension funds and Supplementary pension insurance (transformed funds) managed by pension management companies
Poland	Pension funds managed by pension management companies, Investment funds managed by asset management companies, Unit linked life insurance managed by life insurers, Bank accounts offered by banks, Accounts in brokerage institutions
Romania	Pension funds managed by pension management companies, life insurance companies and asset management companies
Slovakia	Pension funds managed by supplementary pension fund Management Companies

Source: Own collaboration based on [Allgayer et al., 2016, p. 80–86, 250–260, 280–285, 305–310; *Report on Financial Market Developments in 2015*, 2016, p. 63; *Country Profiles: Bulgaria*, 2016].

Having given the savers a lot of freedom to choose the right product option and investment strategy, while offering no guarantees, additional old-age pension savings create an asymmetrical risk sharing in the pension area in all analysed countries. Pure defined contribution formula results in huge exposure to investment risk, inflation risk and risk of inadequate benefits in generally. In fact, all investment and inflation risk in supplementary pension systems in CEE is carried by individual savers. The level of exposure differs depending on the risk-profile of a pension plan and it is substantially lower in conservative pension products (bond funds and bank accounts). No country implemented any guarantee of the investment returns that could reduce some risks for savers[4]. Unlike regulations in the second mandatory funded pillars of pension systems, no minimum returns or assuredness to keep the real value of the accumulated funds are offered in the third supplementary part of the pension security.

Anyone aged 16 or more can contribute to the supplementary pension systems in Bulgaria and Poland. Regulations in other countries state that a saver has to be an adult and a resident of the country. Payments into individual pension plans can be done by savers only (Poland) or by savers and the third party (e.g. employers) on behalf of savers (Bulgaria, Czech Republic, Romania, Slovakia). Contribution to voluntary occupational programmes is generally financed by employers but in some systems (e.g. in Poland) an employee can put additional money into his/her pension account.

The coverage depends mostly on the fiscal incentives implemented. Hence the highest participation rate can be observed in Czech Republic (ca. 60%) and Slovakia (35%), [Allgayer et al., 2016, p. 83–86, 301; Molek 2014, p. 178]. In Bulgaria there were only 598 000 accounts existing in voluntary pension funds and 6 802 accounts opened in voluntary professional pension funds at the end of 2015[5]. The coverage in Romania amounts to 3% meaning that only 0,3 million individuals have supplementary pension security, while in Poland the participation rate is 2,4–5,5% depending on the type of a supplementary plan.

[4] Except for no-loss guarantees in transformed funds in the Czech Republic that have been created when supplementary pension insurance was changed into transformed funds. Transform funds do not accept any new members. They invest savings collected in supplementary pension insurance plans.

[5] It amounts to 18,3% and 0,2% of the labour force relatively.

3. Assets under management and investment policies

All the analysed supplementary old-age pension systems have not reached maturity yet. Hence the coverage and assets under management are not at very high levels related to GDP. In Poland there were only PLN 17 billion (€ 3,9 billion) gathered in third pillar at the end of 2015 that represents less than 1% of Polish GDP. The numbers do not look extraordinarily in other countries too. Bulgarian pension plans' assets amounted to BGN 837 million (€ 428 million, less than 0,5% of GDP), while in Romania it was ca. € 277 million (less than 0,1% GDP) at the same time. Higher assets are invested in Slovak and Czech third pillar where pension savings account for € 1,5 billion (ca. 0,9% of GDP) and CZK 349,5 billion (€ 13 billion, ca. 3,7% GDP) respectively [Allgayer et al., 2016, p. 250, 285, 309; *Report on financial market developments in 2015*, 2016, p. 66].

In general, entities that invest pension savings are allowed to manage more than one supplementary pension fund, except for Bulgaria. In Slovakia, there exist two types of plans – contribution funds (conservative, balanced and growth funds) and pay-out funds (conservative only). Romanian pension fund managers are free to allow as many funds as they like, while in the Czech Republic pension managers have to offer conservative funds but may in addition create funds of other risk profiles (balanced and aggressive funds). In Poland financial institutions offer broad variety of savings products with different investment profiles from bank accounts and bond funds to direct investment on financial markets.

Most CEE countries did not implement any or implemented rather soft investment restrictions in their supplementary old-age pensions. Only in Romania voluntary pension funds face the same investment limits as mandatory pension funds (2nd pillar) with only a slightly higher limit on investments in private equity (5%) and commodities (5%) [Allgayer et al., 2016, p. 284].

Due to lack of regulations obliging pension fund managers to disclose gross and net returns on the funds, it is hardly possible to get the comparative data on the efficiency of supplementary pension funds in analysed countries. Some effort to change this situation was made by Better Finance together with European Commission that co-finance the regular assessment of pension savings returns and provide savers with few editions of report on real returns in third pillar in selected European countries [Berthon et al., 2014; Klages and Viver 2015; Allgayer et al., 2016]. Based on data presented in the mentioned analysis one can draw a conclu-

sion that the low attractiveness of supplementary pension savings in most CEE countries may be also attributed to rather unsatisfactory investment real results ranging annually from –0.5% in Bulgaria to some 2.66% in Romania for the period 2002–2015 and 2007–20015 respectively. In Slovakia supplementary pension funds brought only 0,2% real return on annual basis in years 2009–2015. Polish employee pension funds stood out offering substantially positive real returns that amounted to 4,12% annually in the period 2002–2015. Moreover, highly extraordinary real returns were also worked out in Poland by voluntary pension funds managed by pension societies among which the best achieved up to 22% real return in years 2013–2015 on an annual basis. [Allgayer et al., 2016, p. 42–43, 271–272].

4. Charges

Despite not making a lot of money for pension savers in most CEE countries, financial institutions charge several types of fees on regular basis (Table 4). In general, institutions managing old-age pension savings may deduct an up-front fee from a contribution paid into plan (except for Slovakia), the management fee from assets under management and a transfer fee in case of early cancellation of the contract[6].

Table 4. Limits of fees charged by supplementary pension plans providers

	Bulgaria	Poland	Romania	Slovakia
Up-front fee	max. 7% + an account opening fee BGN 10.00	No limits set by law	max. 5%	–
Management fee	up to 10%*	No statutory limit, in fact up to 4% AuM, success fee exists in some products	up to 2.4% AuM	Max. 1.1% AuM (contributory funds) Max. 0.8% AuM (payout funds) +10% success fee (contributory funds only), HWM principle

[6] Data on transaction fees is not available.

	Bulgaria	Poland	Romania	Slovakia
Transfer fee	BGN 20.00 (in the first year only)	No statutory limit, (in the first year only)	Max. 5% of AuM (in first two years only)	Max. 5% of AuM (in the first year only)

Notes: AuM – Assets under management, HWM – High-Water Mark
*10% of the positive nominal return.
Source: Own collaboration and [Allgayer et al., 2016, p. 87–88, 262–265, 286–289, 310–312].

An up-front fee diminishes payments made into pension accounts in Bulgaria, Romania and in some financial products offered in Poland. The limits of possible contribution's deductions are relatively high, especially when taking into consideration characteristics and risk profiles of financial products offered. In Poland an up-front fee appears in insurance products, while it is rather rare in investment funds or bank accounts. No official statistics are available for the Czech Republic regarding any type of the costs charged by financial institutions operating in the supplementary old-age provision.

Management fees are charged both at a fix percentage rate of assets under management (Poland, Romania, Slovakia) and as a fraction on excessive positive returns (Bulgaria, Poland and Slovakia). Due to lack of limits set by law, the fixed management fee is especially high in some aggressive pension funds in Poland (up to 4%). Bulgarian and Slovak supplementary savings are more charged when investments bring profit and it somehow protects the pension pots from excessive costliness in the times of decreasing asset prices, especially when success fee operates in accordance with High-Water Mark principle (Slovakia). But in spite of these conditional and flexible elements built in some management fees, the cost of management consumes considerable share of generated investment returns.

Transfer fee (cancellation fee) has to be paid to a financial institution when a saver changes the financial institution and transfers money to another one soon after concluding a contract. The fee is charged when savings are transferred more frequently than after a year (Bulgaria, Poland, Slovakia) or two years since signing the pension contract (Romania). In some countries (Bulgaria) administrative charges (including transfer fee) are paid out of the pocket and hence they do not diminish the assets gathered in pension pot.

Conclusion

All the analysed supplementary old-age pension systems operate relatively short compared to additional old-age pension plans functioning in Western Europe. However, after twenty years of operation, it is possible to assess the introduction phase and to point out both important achievements and unplanned failures of the supplementary pension security. Moreover, it seems also viable to describe some challenges that third pillars in CEE will face in the coming years and decades.

Undoubtedly, at the time of their implementation, funded pensions were perceived as kind of a novelty in CEE countries that used to calculate pensions on a defined benefit formula (DB) and finance them by Pay-As-You-Go (PAYG) mechanism. Participants were attracted by higher fairness of new pension formulae and the promised ownership of funds collected in their individual accounts. The mandatory funded pensions were created as an element of the basic old-age security while third pillars were created to supplement pension benefits to an adequate level. Reforms created a new environment for individual savers to invest on financial markets, to develop financial knowledge and financial literacy by making pension decisions. Basic foundations for social trust to financial markets were also built then.

Statutory funded pensions (the so called 2nd pillar) covered rapidly the majority of the insured population (except for the Czech Republic where mandatory pension funds have not been successfully implemented) in first months and years after their introduction. The supplementary pensions were growing not so quickly and only in one country (the Czech Republic) covered more than half of the working population. Apart from Slovak individual pension plans, third pillars are very weak and came into stagnation even though some fiscal effort has been undertaken to make them grow. Hence the biggest failure is an insufficient coverage.

Generous fiscal incentives may influence the coverage in relatively short and medium term as they did in Slovakia and the Czech Republic. But vast coverage does not guarantee adequate benefits when only small amounts of contributions are put into pension accounts. E.g. in the Czech Republic an average contribution amounts to less than 2% of the average wage. Limited tax deductions and state subsidies forced people to save mostly only up to the sum that offers them a full state subsidy and tax relief [Molek, 2014, p. 180]. As a result, high coverage coincides with low as-

sets under management in this country. In other countries, low coverage coexists with the low average pension account balance.

The analysis of the results of fiscal incentives offered in voluntary pension systems in CEE revealed also an unintentional reallocation effect[7] observed for example in Poland, where 90% of contributions paid into individual retirement savings accounts came from the best earning 20% of the population [Rutecka, 2014, p. 34–35]. Moreover, supplementary pension systems failed to attract relatively young participants who may benefit the most from deferred tax and compound interest rate[8]. That weak popularity among individuals cannot be compensated by employers' contributions that are paid only to limited number of funds. In the Czech Republic employers' contributions are paid into ca. 20% of third pillar accounts which constitutes the highest percentage among the analysed countries. [*Report on financial market development in 2015*, 2016, p. 68; Rutecka, 2014, p. 80].

Having observed the poor investment performance and unreasonably high fees on supplementary pension market, some governments have decided to revise the mechanism built in the pension vehicles. The main changes include cutting management fees and making them dependent on investment results. Until 2020, Slovakia will duly reduce the management fee limit to 0.4% of assets under management in conservative funds and 0.8% in other funds. Also Bulgaria implemented first regulations to cut up-front and management fees in pension funds. Firstly, the universal pension funds were influenced by this regulations, making their management fees decrease from 1% to 0.75% of assets under management until 2019 (an upfront fee is to be reduced to 3.75% in the same period), [Allgayer et al., 2016, p. 88]. In the next step, voluntary part of the system may be taken into consideration and it could bring about higher profitability for savers. Other countries may follow, after conducting thorough research on the situation on their supplementary pension markets.

After few years of unsatisfactory rates of returns resulting from conservative investment strategy, some countries started discussion about implementing multi-funds that could better meet the needs of people being 20–30 years before retirement. It was Bulgaria which noticed that if

[7] Reallocation effects appear when supplementary pension savings come from transfers from other saving products and not as a result of consumption reduction.

[8] In the Czech Republic 57% of savers are aged 60+ [*Report on financial market developments in 2015*, 2016, p. 68].

nothing changes, the insured will continue to pay contributions that in aggregate terms shall overweight the benefits at retirement[9]. In the environment of high and mostly fixed fees charged by financial institutions, higher returns achieved by more aggressive funds (connected with higher investment risk) are necessary to defend real value of pension pots. The solution could be also implementation of contribution funds and pay-out funds that differ in terms of investment policy similarly to regulations introduced in Slovakia. But in the accumulation phase savers still need pension funds with various risk profiles (conservative, balance, aggressive) to fit best their needs.

Together with implementing pension funds of different risk profiles, some parallel educational activities are of utmost importance. Savers must acquire knowledge on how to behave on financial markets, when to change a financial institution or when to choose more conservative pension vehicle, especially when they have only few years left to retirement. Undoubtedly, education should bring about positive results for the whole generations of savers but the significant development in financial literacy should be expected in decades not years afterwards.

Last but not least problem of supplementary old-age pension provision is that it lost social trust after politicians had started to ruin mandatory funded elements of old-age security. In fact, in recent years almost all analysed countries partly retreated from the reforms implemented in the 90's of the XX century and transferred money from funded to unfunded pillars due to state budget deficits. Poland was the first to reduce the contribution rate to second pillar directing more money into PAYG element and few years later made open pension funds (OFE) voluntary (since 2014). The same happened in Slovakia in 2012 and in 2015 in Bulgaria where the insured have been given a choice whether to split a mandatory old-age pension contribution between first and second pillar or to participate only in the PAYG system [Allgayer et al., 2016, p. 80, 303]. Finally. The Czech Republic joined the group that decided to terminate the second pillar reform (pension savings system) introduced in 2013 and instead encouraged its population to gather pension savings in supplementary products [Jahoda, 2015, p. 3].

Undermined trust needs huge and long term efforts to recover. If no changes are made in public information about old-age pension mecha-

9 Due to inappropriate investment policy and excessive fees.

nisms and participation rules, the disoriented and misled insured may not be willing to reduce consumption and save for retirement. Such a negative scenario resulting in long-term dysfunction of supplementary pension systems is highly feasible if no clear and true record of funded pension systems operation is disclosed. Understandable and comparable information on pension vehicles offered on pension markets would be a milestone in the development of supplementary old-age provision in CEE countries.

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Summary

The article analyses the supplementary old-age pension system's landscape in selected countries of Central and Eastern Europe, namely: Bulgaria, Czech Republic, Poland, Romania and Slovakia. Starting with the origins and the general architecture of supplementary parts of pension systems in CEE, information on their coverage, financial vehicles, tax incentives, fees and forms of benefits will be presented in detail. This comparative description will create a kind of a map encompassing the variety of third pillar pension plans in that part of Europe. Finally, some problems and challenges facing the systems will be discussed bringing about some information on expected amendments to CEE supplementary old-age pension systems.

Keywords

old-age pensions, supplementary pension plans, individual pension plans, retirement accounts, occupational pension plans