PENSION FUNDS AND THE FINANCIAL CRISIS IN THE CEE COUNTRIES

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In this paper, the authors analyze the influence of the international financial crisis on the current architecture of the CEE pension systems and their further reforms. As a consequence of the financial crisis, the very fragile pension reform has been subject of debate in the new member states of European Union, given their deep recession and registered fiscal deficits. In many of the CEE countries, which have adopted/developed later the second pillar, the financial crisis has raised questions in what concerns the benefit of moving to a mixed pension system, in comparison with the former one, which relied exclusively on public pay-as-you-go schemes. The current literature analyses the situation in each of the CEE countries, but does not make an overall analysis of the situation of the CEE countries, member of the European Union. The authors show the short-term negative effects of the financial crisis on the pension reform in these countries, but also the longer run effects, on the continuing deteriorating finances of these pension systems, in the context of the aging of population and unsustainable pension schemes. Alongside reviewing and commenting the national authorities’ responses to the financial crisis, we are proposing also some measures meant to enhance the further pension system reform and to improve the performance of the private pension funds. Pensions have a long-time horizon and it would be very wrong to produce a reversal of the past reforms since the main problems of adequacy and sustainability remain vivid (demographic challenge and population aging). It is also true though that, while shifting from an exclusively public pay-as-you-go system towards a mixed pension system, especially in times of financial crisis, authorities must pay increased attention to the management and supervision of the DC pension plans, to the risk management standards and regulations of the private pension funds, alongside other measures meant to enhance further pension system reform.

Keywords: financial crisis, pension funds, CEE countries, reform, pillars  
JEL codes: G01,G23, H55

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1. Introduction
As a consequence of the financial crisis, the very fragile pension reform has been subject of debate in the new member states of European Union, given their deep recession and registered fiscal deficits. The main benefits that a functional reformed pension system was promising to bring are exactly the reasons why this reform is under critique nowadays (instead of a reduced public burden we have a public debt that reaches worrying levels, instead of attractive returns, translated into higher benefits for the pensioners, we have lower returns due to the collapse of financial markets and the economic conditions in general). The paper makes an analysis of the influence of the international financial crisis on the reform of the pension system, analyzing the measures taken by national authorities as response to the financial crisis and outlining some concrete measures for supporting the future reform of the pension system.
The paper is organized as follows. Section 2 describes the manner in which the financial crisis can exert negative influence on the pension system, analyzing the determinants that can trigger a larger impact of the financial crisis on the pension reform, in the case of the considered CEE countries. Section 3 makes a short review of the national authorities’ responses to the financial crisis in what concerns the pension policy. Section 4 concludes, outlining the reasons for further pension reform, considering also some valuable lessons that need to be learned from the financial crisis and proposing some measures in order to support pension reform.

2. Channels through which the financial crisis exerts negative influence on the pension system

The financial crisis which occurred in the second half of 2008 generated worries among the beneficiaries of the pension systems. This was a normal reaction, taking into consideration the fact that, beginning with 1998 (when the first CEE country, Hungary, implemented the 2nd pillar), millions of people have directed a part of their social security contributions towards private pension funds, which have invested their savings on financial markets, deeply affected by the crisis. Without any doubt though, there were individuals more affected by the crisis than others. This was probably caused by the following three issues: a) whether in the country of reference was implemented a minimum social pension or there were guarantees in the architecture of the private pension system; b) the importance of the second pillar in the economy; c) the existence of some limits concerning the structure of the investments made by pension funds.

As far as concerns the first factor of influence, the CEE considered countries were somehow protected, since they all have established a minimum social pension, still with differences regarding the assurance of a performance guarantee in the private pension provision. Some of the countries have established: *minimum relative guarantees*, computed in function of the performance rates obtained by different type of pension funds (conservative, balanced and growth funds) in a certain period, usually two or three years (Slovakia, Romania, Bulgaria, Poland) or in function of the interest rate for long-term state bonds (Slovenia); *minimum absolute guarantees*, which are designed to guarantee the net contributions of participants (Romania, Slovakia) or to ensure a positive performance rate and in case of failure, covering from the reserve fund of each pension fund (Czech republic- for the third pillar); *no performance guarantees* (Estonia, Hungary, Latvia, Lithuania).

Regarding the importance of the second pillar in the architecture of the pension system, it can be assumed that those countries which very developed second pillars would be harder hit by the financial crisis than the other ones, which are not depending on the dynamics of the financial markets.

**Table no. 1:** The importance of the 2nd Pillar in the pension system (2010)

<table>
<thead>
<tr>
<th>Contribution (% gross income)</th>
<th>BG</th>
<th>CZ</th>
<th>HU</th>
<th>ES</th>
<th>LV</th>
<th>L1</th>
<th>PL</th>
<th>RO</th>
<th>SK</th>
<th>SL</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd Pillar; 3(from 2013)</td>
<td>8</td>
<td>4</td>
<td>5.5</td>
<td>7.3</td>
<td>2.5</td>
<td>9</td>
<td>No 2nd Pillar; DC mandatory occupational pensions for some sectors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size (% GDP)</td>
<td>3.97</td>
<td>5.5</td>
<td>10.34</td>
<td>6.88</td>
<td>5.36</td>
<td>3.55</td>
<td>14.11</td>
<td>0.49</td>
<td>4.58</td>
<td>3.15</td>
</tr>
</tbody>
</table>

Source: realized by authors, data supplied by ISSA, web pages of national commissions of surveillance of the private pension systems

We can see that, as far as concerns the CEE countries, the second pillar market is at the beginning, fact that diminishes the potential impact of the financial crisis, the second pillar market varying in its importance from 0.49 % of GDP in Romania to 14.11 % of GDP in Poland
brought through a recovery, not reaching yet though the pre-brought through a recovery, not reaching yet though loss of more than 30% in Estonia to a loss of only 10.5% in Slovakia. Hence the impact of the crisis on pension funds was felt differently in the CEE countries, from a loss of more than 30% in Estonia to a loss of only 10.5% in Slovakia. The following years have brought though a recovery, not reaching yet though the pre-crisis level.

When a financial crisis occurs, it often produces a devaluation of the accumulated funds (European Commission, 2010). Though, the extent of the devaluation is depending strongly on the pension scheme which private pension funds may apply. A growth fund, with an aggressive investment policy, which rather places their assets in shares than in bonds, is likely to be more affected by a financial crisis. In all CEE countries, 2008 was a year of adverse capital market performance, translated into negative real returns for the private pension funds (Figure no. 2). Hence the impact of the crisis on pension funds was felt different in the CEE countries, from a loss of more than 30% in Estonia to a loss of only 10.5% in Slovakia. The following years have brought though a recovery, not reaching yet though the pre-crisis level.

Figure no. 1: Pension funds’ asset allocation for investment in CEE countries (2010)
Source: realized by authors, data provided by OECD Global pension statistics

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The decline in the rate of returns was more difficult for those individuals at retirement age. Fortunately, in the CEE countries, the second pillar was introduced only recently, and excluded older employees, hence very few individuals are currently retiring with benefits from the private pension funds. If we consider the oldest second pillar countries in the region (Hungary, followed by Poland), only new entrants in the working field were obliged to join the second pillar, for the others it was voluntary. Moreover, due to the financial crisis, Hungary has allowed the return of those individuals older than 51 in 2008 to the public system, resulting even fewer employees in this situation.

Regardless the magnitude of the influence of the financial crisis upon the pension systems in some countries, it remains clear that it had a negative impact on both pension pillars. Given the volatile nature of the investments made by private pension funds, the second pillar was more affected given the financial risk at which financial markets are exposed. Although less affected, the first pillar was also negatively influenced by the financial crisis, once with the reduction of the aggregate national income, since it relies on the principle that the current generation of employees pays for the current generation of pensioners. The national income experienced a dramatic fall in almost every CEE country, which lasted till 2011.

3. Pension policy responses to the financial crisis in the CEE countries

In many of the CEE countries which have developed later the 2nd pillar, the financial crisis has raised questions in what concerns the benefit of moving to a mixed pension system, in comparison with the former one, which relied exclusively on public PAYG schemes. Some of them have even taken some concrete actions in this respect. Some of them have modified the overall contribution rate. Some increased it in order to alleviate the fiscal deficit (Romania), others have reduced it, with the aim of fostering the employment and incomes (Bulgaria). Some countries have frozen or adjusted differently in comparison with the prior calendar the 2nd Pillar contribution rate (Estonia, Lithuania, Latvia, Romania, Estonia). Even more radical measures have been taken by some CEE countries, allowing individuals to switch back to the old system, getting out of the 2nd Pillar (Hungary, Slovakia) or making the 2nd pillar voluntary to new entrants on the labor market (Slovakia). Finally, some have taken some measures in order to prevent early retirement (Hungary, Poland, Latvia) or they increase the retirement age (Hungary, Romania, Poland). A more detailed view of all these measures is described below (Table no. 2).
<table>
<thead>
<tr>
<th>Country</th>
<th>Measures</th>
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| **BG** | - The government reduced the overall contribution rate to the pension system from 23% to 21% in 2010 (1.1 % for the employer and 0.9 % for the employee) and then gradually to 18% by 2013;  
- From 2012, the years of service for retirement will increase with four months per year. |
| **CZ** | - Delaying the introduction of the 2nd Pillar: 1st January 2013. |
| **HU** | - The government allowed the return from the private to public pillar during 2009 for those who are older than 51 at the end of 2008;  
- Elimination of 13th month pension;  
- In the future, the pension growth will be established according to an algorithm depending on the GDP growth as follows: GDP growth < 3%, 100% inflation; GDP growth between 3-4%, 20% wages, 80% inflation; GDP growth between 4-5%, 40% wages, 60% inflation; GDP growth >5%, Swiss indexation;  
- Increase in retirement age from 57 to 62 years in 2010 and to 65 by 2012;  
- Increase in penalties for early retirement and giving bonuses for delayed retirement. |
| **ES** | - The contribution to the pension funds comprised in 2009 6 % of the gross income (2 % from the part of the employee + 4 % from the part of the state). The Estonian government has then diverted its 2nd pillar contributions (of 4%) to 1st pillar for two years (2009 and 2010); In 2011 there was a moving back to a 2% contribution to the 2nd Pillar, that is expected to rose gradually at 4% in 2012, with the possibility of higher 2nd pillar contributions of 6% in the period 2014-2017. |
| **LV** | - Contribution rates to the 2nd pillar reduced from 8% to 2% in May 2009; increasing to 4% in January 2010 and to 6% in January 2011 and remaining at this level (2nd pillar contribution rate was to rise to 10% in 2010 prior to the amendment)  
- First pillar benefits cut  
- Reduction of early retirement pensions from 80% of normal retirement pension, to 50% of normal retirement pension.  
- Early retirement will no longer be an option from January 1, 2012 |
| **LI** | - Reduced the contribution rate to 2nd pillar from 5.5 % to 3 % in 2011 for two years. In 2011, compensation will take place by raising the contribution to 6 %.  
- The overall contribution rate was increased by 2% starting in January 2010.  
- Benefits cuts – all state-pensions were recalculated from 1st January 2010. |
| **PL** | - The government took the decision of reducing the contribution rate to the private mandatory pension funds in January 2011, from 7.3 % to 2.5 % (although with the possibility of rising the contribution to 3.5 % in the near future).  
- Elimination of numerous early retirement schemes (previously available to some 1 million people) .  
- Increase in retirement age for men and women to 67 by 2030 |
| **RO** | - The overall rate contribution increased from 27.5% in 2008 to 31.3% in 2009, remaining stable in the present period.  
- Although the contribution rate to the 2nd pillar should have experienced an increase of 0.5 %, from 2 % in 2008 to 2.5 % in 2009, the level was frozen at 2% in 2009; the increase was realized only in 2010 (to 2.5 %) and then in 2011 (to 3 % of the gross income).  
- Equalizing gradually the retirement age of women with men at 65:  
  - in 2011-2015, for women from 59 to 60 and for men from 64 to 65;  
  - from 2016-2030, for women till 65.  
- Elimination of special pension schemes, integrating them in a public pension system and prohibition of early retirement for a period of 6 months (from July 2010 to 1st January 2011) |
| **SK** | - From a new defined-contribution scheme, the workers have been allowed to switch to the public system, having two options for this: January –June 2008 and November 2008 – June 2009; As far as concerns the 2nd Pillar participation for new participants, it was made voluntary as of January 2008. |
4. Conclusions
Although the global financial crisis has generated difficult moments for all CEE countries, its influence pales in comparison with the “demographic time-bomb”. Like Börsch-Supan (2009) observes, while the financial crisis is just one crisis among others, a century event, population aging is not just a phase; it will not go away, not even after the baby boom generation after 2050. We believe that all these actions are short-term solutions taken by the authorities in order to alleviate the budget tensions, but the reform of the pension system must be continued. The architecture of the pension systems is thought on a long run basis, hence taking these actions to avoid immediate circumstances can have negative long-term effects on the system. While the financial crisis is decreasing in its intensity, the current problems of adequacy and sustainability of the pension systems remain. Like Jarrett (2011) pointed out, trying to solve the problem of public finance sustainability by radically shrinking the 2nd tier of the pension system has obvious costs in terms of poverty among old-age pensioners. Their benefits will be considerably lower than the ones of working age and their confidence in the multi-pillar system would be strongly affected.

Moreover, some other valuable lessons learned from the financial crisis involve:
- Multi-pillar systems, in which private pension provision has a greater economic significance, are more exposed to financial turmoil, but they represent a necessity;
- The transition from DB to DC pension plan is a must, but since it brings a shift for the risk from employer towards individuals, a special attention must be paid to the management and supervision of the DC pension plans;
- Better regulation, increased transparency is required, allowing future pensioners to know precisely which is the investment strategy, which is their risk and their expected rate of return;
- Establishing a public-private campaign, to restore people’s faith in private pension funds and to increase their financial education;
- Establishing the right balance between public and private tiers, in order to guarantee minimum retirement income; like Chybalski (2009) points out, “it appears that in the post communist countries, whose populations still have a low propensity to save, and in any case have much less opportunity to save voluntarily than in Western Europe due to their level of earnings; the pensions system must be based on compulsory pension cover, in order to prevent the “free riders” phenomenon”;
- Allowing private pension funds to invest abroad and benefit from the portfolio diversification;
- Increasing further the retirement age, up to 70, equalize it across the two sexes to deal with the long-run demographic threat, reduce access to early retirement;
- Complementing pension reforms with labor market reforms (giving incentives for actively looking for a job, re-entering the working field after maternity leave, hiring elderly).

References