Managing the risks of 2nd pillar pension schemes; the situation in the former Yugoslavia and Albania

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1. Subject matter, purpose and structure of the report

During the transition period, most countries in central and eastern Europe introduced major changes to their pension systems. These reforms not only brought about adjustments in the pre-existing pay-as-you-go-systems (PAYG), but also the introduction of funded pension schemes, as well as the emergence of an array of voluntary pension arrangements.

In the countries/territories under investigation various reform paths have been chosen. Croatia, Macedonia and Kosovo all introduced mandatory funded pension schemes as part of a multi pillar pension system. These schemes are referred to as second pillar pension schemes. In Macedonia the new system became fully operational in 2007. In Croatia en Kosovo the new system entered into force in 2002 and 2003.

Serbia and Montenegro do not contemplate the introduction of a funded system as part of a multi pillar system in the near future. It is felt that the poor economic outlook and the unfavourable standard of living of the people in these countries do not allow for such a change.

Albania introduced a new pension system in 1993 as part of a new comprehensive social insurance scheme. The system operates on the pay-as-you-go principle and offers a mix of compulsory, voluntary and supplementary pensions. However, the pension system is under much strain and it is reported that the Albanian government will take a decision in this year as to introduction of a second pillar pension.

Funded pension systems offer all sorts of advantages compared to systems which are solely based upon the pay-as-you-go-principle The financial burden is shifted to another generation and funded systems include the promise of higher replacement rates. But there also certain flaws attached to second pillar pensions. For example, the levels of benefit are dependent upon the return of investments which may not always be prosperous and which may fluctuate, giving rise to differences in entitlements, not only in time but also between funds. Unless the state imposes a strict regulatory regime, individuals may be exposed to high risks.

This report focuses upon the disadvantages of a mandatory second pillar system and the way these can be addressed. The instructions for this report as presented by the Cards/Sisp programme read as follows:

One has to be attentive to the issue raised by compelling people to choose (possibly without good knowledge) and their choice resulting in substantially different outcomes. Are there guarantees to be built in or even equalisation mechanisms? In so far people have a *choice* as to the pension institution to take care of their compulsory second (and sometime also first plus pillar), it would be interesting to see what is guiding their choice. Freedom of choice without good information is indeed a game of chance. Should social security force people to gamble? What information should in any case be provided? What are the best practices to be followed?"

The implementation of funding systems also relies on optimism of the insured people about the rate of return and adjustment may need to be made in the future for example by raising the contribution rate. What commitments can a state take up in this respect? The success of funding systems is also tightly linked with the growth of the economy, fiscal stability, and needs to be managed by an efficient administration system with a close supervision of the state which will have, in case of financial crisis, to guarantee a minimum amount of pension benefits in order to avoid social crisis.

The foregoing instructions suggest a normative approach. If the state makes the payment of contributions for a second pillar pension obligatory, it should at least offer some guarantees that the system is transparent for the citizens, that it is managed properly and that the risk of failing returns on investments is minimized. The purpose of this report is to investigate to what extent pension systems of the countries involved live up to this standard.

In paragraph two the above normative proposition will be worked out from a theoretical point of view. What are the recognized disadvantages of a funded pension system and to what extend must the state be held responsible for addressing these disadvantages? The paragraph concludes with a summary of general standards that states should take into account when introducing mandatory second pillar pensions.

Paragraph three deals with the questions regarding the extent to which the newly introduced pension schemes in the countries involved live up to the standards formulated in the previous paragraph.

Finally, paragraph four contains a summary and some recommendations for the countries involved.

The country analysis contained in the paper is necessarily confined to Croatia, Kosovo and Macedonia, since these are the only countries/territories to have adopted a mandatory second pillar scheme. Unfortunately, insufficient information was available as to the situation in Bosnia and Herzegovina. For this reason I have decided not include these territories. With regard to Croatia and Kosovo I was pleased to find that the pension reforms in these countries/territories have been extensively evaluated by the World Bank; much information (in the English language) is available about the second pillar pension and the quality of the regulatory and supervisory framework. This is (as yet) not the case for Macedonia. The Macedonian conclusions drawn in the report are therefore sketchy and provisional.

The report draws its information from the various reports composed by local and EU experts within the framework of the CARDS-SISP project. These are the so-called Annexes. With regard to the general analysis adopted in the second part, I made use of a number of OECD and World Bank reports, in particular the comprehensive World Bank publication of Robert Holzmann and Richard Hinz, *Old age income support in de 21-ste century, an international perspective of pension systems and reform*, 2005. This report contains a separate chapter on the situation in central and eastern Europe.

2. The role of the state in managing the risks of mandatory second pillar pensions

Defining ' mandatory second pillar pensions'
The term "second pillar" pension scheme is connected to the three pillar model advocated by the World Bank in the report *Averting the old age crisis*, published in 1994. The three pillars consist of:
a. a mandated, unfunded and publicly managed defined benefit system
b. a mandated, funded and privately managed defined contribution system
c. a voluntary retirement system

The multi-pillar system presented in this way is merely a theoretical model. In reality, the design of pension systems is very diversified. It reflects political choices, historical traditions and the specific economic challenges faced by the different countries. Such a situation easily gives rise to conceptual confusion as to the meaning of the concepts: first, second an third pillar schemes. For example in many Western European countries the term second pillar is often associated with the supplementary pension schemes set up under collective labour agreements. In some countries such collective schemes have a semi public character and the affiliation of the employers and employees may be rendered obligatory by law. In other countries the collective schemes are set up on a strictly private basis, while participation is not necessarily obligatory.

In order to avoid misunderstandings, the present report employs the theoretical concept of second pillar pensions, as originally proposed by the World Bank. In other words it refers to schemes, which are
- obligatory for the participants
- based upon the capitalisation method (as opposed to the pay-as-you-go-principle)
- managed by funds which operate under private law
- based upon the defined contribution principle

As we will see below, the recently introduced secondary pillar pensions of the three countries/territories under consideration (Croatia, Kosovo and Macedonia) largely reflect these characteristics.

Disadvantages and shortcomings
The call for second pillar pensions in Central and Eastern Europe is a direct reaction to the shortcomings of pre-existing pay-as-you-go-schemes in the changing economies in this region. During the early transition period all the

countries had to react to pressures arising from a shrinking base of contributions and a growing population of beneficiaries, both of which were the result of contractions in economic activity. Non-compliance exacerbated the problem. Persons are not inclined to pay high contributions when the system fails to deliver the promise of adequate pension entitlements. The story is that of a vicious circle. Once the participation rate starts to diminish, the problem gets even worse until the sustainability of the entire system is called into question.

Second pillar pensions are intended to solve the crisis. These schemes allow individuals to contribute toward their own future pensions payments, so that individual contributions plus any investment gains add up to the future pension payment stream. The promise of higher replacement rates should bring back the confidence in the system, which in turn should have a favourable effect on the participation rate. Another advantage of such a system is that there is no direct dependence on new generations or cohorts being strong enough to finance previous ones. The intrinsic problem that pertains to funded schemes, namely that persons are not financially capable or willing to contribute can be overcome, by making the system mandatory.

While a shift towards a mandatory funded scheme addresses the crisis in the first pillar pension scheme, it also presents a number of problems. Here I will present a general overview of the risks that are frequently referred to in literature.

> <u>The rights of the elderly generations</u>
> The first problem is a transitional one: the funded system will only benefit future generations. This gives rise to the question of how to address the rights of elderly workers and pensioners.
>
> <u>Failing administration</u>
> Without measures to counterbalance the risks, a fully private system of funded pensions, may eventually lead to the creation of inefficient firms, corrupted funds or to the concentration of capital in the hands of a select few. The experiences of some pension funds in the US (Enron) and the UK (Maxwell) are all too well known. A further question is whether a country's financial infrastructure and political economy can live up to the task of introducing second pillar pensions. Not all countries have good experiences in this respect. For example in Poland, the administrative apparatus of the social security institution was unable to deal with a timely transfer of contributions to private pension funds, and a debt to the funds was accumulated. In Hungary, the government reversed the decision to increase the size of the funded pillar and allowed the participants to move back to the pay-as-you-go system, creating uncertainty as to the fiscal liability of government and undermining the credibility of the new system In other words the reform not only requires a strong regulatory capacity but also a stable political and financial infrastructure.

Market failure

As a funded pension scheme accumulates capital, it is possible to invest this capital over a longer period of time, the profits of which can be used for propping up the level op the pensions. By their very nature, market-driven returns will vary from period to period. The result is that the returns of the funded pensions may fall below the expectations. This risk is so much inherent to the second pillar pensions, that it can hardly be perceived as a disadvantage. Nonetheless, the less governments are capable of introducing a sound regulatory and supervisory mechanism, the more the system becomes susceptible to market failures and the more the individual becomes exposed to risks. Without such machinery the risks for the individual may be simply too high. The experiences of many British people who were first encouraged to opt out of the state system scheme in favour of personal pension accounts and who then saw their savings disappear during the collapse of the market after 9/11 tell the story.

Lack of transparency

This issue arises in countries which allow insured persons to choose to affiliate themselves to different private investment funds: on the basis of what criteria do they choose? If the 'clients' are fully dependent upon the information provided by the private funds, which have a commercial interest in attracting their capital, there is the risk that they make the wrong choices on the basis of which their original expectations are not met. Clearly, the Estonian case, where pension funds have reportedly resorted to creative advertisements tricks in order to attract customers, such as the participation in a lottery to win a holiday trip[1], is somewhat disconcerting in this respect.

Managing the risks of mandatory second pillar pension schemes

If the introduction of the mandatory second pillar pension schemes would be allowed to take place without any form of government control, i.e. in a situation of fully fledged privatisation of public pension schemes, all the above risks and disadvantages are likely to occur. It is submitted that such a form of privatisation is therefore contrary to concept of the right to social security as being a fundamental right. This right presupposes a final responsibility of the state towards a properly functioning pension system which gives rise to adequate entitlements that are available for all. Thus the introduction of second pillar pensions must necessarily give rise to a public regulatory mechanism which is capable of managing the risks referred to above.

On the basis of this submission a set of minimal criteria can be developed to which the states must adhere. It is then possible to test whether the countries under consideration comply with these criteria. The minimal requirements are these:

[1] Lauri Leppik, *Success factors in pension reform,* Bratislava, 2004, www.praxis.ee/data/Success_factors_of_the_pension_reform.pdf

a. The introduction of the mandatory second pillar pension schemes must be accompanied by transitional arrangements which take into account the interests of the elderly generation and the existing pensioners. (*standard a: a proper transitional regime*)

b. The state must introduce a regulatory and supervisory mechanism which should oversee and control the governance, accountability, and investment practices of the private actors, with a view to:
   - o minimizing the risks for individuals of market failure
   - o preventing mal practices and failures to comply with obligations vis á vis the beneficiaries (*standard b a proper regulatory and supervisory mechanism*)

c. The state must make sure that the insured persons are objectively informed about the consequences of their choices, for example for specific pension funds or investment arrangements (*standard c: objective information*)

3. The Second pillar pension schemes in Croatia, Kosovo and Macedonia

3.1 The situation in Croatia

The system
A three pillar pension system was introduced through the Pension Insurance Act of 1998 and the law on Mandatory and Voluntary Pension Funds of 1999. The Pension Insurance Act paved the way for a mandatory second pillar pension to supplement the pay-as-you-go burden on the Pension Fund by partly substituting it with a privatised defined contribution system. The new system, which entered into force in 2002, is based upon individual contributions to a private capital account held with a licensed private pension fund.

Standard a: a proper transitional regime
The introduction of the second pillar was accompanied by a balanced transitional regime. At its point of introduction in 2002 all employees under 40 years of age were required to become members of one of the new private pension funds that had been established. For those under 40 years of age participation is compulsory. For those between 40 and 50 years of age at the time of the introduction of the scheme, participation was voluntary, but irrevocable. It follows that those who are 50 years of age and older remain dependent upon the first pillar pension scheme. The extent to which this scheme continues to treat this generation justly has been called into question by a number of pension cuts which occurred during the nineteen-nineties. The cuts, sometimes referred to as the so called ‘pensioners’ debt’, resulted from the fact that between 1993 and 1998 pensions were no longer indexed according to rises in wage levels, but ad hoc to price level changes. As a result, the real value of the pension decline considerably. The cuts have been successfully challenged before the Constitutional Court and the pensioners’ debt was partly reimbursed by the previous government. The present government is reported to be committed to paying back the

remaining debt.[2] On the whole, it can be said that despite (or perhaps rather thanks to) a number of reform measures at the end of the nineteen-nineties, that first pillar system still stands firmly.

Standard 2: a proper regulatory and supervisory mechanism
Private pension funds are regulated by the supervisory Agency for Pension Funds and Insurance (HAGENA), which was established in 2001. HAGENA is responsible for developing the regulations, which will govern the operations of the second and third pillar pension funds, licensing and authorization of the private pension funds, and supervision and monitoring the funds. Seven private pension funds were established in 2001 of which four funds have survived in operation, most of which are at least partially owned by financial institutions of EU Member States. The funds' performance is monitored on a daily basis and there are no current anxieties about the effective operation of the system. The Croatian Pension Reform has been extensively evaluated by the World Bank in 2003.[3] With regard to the regulatory and supervisory framework, the report has highlighted a number of weak points which need further revision and/or close monitoring. The conclusions seems to be that when these elements are properly addressed the framework satisfies the requirements.

Standard c: objective information
An intensive and broad public education and information campaign was an important element of the pension reform in Croatia. Due to the high sensitivity of pension issues and the general distrust of the broad public towards the pension system itself, initial PR efforts during the legislation building process in 1998 was aimed at educating people with regards to the basic concepts of a three-pillar system, explaining the necessity to revise the parameters and downscale the first pillar, and presenting expectations regarding the introduction of the mandatory second pillar. In the first period, the public campaign was oriented towards education about the second pillar and promotion of a funded pension system. From November 2001, the focus was on information about individual account registration processes for mandatory participants and particularly the population between 40 and 50 years of age who could have an option of joining the second pillar. In order to provide them with a tool to make a qualified choice, HAGENA made available and publicized a computer program for calculating expected pension levels in the new system versus the levels in the old system In the period between November 2001 and June 2002 there were almost 90,000 visits to the web site, most of which in order to use the pension calculator. On the basis of the foregoing information derived from the World Bank evaluation of the Croatian Pension Reform[4], it seems that Croatia has lived up to the standard of objective information.

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[2] According to the information contained in the Croation Annexes

[3] Zoran Anusic, Phillip O'Keefe and Sanja Madzarevic-Sujster, *Pension Reform in Croatia,* World Bank, 2003.

[4] Zoran Anusic, Phillip O'Keefe and Sanja Madzarevic-Sujster, *Pension Reform in Croatia,* World Bank, 2003, 37.

3.2 The situation in Kosovo

The system
In 2002 Kosovo introduced an entirely multi pillar system. The first pillar is set along the lines of a social pension. Its introduction became necessary in view of the fact that the former Yugoslavian pensions were not being paid out, one of the reasons being that most of the pension records had been lost during the war. The basic pension provides flat rate benefits to guarantee a minimum standard of living for all Kosovan residents, financed out of the state budget. Entitlement is solely based upon a person's age. The interruption of employment status is not required either. The mandatory second pillar pension is based upon the defined contribution system. There is no choice between different private pension funds. Instead the fund is administered by the Kosovo Pension Saving Trust (KPST). It has seven members, the majority of which are professionals). All contributions are transferred to the Trust, which is responsible for tracking contributions, investing pension assets and arranging for the payment of pensions. All assets are invested abroad. The Trust creates an individual account for each participant, and credits the account accordingly throughout the working life of the participants. At retirement, the balance of funds in an individual's account is to be used to buy an annuity, provided that the accumulated balance is sufficient to meet the minimum threshold. Otherwise, the payment takes place as a lump sum benefit. The savings program was implemented in two phases. In August 2002, contributions became mandatory for employees in the public sector, public enterprises, socially owned enterprises an private enterprises with more than 500 employees. In August 2003, the mandatory component of the program was extended to cover all workers, including the self employed.

Standard a: a proper transitional regime
Due to the unique circumstances in Kosovo which led to the immediate introduction of a first pillar social pension, problems in this sphere do not occur. A prerequisite is that the social pension will continue to deliver adequate minimum pensions in the future. This will largely depend on the available tax resources and future political development.

Standard b: a proper regulatory and supervisory machinery
The Kosovo Pension Savings Trust was created with the sole mandate of administering the saving pension program in the interests of contributors. In order to ensure objectivity and compliance with fiduciary responsibilities KPST was established as an independent trust, with the power to manage and invest funds prudently for participants and free from political interference. At present all four professional board members are filled by foreign experts, while the two representative member positions are filled by domestic experts. A first assessment of the overall governance of KPST indicates that it is soundly administered.[5] The authority to regulate KPST rests with the overall regulator of financial services in Kosovo. This

[5] John Gubbels, David Snelbecker and Lena Zezulin, *The Kosovo pension reform: achievements and lessons*, World Bank, 2005, 34

authority has far ranging powers that allow it to oversee the operation of the Trust to ensure that the interests of the participants are met. The World Bank qualifies the supervisory and regulatory framework of the saving pension program as "strong".[6]

Standard c: objective information
Since Kosovo participants do no have to make any personal choices in the second pillar, this standard is not relevant.

3.3 The situation in Macedonia

The system
In Macedonia pension reform was initiated in 1997 and in 2000 the Pension and Disability Insurance Law was adopted. This reform allowed for the introduction of a mandatory second pillar pension system to supplement the first pillar pensions. The second pillar has only recently become operational. In Macedonia the first and second pillars are strongly integrated. Under the previous pension system, the employer paid 21.2% of each employee's salary to the Fund for Pension and Disability Insurance of Macedonia – PDIF. In the reformed system the same contribution will be paid. In the meanwhile two private pension funds have been established. Employees will be covered by both the PDIF and one of these two private pension funds. The total of 21,2% contribution is divided into two parts: 13,78% will remain in PDIF and 7,42% will be transferred to an individual account in the chosen private pension fund. All those employed after 1 January 2003 are obligated to switch to the two-pillar system. Those who join the two pillar pension system by joining a private pension fund will receive a combined pension from the PDIF and from the accumulated assets from the Pension Fund on their individual account at the time of retirement

Standard a: a proper transitional regime
All persons employed after 1 January 2003 are obligated to switch to the two-pillar system. Those employed before this date will be given the opportunity to choose whether they want to do this or remain in the first pillar system. For those employees who remain in the first pillar pension system, the pension and disability insurance is covered solely by the PDIF, and there will be no changes to the way they built up a pension. The protection of the elderly generation is secured through a general instrument for setting minimum pensions.. The minimum amount of old age pension from compulsory pension and disability pension together with the pension from the second pillar system cannot be lower that the determined average wage of all employees in the previous year. These levels are 41% for beneficiaries with an insurance period of more than 35 years (male) or more than 30 years (female), 38% (30; 25) and 35% (25; 20). If the insured person does not reach these insurance periods, the state subsidizes the rest of the amount.

Standard b: a proper regulatory and supervisory mechanism

[6] John Gubbels, David Snelbecker and Lena Zezulin, *The Kosovo pension reform: achievements and lessons*, World Bank, 2005, 2.

Contrary to Croatia and Kosovo, the strength of the regulatory and supervisory framework has as yet not been evaluated by the World Bank, at least not visibly for the general public. At the time of writing not much information in the English language is available about the specific lay out of the framework. What is clear though is that MAPAS is the agency encharged with the regulation and supervision of the fully funded pension insurance. According to MAPAS the regulatory and supervisory framework is based upon the following principles:

• Complete separation of pension fund assets from the assets of the pension companies that govern these funds

• Clear and strictly defined rules and limitations with regard to the investment of assets

• Government guarantees of an 80% coverage of private pension funds assets in the case of fraud or theft

• Regular supervision of pension system institutions by the Government and high fines for any illegal activities undertaken

Further information as to the quality of the regulation and the implementation of these principles is required in order to be able to conclude that Macedonia satisfies the regulatory and supervisory standard.

Standard c: objective information

This responsibility is fully taken up by MAPAS which seems to run an active public information campaign.

4. Summary and conclusions

In the countries/territories under investigation various reform paths have been chosen. Croatia, Macedonia and Kosovo all introduced mandatory funded pension schemes as part of a multi pillar pension system. These schemes are referred to as second pillar pension schemes. In Macedonia the new system has become fully operational in 2007. In Croatia and Kosovo the new system entered into force in 2002 and 2003. Other countries/territories in the region have not (yet) introduced second pillar pension schemes.

Mandatory second pillar systems offer all sorts of advantages, especially when they are introduced to supplement first pillar pay-as-you-go arrangements. However there are also certain disadvantages. This report focuses on these disadvantages. The first part (paragraph 2) describes the generally recognized weaknesses and formulates three standards to which states must adhere in addressing these.

The weakness are:

- the rights of the elderly generations (not fully included in the second pillar)
- failing administration
- market failure
- lack of transparency

The standards are:

a. The introduction of the mandatory second pillar pension schemes must be accompanied by transitional arrangements which take into account the interests of the elderly generation and the existing pensioners. (*standard a: a proper transitional regime*)
b. The state must introduce a regulatory and supervisory mechanism which should oversee and control the governance, accountability, and investment practices of the private actors, with a view to
    - minimizing the risks for individuals of market failure
    - preventing mal practices and failures to comply with obligations vis a vis the beneficiaries (*standard b a proper regulatory and supervisory mechanism*)
c. The state must make sure that the insured persons are objectively informed about the consequences of their choices, for example for specific pension funds or investment arrangements (*standard c: objective information*)

In the second part (paragraph 3), the second pillar pension systems of Croatia, Kosovo and Macedonia have been tested against the foregoing standards. These are the conclusions:

1. Croatia
    - Standard a: after a period of severe problems in maintaining the levels of the first pillar pensions the situation is now stabilized, promising a reasonable basis for those who cannot fully enjoy second pillar pensions
    - Standard b: the World Bank has evaluated the system and has highlighted a number of weak points which need further revision and/or close monitoring. The conclusions seem to be that when these elements are properly addressed the framework satisfies the requirements
    - Standard c: fully satisfied

2. .Kosovo
    - Standard a: the first pillar social pension offers a safety net for all. A prerequisite is that the social pension will continue to deliver adequate minimum pensions in the future. This will largely depend on the available tax resources and future political development.
    - Standard b: the administration of the Kosovan second pillar is placed in the hands of a professional board. The regulatory and supervisory system is seen as strong.
    - Standard c: not relevant

3. Macedonia
    - Standard a: fully satisfied through a combined first and second pillar minimum pension regime
    - Standard b: there is supervisory and regulatory framework but its quality has not yet been publicly evaluated. More information is needed to draw any conclusions.
    - Standard c: seems to be satisfied.