Allianz International Pensions

What's **happening** in…

May 2016

…Poland?

Struggling with adequacy

Poland was one of the first countries in Central and Eastern Europe to overhaul its monolithic pension system toward a **multi-pillar system**.

Triggered by the adverse economic environment during the financial crisis, the **second pillar has been substantially downsized** in size and scope.

In the medium term, the reform does not compromise the financial sustainability of the pension system, but the issue of **retirement income adequacy** for future retirees has been highlighted.

Additional old-age provision is essential to sustain the living standard during retirement, but voluntary retirement savings are not widespread.

To counteract the low diffusion of retirement savings, a series of policy measures have recently been proposed, including **auto-enrollment in occupational pension schemes**.

Rebuilding trust in the fundamental structure of the pension system is essential to support voluntary retirement savings.

Reforming Polish public pensions: one step forward…

In the early years of economic transition from centrally planned economies, Polish society faced extraordinarily challenging circumstances. The pension system inherited from the communist era was ill-equipped to deal with the outbreak of high and persistent inflation rates after 1990. Backed by strong popular support, an ambitious reform was passed in 1998, moving the pension system from a monolithic, defined benefit (DB) system, toward a multi-pillar system, with a notional defined contribution (NDC) first pillar and a mandatory, privately managed, defined contribution (DC) second pillar. The new system was launched on 1 January 1999 and covered all individuals born from 1949 onwards. Those born before 1949 remained in the old system. In the new system, social security contributions made prior to the reform were split so that two-thirds of them (i.e. 12.22% of the assessment base) were transferred into the NDC scheme, while one-third (i.e. 7.3% of the assessment base) was paid into the DC system, managed by the Open Pension Funds (OPFs). Individuals born between 1949 and 1969 were given the option of choosing between paying their entire contribution into the NDC system or splitting it between the two accounts.

However, measures originally planned to reduce the expenditures in the PAYG scheme to finance the transition to the new system did not survive the parliament debate *(see Box 2)*. On the contrary, pension expenditure is estimated to have increased by around 0.5% of GDP per year between 1999 and 2009 (Chłón-Domińczak and Stańko, 2011).

To complement the benefits received from the mandatory pillars, the 1999 reform also set the legislative framework for supplementary occupational pension plans, so-called Employee Pension Programs (EPPs), providing fiscal advantages for employers. Further blocks have subsequently been added to the pension system in the form of tax-favored individual retirement accounts, namely the IKE and IKZE plans, introduced in 2004 and 2012 respectively *(see Box 1)*.

… and two steps back

Although Poland weathered the storm of the global financial and economic crisis relatively well, public finances have deteriorated since 2007. The tougher fiscal environment has pushed the burden on public finances of pension system transition costs up the agenda. Having entered the crisis with a relatively high level of public debt, and given the existing constitutional constraints on ►

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BOX 1: OCCUPATIONAL AND INDIVIDUAL COMPLEMENTARY PENSION SCHEMES AT A GLANCE

Employee Pension Programs (EPPs)

EPPs are funded DC schemes which can be offered in three forms:
- Group unit-linked insurances
- Employer agreements with investment in an investment fund
- Closed funds set up and managed by a company for their employees (Employee Pension Funds)

It is the employer's choice as to whether they set up an EPP. The only conditions for eligibility are an employee's tenure, and the fact that at least half of a company's employees must be eligible. If set up, employers must contribute to the plan, whereas the employee's contribution is voluntary. Employers can deduct up to 7% of their EPP contributions from the base salary for the payment of first-pillar social security contributions. Employees pay income tax on the employer contribution, and benefits are not taxable. Withdrawals are allowed from the age of 60, or 55 if pension entitlements are obtained earlier. There is no obligation on how the capital is paid out (lump sum or an income drawdown).

Individual retirement accounts (IKEs and IKZEs)

Both IKEs and IKZEs are available as mutual funds, life insurances, brokerage accounts, bank accounts or voluntary pension funds. The two schemes have different tax advantages: while contributions to IKEs are taxed and capital gains are exempt (up to 300% of the average wage), contributions to IKZE schemes are tax exempt and capital gains are taxed at a lower rate. In both cases, benefits are later taxed. There is no obligation to annuitize the accumulated savings.

increasing public debt (on top of the constraints set by the Maastricht treaty), Poland had a reduced fiscal space in which to act *(see Box 2)*.

The government took a two-fold approach to improve the long-term sustainability of the first pillar. On the one hand, it initiated reforms within the first pillar: restrictions of early retirement were passed in 2008 and the legal retirement age was increased to 67 in 2012. On the other hand, it also decided to scale down the second pillar to ease immediate budget problems. A first step was taken in 2011, when the contribution rate paid into the OPFs was reduced from 7.3% of the assessment base to 2.3%. The 5-percentage-point difference was directed into a new sub-account within the NDC system, following a different indexation rule.[1] The 2011 reform did not change the mandatory character of the participation in the second pillar. Furthermore, it envisaged a gradual increase in the contributions to the OPFs from 2.3% to 3.5% by 2017.

The picture changed after budget forecasts worsened at the end of 2012. A more radical step became law at the end of 2013, involving the immediate transfer of 51.5% of OFP assets into the NDC system and the introduction of the so-called 'zipper' or 'slider' mechanism. This involves the automatic redirection to the NDC system of contributions paid to the OPFs, starting 10 years before statutory retirement age. Over the same period, the assets accumulated in the second pillar will be transferred at a rate of 10% annually to the NDC sub-account. The zipper mechanism, thus, solves the open issue of devising a payout mechanism as the second-pillar pension will be paid through the first pillar.

The reform also altered OPF participation from mandatory to voluntary. New entrants to the labor market and existing participants must explicitly opt in to either join or remain in the system. As a result, a much smaller share of workers is now actively participating in the second pillar, mostly high earners. A window will open every four years (starting in 2016) to reverse decisions, thus allowing individuals to (re)join or to exit the second pillar.[2] Finally, the law froze any further increase of the contribution rates to the OPFs, which will remain at 2.92%.

Figure 1 provides a schematic representation of the Polish pension system as it is today.

The Polish pension system is on a more financially sustainable path...

After many reforms, Poland has managed to turn to a more financially sustainable path for its first pillar. In 2013, ►

1 Contributions to the newly created NDC sub-account are indexed according to the average growth rate of nominal GDP over the past 5 years. Contributions to the main NDC account are indexed according to nominal wage growth.

2 The decision to join or leave the system refers only to the flow of future contributions. For individuals who decide to leave, the assets already accumulated in the second pillar cannot be withdrawn until retirement.

BOX 2: THE INTERPLAY OF TRANSITION COSTS, THE FINANCIAL CRISIS AND FISCAL CONSTRAINTS IN SHAPING RECENT PENSION DEVELOPMENT IN CENTRAL AND EASTERN EUROPE (CEE)

From the end of the 1990s to the mid-2000s, pension systems in CEE underwent a series of structural reforms in line with the 'multi-pillar model' laid out by the World Bank in its influential report Averting the Old-Age Crisis. That meant establishing privately managed, defined contribution accounts for each worker (second-pillar accounts) financed by diverting part of the mandatory contributions to the public pension scheme. With the exception of Lithuania, participation in the second pillar was deemed mandatory for all new entrants to the labor market and, in many countries, also for workers below a certain age threshold.

One issue clearly underestimated when the reforms were passed was transition cost financing. Diverting part of the contributions originally designed to finance the PAYG pillar opens up a funding gap, as the contributions collected within the first pillar do not fully cover current pension expenditures of the PAYG system. Although the existence of such a gap was acknowledged at the time of the reform, an explicit financing mechanism was either completely absent or based on overoptimistic assumptions. Consequently, governments in CEE resorted to issuing debt to finance the transition costs. Interestingly, investment rules set by the regulators provided a strong incentive for the pension funds to invest their assets mainly in the same government bonds issued to fill the gap into the PAYG system.

The economic and financial crisis that hit CEE countries in 2008 brought the funding problem of the second pillar to a head. As the contraction in economic activity led to a drop in revenues, national budgets came under strain, making the financing of the PAYG funding gap through debt increasingly difficult. Although at the onset of the crisis the debt level in CEE countries was relatively modest compared to western Europe, financing the transition costs through debt has significant costs, which add to the debt and interest payments for decades.

Furthermore, expansionary fiscal policy pursued during the decade preceding the crisis in some CEE countries meant that fiscal deficits were relatively large. The criteria set by the Maastricht Treaty and Stability and Growth Pact in terms of general government balance further reduced the fiscal leeway available to governments. Policymakers were thus forced to revise the design of their pension systems and to address the funding problem.

Since the crisis, pension systems in CEE countries have undergone a new wave of reforms, the direction of which has varied from country to country. At one end of the spectrum are countries that have either shut down or significantly reduced the size and scope of the second pillar permanently; at the other end lie countries that acted on the level of contributions to the second pillar, either temporarily reducing it or freezing it and postponing the programmed path of increases.

pension expenditure represented 11.3% of Polish GDP, in line with the average of the EU's 27 countries and below the average of the countries in the eurozone. According to the latest EU Ageing Report, the expenditure is projected to fall below the EU average by 2040. Besides bringing a one-off transfer of assets into the first pillar, the recent downsizing of the OPF system will also lead to a gradual increase in its revenues over the coming decades, thus reducing the mismatch between current expenditures and contributions in the short to mid-term. However, as the current cohort of workers enters retirement, the higher pension rights accumulated under the first pillar will lead to an increase in pension spending not matched by an increase in revenues, thus leading to a widening of the social security deficit after 2050 (Jabłonowski and Müller, 2014).

Judged by its ranking in the mid-range of the 2014 Allianz Pension Sustainability Index (PSI)[3], the Polish pension system is under moderate pressure for further reforms to ensure long-term financial stability, mainly because of the negative demographic outlook and the low effective retirement age.

... but adequacy represents an issue

One of the main consequences of the switch to the NDC formula is a substantial decline in the generosity of pension benefits. Average replacement rates are expected to be roughly halved by the year 2060. A full reversal of the pension rules leading to such cuts ►

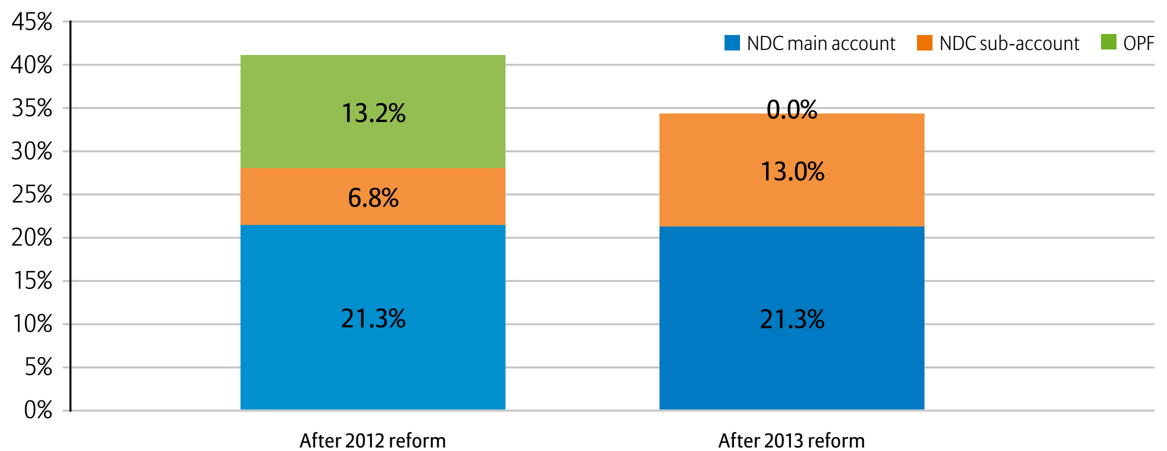
3 The Allianz PSI is a synthetic measure to evaluate the pressure on governments to reform their pension systems. It uses a range of indicators (falling into three broad sub-categories: demographics, public finances and pension system design) to assess and compare pension systems from the perspective of their long-term financial sustainability. See Allianz, 2014.

Figure 1: Polish pension system at glance

MANDATORY			VOLUNTARY			
PAYG-DB	PAYG-NDC	NDC sub-account	OPFs	EPPs	IKEs	IKZEs
Pay-out phase only	Total contribution rate: 19.52% of which: 12.22% to PAYG-NDC		Contribution rate: 2.92%	Incentives only for employer	Tax incentives	
Social Security			Occupational		Individual	

Source: Allianz International Pensions representation

Figure 2: Gross pension income as share of individual earnings at retirement (gross replacement rate), for a man retiring in 2060



Source: Allianz International Pensions calculations

would not be financeable in the long run. Consequently, although the system provides current retirees with adequate income (for the vast majority of them, pension benefits are calculated according to the pre-1999 rules), the situation for future retirees will be different.

If the long-term adequacy of the pension system was already an issue before the latest developments, the 2013 reform further accentuated the problem (IMF, 2014). The voluntary nature of the participation in the second pillar, as well as the reduction of the contribution rate diverted to the funded pillar, mean that the retirement income of future pensioners will rely more heavily on (declining) first-pillar benefits. *Figure 2* compares the gross replacement rates[4] after both the 2012 and 2013 reforms for a man retiring in 2060 after a full career spent earning the economy-wide average wage. Under the assumptions in our model,[5] the shift of contributions from the OPFs to the NDC sub-account leads to a gross replacement rate for future retirees that is 7 percentage points lower. This is mainly down to two reasons: firstly, the returns credited to the NDC sub-accounts are expected to be lower than the capital market returns that could be earned in the OPF system. In fact, NDC sub-accounts are indexed according to the average nominal GDP growth, which is expected to slow due to the exceptional aging pace in Poland, reducing potential growth. Secondly, the annuitization of the account balances in the OPF via the private market are more favorable than the annuity rate of the NDC system.[6]

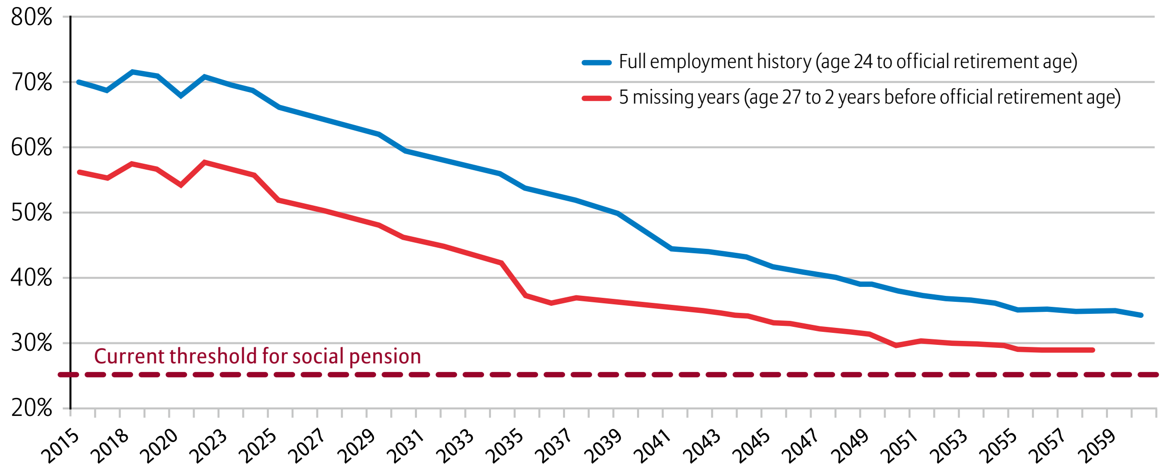
For individuals with a discontinuous employment history, the situation in retirement will become even more critical. As shown in *Figure 3*, from the 2040s onward, replacement rates from the mandatory system for men earning the average income and with five years of missing contributions will be pushed close to the current social pension threshold. ►

4 Level of gross pension income in the first year after retirement as share of individual earnings at the moment of retirement.

5 Our model is based on the same set of assumptions used by the OECD pension models. For more details, please refer to OECD, 2015, Chapter 6.

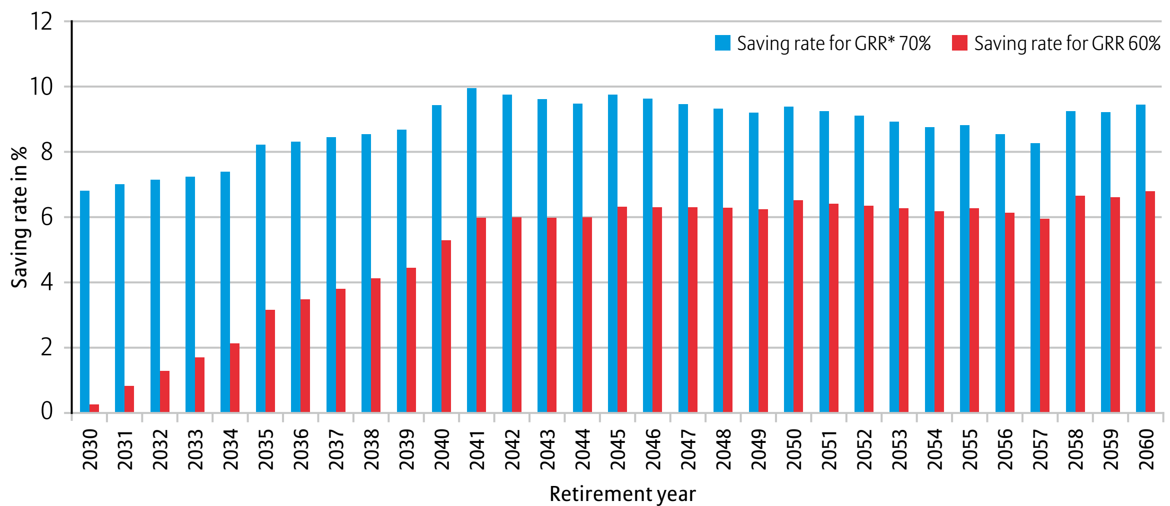
6 In the NDC system, the annuity is calculated by dividing the accumulated balance by the life expectancy at retirement age. In the private market, annuities are calculated taking into account residual life expectancy plus a return rate. As a consequence, the same amount annuitized via the private market provides a higher monthly payment.

Figure 3: Gross replacement rates for retirees with full vs. broken employment history under the current institutional setting



Source: Allianz International Pensions calculations. For further details on the model, please refer to footnote 5

Figure 4: Required saving rate for average earners with a full employment history



**GRR = Gross Replacement Rate*

Source: Allianz International Pensions calculations

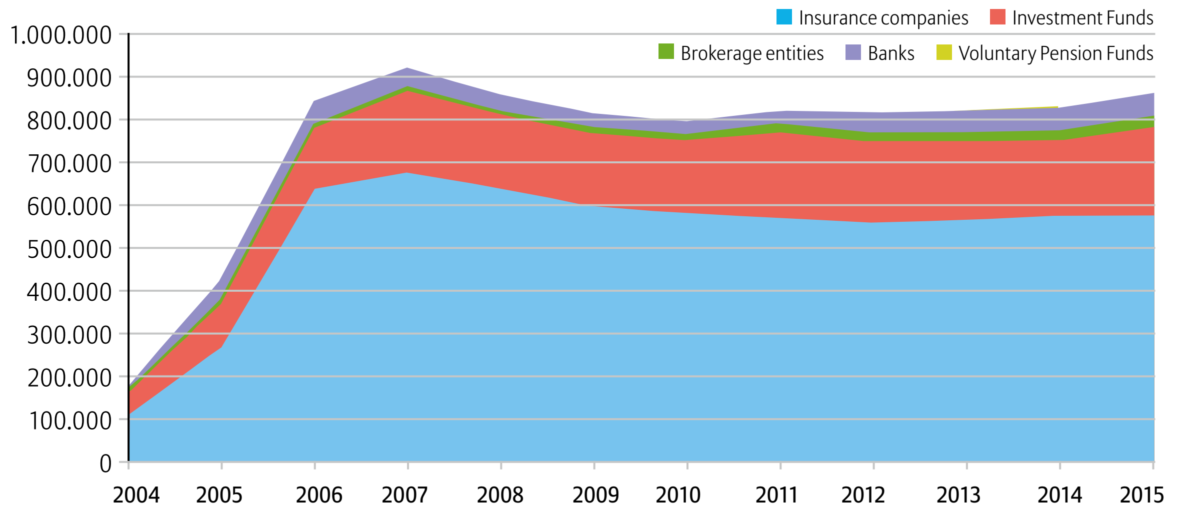
Put in an international context, the Polish system appears to have a low potential to provide an adequate retirement income, as highlighted by Poland's low ranking in the Allianz Retirement Income Adequacy (RIA) Indicator (Allianz, 2015). The low level of replacement rates provided by the first pillar, coupled with the very small size of pension assets accumulated in funded systems, are the main factors behind the country's poor ranking.

Save more for tomorrow?

Additional savings are essential to compensate for the reduction in pension benefits from the mandatory system. For average earners with a full and unbroken career, the required saving rate to reach a gross replacement rate of around 70% of the final salary ranges between 6% and 10% of their current income, depending on the birth cohort of the retiree *(Figure 4)*.

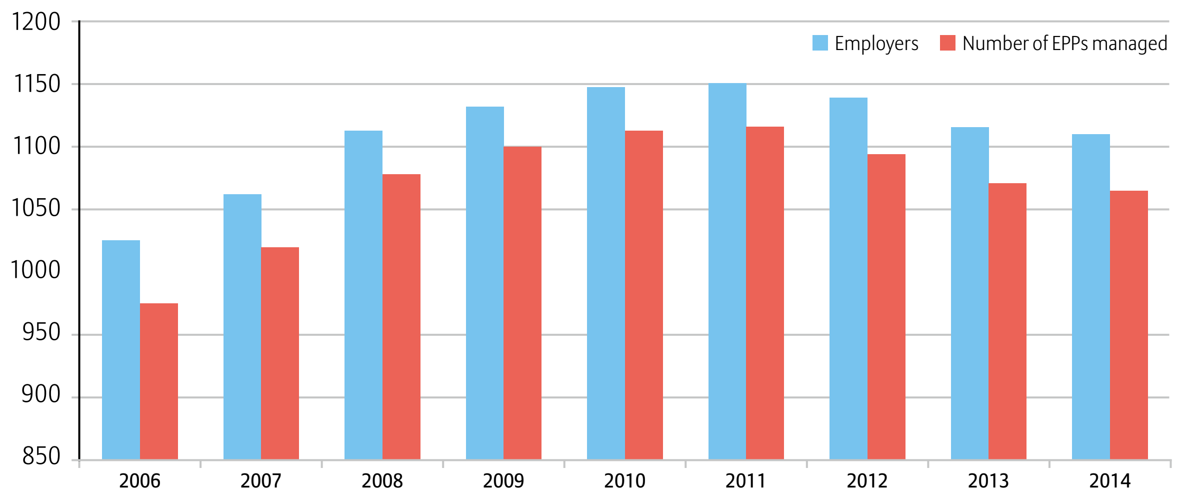
Polish citizens are well aware of the need for extra retirement savings. According to an opinion poll run in 2010, ►

Figure 5: Members of IKE plans, by type of provider, 2004-2015



Source: Allianz International Pensions representation based on data from the Polish financial supervisory authority

Figure 6: Employers conducting Employees' Pension Programs (EPPs) and number of programs managed



Source: Allianz International Pensions representation based on data from the Polish financial supervisory authority

more than 70% of respondents think that pension benefits from the mandatory system will not be enough in retirement (Public Opinion Research Center, 2010). The saving capability of Polish households is also increasing. Since 2000, the share of households with some savings increased by approximately two-thirds, reaching the 40% mark in 2013. Most of the savings, however, are kept in bank de-posits or even in cash (Council for Social Monitoring, 2014).

In spite of optimistic expectations when introduced, complementary retirement savings are currently not very widespread. Membership in IKE plans increased to 900,000 in the years preceding the financial crisis, but it declined during the crisis and has remained flat since *(Figure 5)*. Despite the more generous incentives, IKZEs have also been relatively unsuccessful in terms of coverage. At the end of 2015, IKE and IKZE contracts covered 5% and 3% of the labor force respectively. EPPs have been available since 1999, but are covering an even smaller share of the labor force. The number of employers running EPPs has also declined since 2011 *(Figure 6)*.

Interestingly, the number of members in both IKEs and IKZEs exhibits a mild upward trend following the ►

down-sizing of the second pillar implemented during 2014. The number of employees participating in EPPs has also increased by 50% since 2005. Nevertheless, the saving efforts of Poles clearly lack a focus on retirement.

Outlook

The Polish pension system changed substantially after the 2013 reform. The newly introduced voluntary participation in a substantially downsized funded system means that future retirees will derive a greater portion of their income from the PAYG NDC system. While this move has a stabilizing effect on the Polish fiscal account in the short to mid-term, and does not endanger the financial sustainability of its pension system, it sharpens the issue of retirement income adequacy for future retirees, as the extra benefits accrued in the PAYG system will likely not fully compensate for the forgone benefits in the funded system. We estimate an extra reduction of up to 7 percentage points in the replacement rate of future retirees due to the 2013 reform.

Private retirement savings are even more necessary for current workers to sustain their standard of living after retirement. Although Poles are aware of this necessity, and their saving capability is increasing, coverage rates of voluntary occupational or individual retirement saving instruments are currently extremely low. As the experience in other countries shows, it takes time for new forms of subsidized retirement savings to take off. Poor product design and lack of awareness among the public further slow the process of acceptance. Additionally, subsidies alone are not enough to reach a comprehensive coverage (Börsch-Supan et al., 2013).

For the current cohorts of Polish employees, time is tight. A broad diffusion of supplementary pensions is badly needed to avoid serious problems of old-age poverty in the coming decades. Unsurprisingly, several policy measures have recently been proposed to speed up the process (TEP, 2014). Besides an improved incentive structure for individual retirement saving plans, an auto-enrolment mechanism in EPPs with an opt-out option has been proposed to foster the spread of occupational pensions.

It is unclear if, and to what extent, such policies will find resonance in the political debate. At a more basic level, however, trust in the fundamental pension system structure and the financial institutions must be restored to boost voluntary retirement savings. After recent developments, this represents an additional challenge for current and future governments.

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