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Jan Monkiewicz, PhD
Professor, University of Banking
and Insurance in Warsaw
Warsaw Technical University,
Department of Management

Polish financial sector in the transformation period: pension reform and pension funds development [*]

The new architecture of the Polish retirement system implemented since 1999 is based on the principle of multiple sources and forms of financing of future pension income that are commonly referred to as pillars. Some of them are compulsory and thus are part of the public pension assurance system, and some are optional but their product is defined by the State. In the World Bank's nomenclature, the obligatory part constitutes the first pillar of pension assurance.

In the case of Poland, this pillar is composed of two totally different parts: a repartition component administered by ZUS (Social Security Office), and a fully funded component administered by open pension funds that are managed by PTEs (pension fund companies). Currently, the pension contribution transferred to the account of the Social Security Office constitutes 12.22% of the gross salary, whereas 7.30% is allocated to the open pension fund account. It should be remembered that apart from that 2.45% of the gross salary is allocated to the ZUS account in respect to sick-leave benefits and 2,0% in respect to accident benefits. Additionally there is also a contribution of 13% in respect of a disability pension. To have a full picture, it should be added that those contributions are made by employees and employers in different proportions.

It is worthwhile to remember that not the whole part of the pension contribution received by ZUS is transferred to the retirement subaccount which thus directly reflects the future pension of the insured. This is because in order to prevent the loss of future liquidity of the repartition pillar a certain part of the contribution, which between 2002 and 2008 constitutes on average 0.25% of the pension contribution transferred to ZUS, is allocated to the so-called national pensions reserve fund. Such reserve funds have also been recently established in many industrialised countries (including the USA, Canada, Sweden, Japan, Norway, and France).

[*] Paper presented at the International Conference on Transformation and Development, University of Washington, Seattle, 2006.

Figure 4
Architecture of the new national retirement system in Poland

Pillar I Public		Pillar II Private	Pillar III Private
ZUS (repartition system)	OFE (open pension fund) (fully funded system)	Employees' pension schemes (fully funded system)	Individual retirement accounts (fully funded system)

The optional part of the Polish retirement system is composed of two types of pension products: a group product in the form of employee pension schemes, and an individual product in the form of individual retirement accounts. Those products are defined by the State, and their use entails the possibility of obtaining relatively limited fiscal incentives by employers (for group products) or employees (in the case of individual products). So far, their popularity has been relatively low and in practice they do not play any important role.

Pension funds, which have taken over 37.4% of the obligatory contribution transferred previously in its full amount to ZUS for retirement purposes, are special legal structures whose only task is to invest the obtained funds. This is done on their behalf and account by pension fund companies that are a particular type of private asset management companies.

The institution of pension funds has been known for a long time throughout history. They emerged as early as the beginning of the 19th century as institutions accumulating funds for retirement purposes in plants located in Germany (among others Krupp, Siemens) and the USA (among others American Express, ATT, GE). The funds established in 1999 in Poland were based on the model of solutions adopted before in Chile, Argentina and Mexico and recommended by the World Bank. From the beginning, the number of their members was high, and it was more than 100% higher than the number of people who were obliged to become members of pension funds as a result of the implementation of the retirement system reform (all those covered by the social insurance system up to 30 years of age by 1999).

Table 9 Number of open pension funds members between 2002-2004

Open Pension Fund Name	31 December 2002	31 December 2003	31 December 2004
AIG	850,421	938,839	992,401
Allianz Polska	233,513	245,284	274,908
Bankowy	383,743	395,444	424,148
Commercial Union	2 488,545	2 540,530	2 576,792
Credit Suisse4 L&P	338,155	367,916	419,33
DOM	245,140	239,793	234,918
Ergo Hestia	358,602	397,907	405,254
Generali	376,585	380,385	402,407
ING N-N Polska	1 832,793	1 966,603	2 110,13
Kredyt Bank	154,803	140,816	-
Pekao	292,477	290,434	289,026
Pocztylion	448,534	452,376	453,707
Polsat	127,306	123,581	2 598,847
PZU Złota Jesień	1 786,728	1 866,692	1 942,99
SAMPO	442,830	510,090	626,202
Skarbiec Emerytura	389,527	606,595	567,400
{ego}*	240,114	-	-
Total	10 989,816	11 463,285	11 979,48

***Source**: ZUS*
* Ego was acquired in 2003 by Skarbiec Emerytura

At the end of December 2004, the 16 existing open pension funds had nearly 12 million participants, which represented an increase of nearly 2 million people in relation to the year 2000. This means that nearly 90% of the professionally active population outside agriculture participated in open pension funds.

In their role as financial institutions, pension funds operating in Poland only seem to be the same as their counterparts existing in developed countries. This is connected not only with the specific features of their liabilities, which as a result of the obligatory nature of the system are much more stable and foreseeable, but also with the specific features of the Polish economy and our financial markets. Thus, those differences exist both as regards the internal features of those institutions and their macro-environment. As a result of the features of their macro-environment, those funds may bring about many positive effects.[1] In particular, this among others may apply to:

- Increased savings, which in Poland are traditionally low. In the last period, the share of accumulation in GDP is merely at the level of 20%, which creates unfavourable conditions for development processes;
- Reduction of the market cost of capital as a result of making the accumulated savings available on the domestic financial market;
- Development of the segment of institutional financial investors through the accumulation of relatively large capital managed by specialised institutions oriented towards the attainment of long-term goals;
- Restructuring of domestic financial markets through the creation of demand for new types of financial instruments and through the change of importance of traditional financial institutions; banks, insurance companies and investment (trust) funds on such markets;
- Introduction of the new practices of corporate governance and the increase of the market and environment transparency through stricter standards of asset management by pension funds, which may, among others, considerably increase foreign investors' trust in the Polish market.

All those potential effects are of fundamental importance to the Polish economy, however their emergence is not a foregone conclusion, nor is the scale of their impact. This depends both on decisions regarding the macro-environment and specific regulations.

The fact that the existence of fully funded pension funds considerably increases savings in the national economy is beyond any doubt. Five years after the implementation of the retirement system reform, at the end of 2004 those funds administered money in the amount of nearly PLN 63 billion (table 10).

[1] D. Vittas – Pension reform and capital market development, WG 2414, World Bank, Washington DC, August 2000.

Table 10 Net assets of open pension funds (million PLN)

Open Pension Fund Name	31 December 2002	31 December2003	31 December 2004
AIG	2 696.2	3 833.9	5 335.0
Allianz Polska	839.7	1 210.8	1 670.5
Bankowy	967.9	1 368.1	1 985.7
Commercial Union	9 059.6	12 710.5	17 371.1
Credit Suisse L&P	761.6	1 143.9	1 954.1
DOM	545.0	749.7	1 011.2
Ergo Hestia	555.3	915.4	1 343.6
Generali	1 057.8	1 481.5	2 101.4
ING N-N Polska	6 996.2	10 046.9	14 079.0
Kredyt Bank	214.0	264.2	-
Pekao	517.0	722.0	1 013.8
Pocztylion	658.5	937.5	1 308.5
Polsat	126.5	181.8	558.8
PZU Złota Jesień	4 448.6	6 272.7	8 695.1
Sampo	914.5	1 374.9	2 169.6
Skarbiec-Emerytura	764.0	1 619.5	2 029.6
{ego}	442.3	-	-
Total	31 564.6	44 833.1	62 626.0

Source: KNUiFE (Insurance and Pension Supervisory Commission) database

We should note that those assets are strongly concentrated between funds. Nearly 75% is controlled by the four largest open pension funds (Commercial Union, ING-Nationale Nederlanden, PZU Pogodna Jesień and AIG). The other 12 entities control merely 25% of assets. In the coming several dozen years the assets of open pension funds will be continuously growing until the moment when the intensified ‘redemption’ of their liabilities begins, which will take place only 15-20 years from now. According to available estimates, in 2010 the value of the assets of open pension funds will reach nearly PLN 170 billion. By this year they will contribute to nearly 60% of the free float on the Warsaw Stock Exchange. Their share in the stock capitalization will exceed by 2010 19%[2].

In general terms the pension reform and pension funds development is considered a success case both in terms of participation rate as well as its overall functioning.

Particularly important is that until now pension funds have achieved relatively good investment returns. In 2000-2004 their weighted average annual rate of return exceeded 11,8%. With the total value of contributions received in 1999-2004 of nearly 50 billion zloties they were able to arrive at the net assets value of 62,6 billion zloties. The net surplus of 12.6 billion zloties indicates their value added role. It excludes both up front contribution fees (ca 3.6 billion zloties) as well as asset management fees (ca 0,8 billion zloties). The results achieved by the end of 2005 are presented in table 11.

Table 11 Overall financial results of the pension funds system 01.01.1999-30.09.2005 (billion PLN)

Contributions paid	+ 60,5
Up front fees	- 4,2
Management fess	- 1
Overall financial results	+ 26,8
Overall net assets under management	+ 82,0

Source: KNUiFE

[2] Estimates of KNUiFE

There are however certain important issues still of concern. They include first of all the relatively high cost of the systemic machinery for the pension fund members. Up to 10% of their life-long pension savings are supposed to become the income of pension managers, without taking account of the costs of pension pay-out operators. They also include a lack of price-related competition among the fund members. Finally they relate to the problems associated with the high degree of centralization of the contributions collection and hence crucial role of the quality of the systemic transfer agent (ZUS). It creates certain important systemic risks in case of its poor performance.

A separate set of problems is related to the maturity of the national financial markets. It turns out that rapidly increasing pension funds assets are not counter-balanced by an adequate supply of financial instruments. This may lead to the emergency of the bubble effect on the local securities market or the need to open the way for capital export.