

# DIAGNOSIS AND DEVELOPMENT PERSPECTIVES OF OPEN PENSION FUNDS

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*Within the last few years, the interest in the issues of the systems that are to provide financial security in old age has increased, while the inefficiency of pension systems is more and more often perceived as a global problem. The erosion of pension systems is visible mainly in the countries that transformed their economies into market-based ones. An efficient and effective construction of social security systems to prevent the effects of an increased risk of old age has become an important goal of social policy in numerous countries. In this relation, many countries, not only European ones, have carried out pension reforms but still many face the necessity of changing their pension systems. The aim of the paper is, therefore, a synthetic presentation of selected aspects of the current development of one of the elements of pension systems, i. e. open pension funds, and the problems that accompany this development, basing on the example of one of the countries of Central Europe, namely Poland. Also, the perspectives for the development of these funds are presented.*

*The paper contains, inter alia, the results of a representative questionnaire research carried out in 2007 among the customers of pension funds, as well as among the experts on the financial system in Poland. It seems that Polish experience related to the introduction of pension funds to the Polish market in 1999 and the numerous positive phenomena that accompany their development may constitute one of the patterns for implementing reforms and introducing pension funds in other countries.*

**Keywords:** open pension funds, forecasts

## **Pension funds as a means of providing security in old age**

For centuries, human beings strived at discovering the way to be able to fulfil their needs and to live in dignity in the period of old age when one's professional abilities and activity decrease. Multi-generational families, guild contribution funds, savings and their individual investment policy, or even elimination of an individual from the community – these are just some of the ex-

amples – often of doubtful quality, to say the least – of diminishing the uncertainty and the lack of protection in old age<sup>1</sup>. It was only at the end of the 19th century

<sup>1</sup> The first support pension fund was a system for the poor over 60, introduced in Denmark in 1891. Also, the American Express funds created in 1875 in the US were among the first pension funds. However, they were private pension programmes. The first compulsory, state system of old-age protection was created as late as in 1889 in Germany, during Bismarck's rule (Crawford, Sihler, 1994).

that the so-called pension systems were created, i. e. the insurance systems whose task is to ensure payments after those who reached the so-called pension age cease their professional activities.

Presently, all over the world there is a great variety of pension systems, both when it comes to principal features of these systems, participation rules and the time of introducing the most recent changes. This variety results from the economic, historical, demographic and cultural conditions of particular countries. It is worth noting that in many countries public and private institutions that provide pensions function simultaneously (Steinmeyer, 1998); therefore, most often the pension system based on the so-called three pillars is propagated (Szumlicz, Żukowski, 2004). This model is composed of three separate but at the same time complementary parts, which have a various hierarchy of importance in different countries (Mech, 1998)<sup>2</sup>:

- public pension programmes – pillar I,
- pension programmes sponsored by the employer – pillar II,
- individual savings pension programmes – pillar III.

In general, the first, basic pillar has an obligatory character and is based on employees' contributions and state revenues and, as a rule, it should ensure the necessary social minimum. Programmes for employees – pillar II, with a capital-based character, often voluntary for the work-

ers – should complement public pension programmes. Pillar III, in turn, may involve individual pension insurance paid in the form of savings or pension payment; as a rule, it covers social and professional groups with higher-than-average earnings.

Effective and efficient structures of social security systems which counteract the results of an increasing risk of old age have therefore become an important element of social policies in numerous countries, including countries of Central and Eastern Europe (Monkiewicz, 2002). The most important reasons for the growing interest in pension systems and their reforms implemented in numerous countries of the world include (Holzmann, Orenstein, Rutkowski, 2003):

- an increase in expenditures for old-age pensions (which must be transferred by those who are professionally active) and an increase of budgetary burden (for example, in 2000 the average share of this type of expenditure in GDP amounted to 10.4% in the EU-15; in non-European countries, such as Australia, Canada, Korea, Japan, New Zealand or the US it amounts to ca. 5.3%);
- socioeconomic and demographic changes (changes in social and family structures, increase in the number of professionally active women, increase in the level of pensions, unemployment growth, health improvement and increased life expectancy (as a result of which more and more people live to the pension age<sup>3</sup>), low birth-rate in many

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<sup>2</sup> Also, the World Bank is opting for the three pillar concept, however, in a slightly different structure. The repertition system is to constitute pillar I, obligatory pension funds with a capital-based character – pillar II and voluntary employees' pension programmes – pillar III, see: *Averting the Old Age Crisis. Policies to Protect the Old and Protect Growth*, The World Bank, Washington 1994.

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<sup>3</sup> In 1950, there were slightly over 200 million people aged over 60 all over the world, while at the beginning of the 21st century almost 600 million. For more on the need of adjusting pension funds to the new demographic reality, see: (Drucker, 2000).

countries, ever later commencement of professional activities resulting from the prolonged education period and others);

- European integration, which increases internal and external migration of the workforce.

Until now, however, relatively few countries have attempted at reforming their pension systems. It is easier to subsidize pension systems (Góra, 2003)<sup>4</sup> than to reform them thoroughly. However, a gradual re-organization of such systems is visible in many countries. Therefore, one can see a tendency towards the changes based on ‘taking into pieces’ of the state pension scheme, abolishing sectoral privileges and the development of professional funds which provide payments complementary to state payments<sup>5</sup>. Almost all countries also strive towards increasing the retirement age (up to 65–67 years) and levelling it for men and women.

### **Open pension funds in Poland: market development diagnosis**

Since 1999, new rules for the functioning of the pension fund (the so-called three-pillar system) have been in force in Poland. Within the so-called pillar II, the entities with a profile of activities that had not previously existed, the so-called open pension funds (OPE) and public pension societies (PPS), have been created. Open pension funds are an integral part of the social insurance sphere; together with the so-called pillar I (payments from the Social Security Serv-

ice – Zakład Ubezpieczeń Społecznych) they constitute the basic old-age pension payment. Activities which are focused on collecting and investing monetary means, accumulating them and allocating them for payments to participants when they retire are the essence of a pension fund.

Among 21 pension societies which started operating on the Polish market in 1999 there were various entities differing in relation to numerous criteria. Over 50 companies, both those already active in the financial sector (banks, insurance companies, investment funds) and those from the outside of the sector (manufacturing entities, television, Catholic church), as well as companies with their registered offices in Poland and abroad were engaged in the creation of public pension societies. During the development phase, in comparison to the 1999 state of play, the number of open pension funds decreased. Therefore, as a result of PPS mergers, as well as take-overs (consolidation) of fund management by a different society, at present there are 15 open pension funds active on the Polish market.

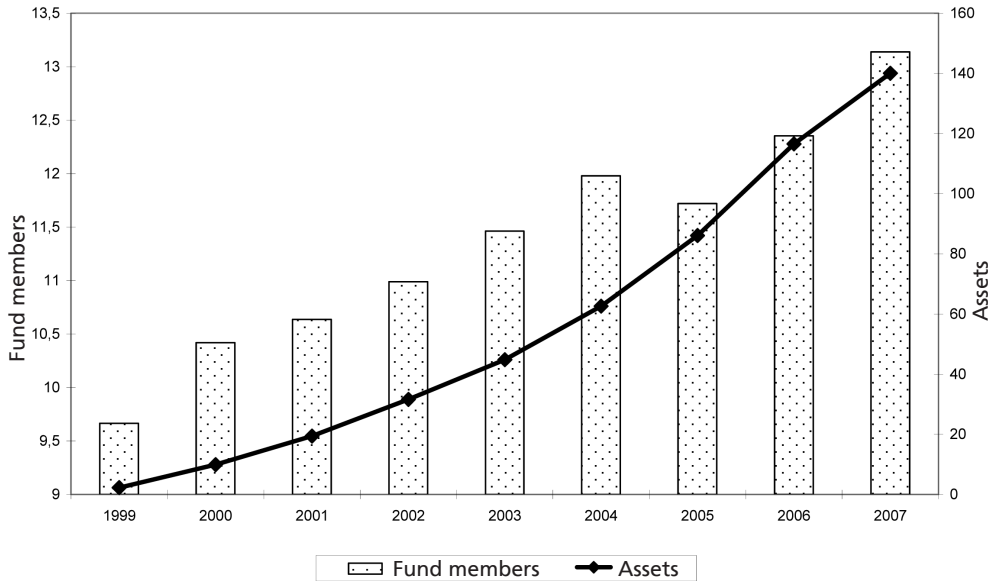
During the phase of introducing OPF into the market, as a result of intensive promotional activities and direct sale through sale representatives, 9.6 million persons joined the funds, of whom, interestingly, as many as 45% were those who were not obliged to join OPF programmes. The following years witnessed a systematic growth in the number of OPF participants – those who start their professional careers and are obliged to select a fund.

Therefore, it is worth emphasizing that 13.45 million Poles have participated in

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<sup>4</sup> For example, the German pension system, which is not able to cover its expenses, is subsidized in 20%.

<sup>5</sup> Pensions in Europe, 1997; Comité Européen des Assurances, p. 61–63.



*Diagram 1. Members and assets of open pension funds in Poland (as of December each year)*

Source: our own analysis based on data from the Polish Financial Supervisory Authority (quarterly newsletters from years 1999–2007).

OPF at the beginning of 2008 (out of ca. 25 million of the inhabitants of Poland in the working age). Diagram 1 presents changes in the scope of the total number of OPF participants.

When diagnosing the possible developments of the OPF market, also some aspects connected with consumer behaviour seem to be of interest. Therefore, how do they behave in this relatively newest sector of the financial market?

Even though the introduction of new rules for the old age pension system was to contribute to an increase in active attitudes and to shaping the rational behaviour of customers in relation to financial provisions and security when they retire, the actual effects of these intentions are

still insufficient. As it results from the research conducted<sup>6</sup>, the customers still are, unfortunately, too passive and the decisions they take are often not very rational. Even though a significantly higher than previously expected interest in the funds in the stage of their launching on the market could prove that Poles feel the need of making independent decisions in the areas where state institutions used to take them, certain premises which partly undermine this hypothesis appeared in the market development phase.

<sup>6</sup> Questionnaire research among OPF customers was carried out by the Department of Marketing Research of the Poznań University of Economics in 2007. A representative research was conducted on a sample of 516 respondents with the use of a standardized direct interview questionnaire.

First of all, one could give the example of the systematically growing percentage of those who start their professional career and who do not select their pension funds but are randomly allocated by the state institution – Social Security Service (Zakład Ubezpieczeń Społecznych, ZUS) – as a cause for concern. While in 2002 there were almost 40 thousand of such persons, in 2007 as many as over 240 thousand did not take the decision on their own.

Secondly, as every member of an OPF has the right to change their fund (free of charge – should this happen after two years of membership), since 2002 one can see the change of one fund into another (the so-called transfers) by about 300 thousand participants per year. Unfortunately, these changes are not always advantageous for the customers. They do not always result from economic reasons. OPF customers enumerate the following factors among the most important reasons for the transfers: the work and the arguments of sales representatives from new funds, insufficient communication between the fund and its customers and a lack of visible care for the customer, the low position in OPF ranks and other subjective reasons on behalf of the customer.

Finally, when analysing customers' opinions concerning various aspects of the functioning of the old age pension system in Poland, one can still note the insufficient level of their knowledge. For example, when asked about the problem of levelling the retirement age for men and women, the decisive majority (almost  $\frac{3}{4}$  of respondents) think that legal provisions should ensure that women retire earlier than men (and this means, inter alia, lower pensions for women and the transfer of capital collected by men to women's pensions).

The basic reason for this situation, apart from the lack of long-term saving habits, is the identified low level of knowledge in the scope of the pension system, stemming from customers' insufficient education. It results in a slight interest in pension funds, their financial results, as well as not very rational reasons of customers' decisions concerning transfers or still an insignificant interest in the solutions offered within pillar III – voluntary pension insurances.

Despite these examples of the present problems, it is worth noting that, in general, customers are satisfied with the changes introduced to the pension system. Only 14% of them would welcome an abolishment of the funds and the return to the previous system, while almost 70% claim that there should be a possibility of voluntary, additional payments to pension funds.

The high growth rate of the amount of assets (cf. data from Diagram 1) is an expression of the dynamic development of the OPF sector in Poland. While at the end of 1999 the amount of OPFs' assets was PLN 2.9 billion (i. e. less than 1% share in GDP), at the beginning of 2008 it already amounted to PLN 138.1 billion (i. e. about 12% share in GDP). The assets obtained by open pension funds from members' contributions are then invested by the funds on the capital market. The increase in the value of assets of a given fund is expressed in the change of the so-called value of participation unit, which – in the long term – makes it possible to assess the fund's investment effectiveness. A weighted average of this unit amounted, at the end of 1999, to almost PLN 12 (i. e. about USD 3) for the whole sector, while at the end of 2007 it amounted to PLN 28 (i. e. about USD

12)<sup>7</sup>. In turn, the return on investment rate is a measure of effectiveness of the open pension funds' investments. For example, a weighted average return on investment rate in the last three years (March 2005 – March 2008) amounted to 31.5% for the sector and is significantly higher than the minimum return on investment rate (16%) or the rate of inflation (ca. 4%).

### **What are the future prospects for the development of the OPF market?**

Taking into consideration the current development of the open pension funds' market in Poland, and in comparison with other countries on whose solutions Poland modelled its own pension system reform (such as Chile, Argentina and Mexico), where a consolidation of the funds also took place, one may think that the number of the pension funds operating on the Polish market will be diminishing further. Such an opinion is shared also by the experts who participated in a survey concerning the outlooks for the development of the financial market in Poland, including open pension funds<sup>8</sup>. They forecast that in 2010 the

number of pension societies will decrease to about 10 (a dominant). At the same time, the creation of new pension funds seems quite unlikely. The OPF sector is characterized by significant secondary entry barriers which are connected with the effect of scale and reputation, as well as with a stable size and saturation of the market and large potential costs connected with the necessity of building it from scratch (e. g. distribution channels, customer service systems, fulfilling licence requirements). Moreover, the high risk of a market entry is conditioned by the fact that 'covering' the amounts invested requires obtaining a proper number of customers.

Together with a systematic growth in the net assets of the funds, an increasing growth of the monetary means, mainly long-term monetary means, will take place. The experts foresee that in 2010 the assets of OPF will reach the level of ca. PLN 200 billion (dominant), while in 2019 over PLN 500 billion (i. e. 33% share in GDP)<sup>9</sup>. The appearance of new financial instruments as well as an increase in the interest in the existing securities may also result from the dynamic growth rate of the net assets of the funds. At the same time, one expects an increase in the freedom of investment in the foreign markets (which, in turn, will require a legal amendment to the provisions concerning the funds' investment strategy).

Also, the creation of pension companies which will deal with the payments of pensions, as well as other institutions and

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<sup>7</sup> Quarterly newsletters of the Polish Financial Supervision Authority from the years 1999–2008.

<sup>8</sup> The author uses some results of the research carried out by the Department of Marketing Research at the Poznań University of Economics among several dozens of experts of the Polish financial market. The research was carried out with the use of the Delphi method in 2005, by sending a questionnaire to representatives of open pension funds, banks, insurance companies, supervisory entities for the financial market and scholars. The survey was implemented in three stages, adopting two forecasting horizons: 2006 and 2010. The mail survey questionnaire used included independent open questions leading to obtaining mainly the answers that can be expressed numerically (the project is financed from the Ministry of Science and Higher Education, no. N N 113 1728 33).

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<sup>9</sup> See also: Perspektywy rozwoju otwartych funduszy emerytalnych na rynku finansowym do roku 2010 (2003), the Polish Insurance and Pension Fund Supervision Authority, Warsaw, 18 p.

services connected with the funds (e. g. in the scope of asset management, investment or pension consultancy) will be a consequence of the implemented reform of the pension system. Hence, as results from the research conducted, the experts expect the creation of two to three (maximum five) pension companies in Poland which will pay pensions from the OPFs. The structure of the system of pension payments in the framework of OPF also requires a decision concerning the form of payments, i. e. the types of products the future pensioners will be able to choose. The key classification dimension of a pension product is the issue of the entity which has to bear the actuarial risk connected with the above-than-average life span after retirement and the entity which bears the financial risk connected with the fluctuating prices for financial instruments. Therefore, when taking the planned pension products into consideration, only 10% of old-age pensioners would opt for a one-off payment of the whole OPF pension amount, should there be such a possibility, 13% would select the payment of a specified number of pension benefits (in the amount depending on the assessed return on investment rate and life expectancy until the means are exhausted), and about 77% would choose a monthly old-age pension payments which would be paid until the personer's death. Moreover, according to experts, ca. 70% of the persons will want to obtain individual pensions while ca. 30% will prefer pensions for married couples.

At the same time, the experts perceive shifting the insurance risk onto the participant of an OPF to be one of the biggest threats to development of this market. Among significant risks for the develop-

ment of the OPF market in Poland, the experts enumerated also, inter alia, market monopolization, a 'shallow' capital market, a lack of attractive deposits as well as investment limitations, state policy and the growing level of transfers between OPF as a result of the activities of their sales representatives and a risk of capital market instability.

A significant risk for the development of the market is also posed by the common low level of knowledge concerning pension funds and their importance for the living standards during retirement, which I have mentioned earlier. Therefore, the necessity of undertaking actions aimed at the shaping of the present and the future customers of OPF in the scope of understanding the substance and the rules of OPFs' functioning is an important challenge for the proper development of the OPF market. Full, cyclical access to information which is comprehensible for the customer gives a better guarantee of his or her higher quality of life during retirement. The beneficiary should be aware of his or her potential financial situation during retirement and should have a well-grounded knowledge of the level of the future payments. The decisions taken by the customers (including, in particular, those concerning transfers) should be based on long-term financial observations (such as, for example, the value of a participation unit) and not on advertisements or sales representatives who are not always operating in a fair way. The communication strategy of pension societies should take into consideration also the aspect of consumer education, with an active influence on customers' motives and attitudes (including their awareness), aiming at educating the optimum patterns

of market behaviour. Consumer education in the scope of pension funds seems to be a great challenge, the implementation of which should be started as soon as possible. Making permanent changes in the way of thinking and attitudes towards pensions requires regular educational activities and not only random advertising campaigns. Both the consumers, expanding their knowledge concerning various aspects of the pension system, and the producers, i. e. the managers of pension societies, for whom the knowledge of consumer behaviour should become a basis for the construction of marketing strategies, should be the recipients of such activities.

Moreover, in the context of globalization and integration of the states of Central and Eastern Europe with the EU, legal and organizational solutions which adjust pension funds to the growing mobility of workforce (which requires an increase in the compatibility of pension systems in various coun-

tries, including – in particular – regulations concerning the transfer of contributions between various countries) require urgent modification, not only in Poland.

To sum it up, it one should state that financial services aimed at financial security of the future old age pensioners – i. e. the pension funds – constitute the fastest growing sector of financial services all over the world (Drucker, 2000). However, their further correct development depends significantly, inter alia, on the economic and political situation of a given country, the financial standing and behaviour of customers, their habits and customs or the trust to the institutions which constitute this sector. Fortunately, the decreasing birth rate and ageing populations in developing countries are more and more often the subjects of debates in many circles – and this may also contribute to the development of pension funds and to governments creating conditions for their correct development.

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## ATVIRŲJŲ PENSIJŲ FONDŲ VERTINIMAS IR VYSTYMO SI PERSPEKTYVOS

**Iwona Olejnik**

S a n t r a u k a

Pastaraisiais dešimtmečiais pasaulyje intensyviai ieškoma atsakymo į klausimą, kokia turi būti optimali šalies pensijų sistema. Lenkija buvo viena iš šalių, kuri 1999 metais reformavo savo pensijų sistemą. Viena iš šios reformos išraiškų yra atvirų pensijų fondų (APF) įsikūrimas. Šiuo metu šiuose fonduose dalyvauja daugiau nei 13 milijonų lenkų, t. y. daugiau nei pusė darbingo amžiaus piliečių, o jų finansinio turto vertė yra 138 mlrd. zlotų (apie 12 proc. BVP). Dauguma Lenkijos gyventojų (70 proc.) pozityviai vertina APF veiklą, nors esama ir skeptikų (14%).

Per visą sektoriaus gyvavimo laikotarpį vyko jo konsolidacija, kurios padarinys yra tas, kad dabar Lenkijoje liko tik dešimt pensijų fondų. Numatoma, kad konsolidacija gali vykti ir ateityje. Prognozuojama, jog didės ir APF esančio finansinio turto vertė. Ji 2019 metais turėtų pasiekti 500 mlrd. zlotų.

APF veikla susijusi su rizika, kurios pagrindiniai veiksniai yra šio sektoriaus monopolizavimas, per didelė fondų dalyvių individuali rizika, „sekli“ kapitalo rinka šalyje, menkas dalyvių finansinės žinios, didėjantis darbo jėgos tarptautinis mobilumas ir kt.