Financial Performance of Mandatory Private Pension Funds in Countries of Central and Eastern Europe. A Comparative Study Between Romania and Slovakia

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Abstract

Decreased birth rate and aging population represent a treat to PAYG public pension systems implemented in countries of Central and Eastern Europe, due to the fact that the financing is direct dependent of the social contributions payed by the taxpayers active on labor market. As solution, World Bank promotes the diversification of funding sources for pension systems and a multi-pillar structure that includes privately managed pension funds. The purpose of this paper is to present how the multi-pillar structure was implemented in Romania and Slovakia, focusing on the evolution and performance of mandatory private pension funds. The main conclusion of this article highlights that in the current demographic context, privately managed pension funds can be a mean of providing the necessary resources to the elderly population during retirement.

Key words: privately managed pension funds**,** reform of pension systems, Central and Eastern Europe.
J.E.L. classification: J32, G11

1. Introduction

Social protection is a fundamental right advocated by the Universal Declaration of Human Rights, the Treaty on European Union, the Charter of Fundamental Rights and the Social Charter of the European Union. The responsibility for ensuring social protection belongs to each state, which has the responsibility to organize and implement the social protection systems.

A category of the population that needs attention is the elderly population, which due to old age and pathologies cannot carry out professional activities to ensure the incomes needed for daily living. Therefore, national pension systems are becoming the main instrument of social policy to ensure the protection of elderly. National pension schemes aim to ensure the financial flow needed for the elderly to live a decent life and, as a consequence, to give protection against the risk of poverty and social exclusion.

Worldwide, national pension systems are organized accordingly to the specifics of each state. However, there are three main typologies of them, namely: the public non-contributory pension scheme, the public contributory pension scheme (PAYG) and private pension funds. The World Bank (WB, from this point forward) and the International Labor Organization (ILO, from this point forward) support a multi-pillar structure of national pension systems consisting of both public and private components. The three pillars promoted by WB are: the public pension system (1st Pillar), privately managed pension funds (2nd Pillar) and voluntary pension funds (3rd Pillar).

In this article, we give attention to the second pillar proposed by WB, respectively the mandatory private pension funds (MPPF, from this point forward) implemented by Romania and Slovakia. The purpose of this article is the study of the characteristics of MPPF from the two Central and Eastern European countries (CEEC, from this point forward), to assess their evolution and performance.

The article is structured in the following sections: the first section introduces the purpose of the paper, the second section briefly presents the theoretical framework on MPPF in CEEC, the third section specifies the research methodology and the research methods used in this study, the fourth section characterizes the MPPF implemented in Romania and Slovakia, and the fifth section shows the evolution and performance of MPPF in the two European countries, the last section being dedicated to the conclusions and final considerations of the paper.

2. Theoretical background regarding mandatory private pension funds in Central and Eastern Europe

Supplementary pensions represent a complementary form of the public pension system, with the role of increasing the incomes of beneficiaries and maintaining the standard of living, as well as consumption during retirement. The supplementary forms of pensions refer to occupational pensions, defined by Council Directive 98/49/EC as a pension scheme, individual or collective, related with a professional activity and regulated by national law, with the purpose to provide additional pensions at retirement (Council Directive 98/49/EC).

At EU level, the supplementary pension schemes are present mainly in the north-western states of the continent, while in the countries in the central-eastern and southern part of the continent, they have a very low coverage. Among the causes that determine the underdevelopment of supplementary pension schemes in CEEC are: the preference for non-financial instruments, the low profitability of financial markets, the modest level of the incomes of population, the scarce of the social partners (European Commission-Directorate-General for Employment, Social Affairs and Inclusion, 2018).

Private pension funds, concept developed by Milton Friedman, use the incomes obtained from social security contributions for investments in financial markets in order to reach additional income. From a legal point of view, private pension funds are contracts that have as object the provision of financial resources after retirement from professional activity, complementary to public pension schemes or replacing them. These can be formed as occupational pension funds, conditioned by the existence of an employment contract, or as individual pension funds, often known as personal pension funds, which offer the possibility to anyone to join a private pension fund. Occupational pension schemes are usually organized by employers or trade unions. Depending on the obligation to join a private pension funds, it can be identified mandatory private pension funds (MPPF), imposed by national legislation, and voluntary pension funds (VPF), having a voluntary participation (Impavido, 2013).

In order to reduce the pressure on the public pension system and to ensure an adequate replacement rate during retirement, at the recommendation of the WB, different countries have implemented a mandatory private pension system. CEEC that have regulated and implemented private pension funds, followed the multi-pillar model implemented by Argentine Republic (Bonoli & Palier, 2007).

MPPF are, in fact, a hybrid form of financial insurance of the elderly, formed by combining features of the public pension system with aspects specific to privately managed pension funds (Sender, 2012). Thus, their financing is based on the contribution of participants, but the management of financial resources is made by private companies specialized in financial investments, through nominal accounts that reflect the contribution history of each participant and the performance of the investment.

3. Research methodology

The topic of this paper highlights the characteristics and performance of MPPF implemented by Romania and Slovakia. Therefore, the research is descriptive and focuses on the comparative presentation of some indicators specific to pension funds. Thus, the following research methods were used: the method of bibliographic study, the method of comparison, the method of synthesis and the graphic method.

4. Mandatory private pension funds in Romania and Slovakia

4.1. Mandatory private pension funds in Romania

MPPF were regulated in Romania at the end of 2004, but the effective implementation took place on 1st July 2006. Law no. 411/2004 establishes organization and functioning, as well as the activity of the managers of the funds. The entry into force of the law imposed the obligation of participation at the scheme for the employed population up to 35 years old and the voluntary participation for persons found in the age group 35-45 years. Joining a MPPF can be done either by the personal option or by automatic distribution, if the taxpayer does not express his choice. Joining a privately managed pension fund is done once the accession contract is signed, which specifies the rights and the obligations of the participants and also of the manager of the fund, their risks and distribution of pensions. Thus, an individual account is opened to highlight the contributions paid, the value of the fund units and the net assets. However, a participant has the right to transfer to another pension fund, only after a prior notification of the transfer to the initial fund administrator (Law no. 411/2004).

Nowadays, in Romania are functioning 7 MPPF with moderate and high risk profile, the main characteristics of them and of the administrators are summarized in Table no. 1.

Table no. 1. Mandatory private pension funds in Romania

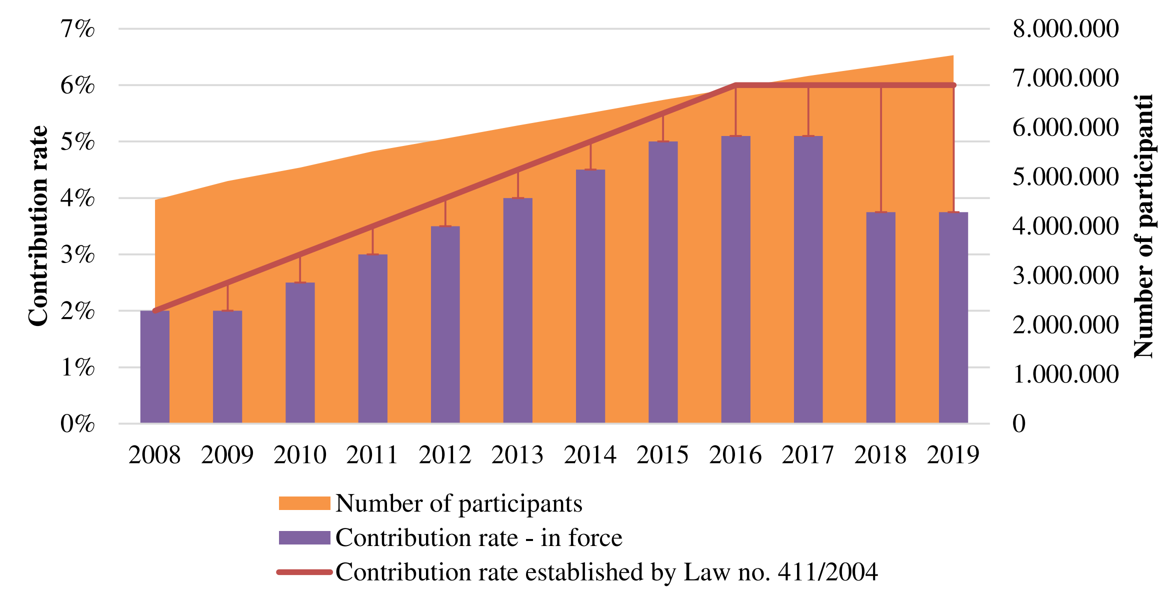
MPPF	**Management company of MPPF (S.A)**		**Depository**	**Capital** (lei)
	Name	**Shareholders**		
Aripi	Generali	1. Generali CEE Holding B.V. 2.Generali Romania Asigurare - Reasigurare S.A.	BRD - Groupe Societe Generale S.A.	67.000.000
AZT viitorul tău	Allianz-Ţiriac Pensii Private	1.Allianz - Ţiriac Asigurări S.A. 2.Tiriac Holdings Limited	BRD - Groupe Societe Generale S.A.	32.375.000
BCR	BCR Pensii	1.Banca Comercială Română S.A. 2.Zbîrcea Gabriel	BRD - Groupe Societe Generale S.A.	88.471.840
BRD	BRD	1.Sogecap 2.BRD - Groupe Société Générale S.A.	Banca Comercială Română S.A.	35.970.000
Metropolitan life	Metropolitan Life	1.Metlife EU Holding Company Limited 2.Metlife Services Spolka z Ograniczona Odpowiedzialnoscia	Unicredit Bank S.A.	94.561.700
NN	NN Pensii	1.NN Continental Europe Holdings B.V. 2.NN Asigurări de Viaţă S.A.	BRD - Groupe Societe Generale S.A.	206.100.000
Vital	AEGON Pensii	1.AEGON Poland/Romania Holding B.V. 2.AEGON Czech Republic Holding B.V.	BRD - Groupe Societe Generale S.A.	72.000.000

Source: Author's own processing based on data published by Financial Supervisory Authority

Since the implementation of the MPPF in Romania, four pension funds have been deregistered after the decision of ASF to retire the registration of the management companies. Thus, the BCR pension fund absorbed the Omniforte fund, Prima Pensie fund and OTP fund; Metropolitan Life was formed from the AIG and VIVA pension funds, and Vital absorbed the EUREKO pension fund, which before have incorporated the BANCPOST and KD pension funds. Subsequently, the ING mandatory private pension fund changed its name to NN.

The withdrawal of contributions is made by redirecting part of the social contributions paid to the public social insurance system (Figure no. 1.). Croitoru (2015) mentions that in the short term, the funds mobilized towards MPPF have a negative impact on the financial sustainability of the public pension system, but in the long term it ensures an adequate level of pensioners' income. From this perspective, the decision to privatize the pension system must be correlated with the national socio-economic and political context

Figure no. 1. Contribution rate and number of participants to mandatory private pension funds in Romania



Source: Author's own processing based on Law no. 411/2004, Laws regarding the Social Insurances Budget between 2008 - 2019

Law no. 411/2004 established the redistribution of 2% of the total contribution paid by an insured to the public pension system to a MPPF, following that in each year to increase this rate with 0.5% up to the maximum value of 6% (Law no. 411/2004). This provision was not been respected exactly and it can be noted a slight gap, which since 2016 had increased, reaching only 3.75% in 2018 and 2019. This drop of the share of the contribution to MPPF is a result of the low returns obtained. Also, other reasons that hold up this decision was the deficit registered by the State Social Insurance Budget and the low confidence of citizens in MPPF.

The participation of the population in MPPF increased with approximately 2,930,500 people between December 2008 and December 2019 (Figure no. 1.). The distribution of participants by age group reveals the decrease of the share of participants younger than 35 years old by 22%, reflecting the demographic situation of Romania and the reduction of the number of young employees on Romanian labor market. Regarding the distribution of participants by gender, it can be noted a minor difference between the number of females and males, in favor of the latter.

The contributions to a MPPF give the right to receive a private pension, once are met the eligibility conditions for receiving the old-age pension within the public pension system (Law no. 411/2004). The redistribution of the private pension is made based on the value of net assets detained in individual account of the participant after an actuarial computation considering life expectancy. However, this value cannot be less than the total value of the contributions paid (Law no. 411/2004). This specification does not apply if the beneficiary of the private pension suffers from a permanent disability, or the value of the net asset is reduced, as well as if the beneficiary is not a participant of the MPPF, but is the legal heir of the net asset. The Supervisory Commission of the Private Pension System (CSSPP) establishes the rules for the redistribution of the minimum private pension. The provision of the cash benefits can be made through a single premium or in several installments for a maximum period of 5 years (Norm no. 27/2017), in country or abroad (Law no. 411/2004).

4.2. Mandatory private pension funds in Slovakia

The implementation of MPPF in Slovakia was made in 2005, establishing the mandatory participation of all new employed individuals. The financing of MPPF was based on the contributiveness of the participants, the share of contributions being 9% of wage incomes and other incomes assimilated to wages. On the background of the socio-economic situation resulted from the financial crisis, since 2012 this percentage decreased by 5%, but starting with 2017 the contribution rate gradually is increasing by 0.25%, reaching 6% in 2024 (OECD, 2019). At the beginning of 2018, the number of participants of a MPPF in Slovakia reached 1,425,843 people (IOSP).

In Slovakia are functioning 17 MPPF, operated by five management companies. The main features of MPPF from Slovakia are summarized in Table no. 2.

Table no. 2. Mandatory private pension funds in Slovakia

Management company of MPPF	**Shareholder**	**Depositary**	**Capital** (euro)	**MPPF**	**Type of MPPF**
Allianz - Slovenská dôchodková správcovská spoločnosť, a.s.	Allianz - Slovenská poisťovňa, a.s.	Tatra banka, a.s.	37.177.280	Guarantor	Bond guaranteed
				Progress	Shares non-guaranteed
AXA d.s.s., a.s.	AXA životní pojišťovna a.s.	UniCredit Bank Czech Republic and Slovakia, a.s.	47.924.980	Stock	Shares non-guaranteed
				Bond	Bond guaranteed
				Index	Index non-guaranteed
Dôchodková správcovská spoločnosť Poštovej banky d.s.s., a.s.	Poštová banka, a. s.	Československá obchodná banka, a.s.	11.949.810,48	Perspective	Index non-guaranteed
				Prosperity	Shares non-guaranteed
				Stability	Bond guaranteed
NN dôchodková správcovská spoločnosť, a.s.	NN Životná poisťovňa, a.s.	Slovenská sporiteľňa, a.s.	10.023.200	Dynamics	Shares non-guaranteed
				Harmony	Mixt non-guaranteed
				Index euro	Index non-guaranteed
				Index global	Index non-guaranteed
				Solid	Bond guaranteed
VÚB Generali dôchodková správcovská spoločnosť, a.s.	1.VUB a.s. 2.GENERALI poisťovňa, a.s.	UniCredit Bank Czech Republic and Slovakia, a.s.	10.090.976	Index	Index non-guaranteed
				Classic	Bond guaranteed
				Mix	Mixt non-guaranteed
				Profit	Shares non-guaranteed

Source: Author's own processing based on data published by National Bank of Slovakia

Each management company holds two types of MPPF, namely: guaranteed MPPF, consisting mainly of bonds and deposits, and non-guaranteed MPPF, with an investment portfolio consisting of various financial instruments: stocks, stock indices or mixed portfolios. The risk associated with guaranteed pension funds is minimal. Usually, joining a MPPF is done through the personal option, depending on the personal risk profile, determined on the basis of a questionnaire, made available by the Association of Pension Management Companies (ADSS).

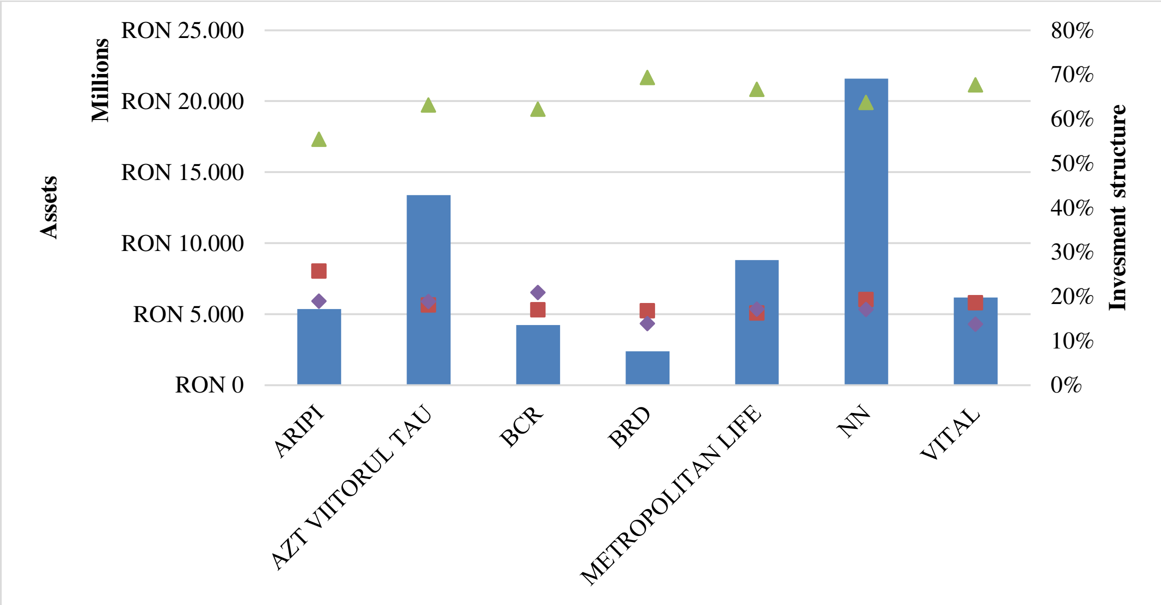
The activity of the management companies of MPPF is supervised by the National Bank of Slovakia. The distribution of benefits is made as an old-age pension, including an early retirement pension, conditioned by reaching the standard retirement age specified for accessing the public pension. In case of death of the participant of a MPPF, the accumulated assets are distributed to the heirs (ADSS).

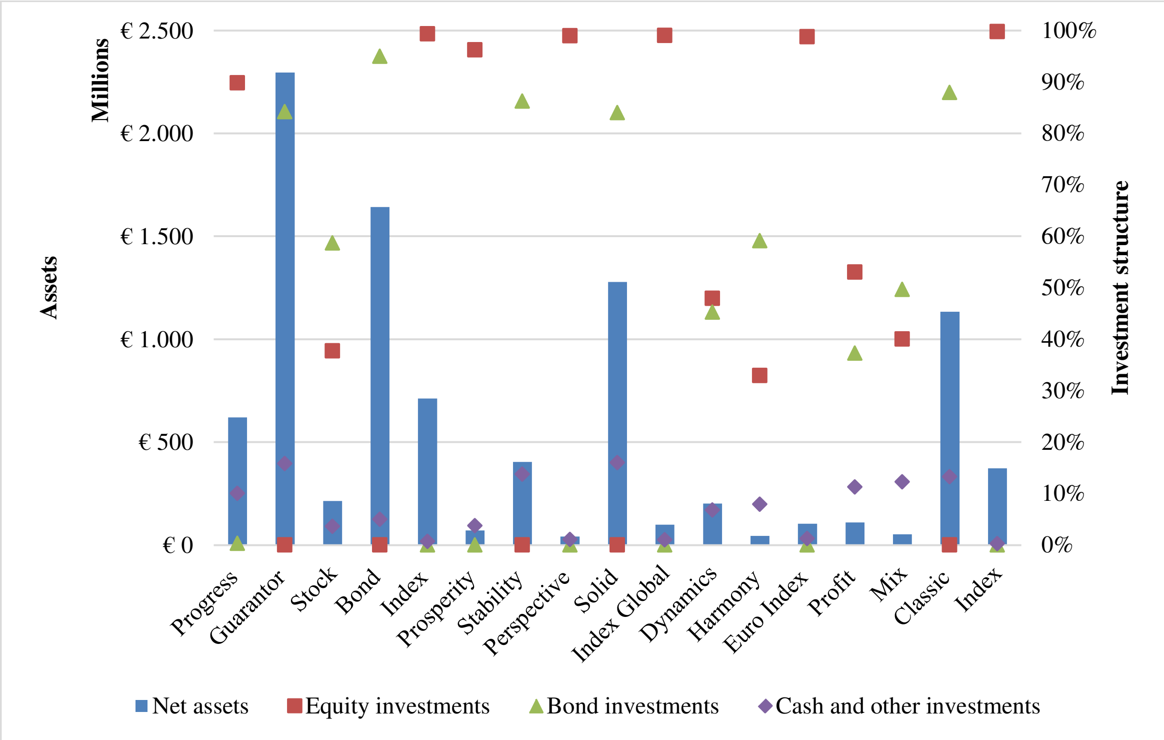
5. Performance of mandatory private pension funds in Romania and Slovakia

According to the *Report regarding the private pension fund market* released by OECD, the number of participants of a private pension fund in CEEC, reported to population aged 15 to 64 years old, increased between 2008 and 2018, attaining a coverage of approximately 57% in Romania and 39.7% in Slovakia. This evolution is reflected in the level of assets, which in 2018 reached USD 12,176 million in Romania and USD 12,038 million in Slovakia (OECD, 2019).

In Romania, the highest level of assets is held by NN pension fund (35% of the total assets) and by AZT Viitorul Tău pension fund (22% of the total assets level). In Slovakia the highest share of assets is held by the Guarantor, Bond, Solid and Classic pension funds, all of which are bond-guaranteed funds (Figure no. 2).

Figure no. 2. Assets and investment policy of mandatory private pension funds from Romania and Slovakia, April 2020





Source: Author's own processing based on data published by ASF and http://www.manazeruspor.sk/

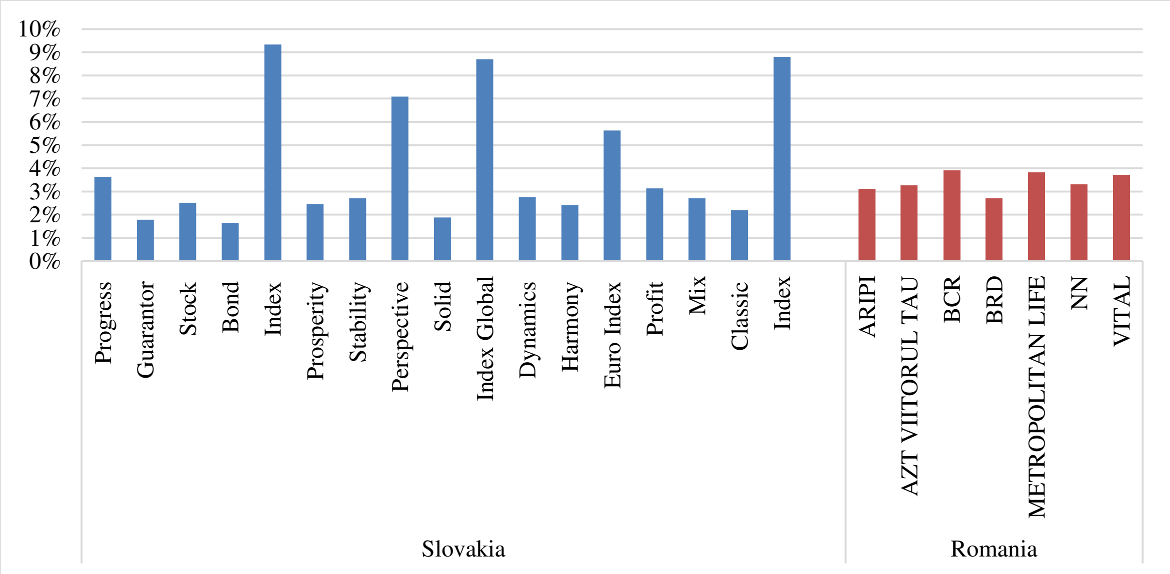
With regard to the investment structure the assets of private pension funds, Community regulations state for a prudent investment, in order to protect the interests of participants and to ensure the long-term profitability of the funds. As a result, the investment portfolio must be sufficiently diversified, both regarding the financial instruments and the issuers of financial securities to avoid dependence on a particular asset or issuer and to reduce exposure at investment risk. Investments should be made predominantly in regulated markets, and investment in derivatives should be made only to reduce investment risk and manage efficiently the securities portfolio.

However, the modern theory on investment portfolios supports their optimization depending on the profitability/investment risk ratio, although from the point of view of practitioners, this theory has shortcomings (Turcaş et.al., 2019). The investment risk is represented by the financial instruments contained in the portfolio, so the lowest exposure to investment risk is found at monetary funds, and the highest at equity funds. Turcaş et.al. (2016) propose the usage of statistical correlations between profitability of financial instruments, meanwhile the diversification of assets should be focused on the protectionist effect and not on decreasing the risk, as well as the usage of technical analysis methods in portfolio monitoring.

The investment structure of MPPF operating in Romania is composed over 50% of assets presenting a low investment risk, as bonds and government securities (Figure no. 2). But, in Slovakia, the investment policy depends on the typology of MPPF. Thus, the guaranteed pension funds have a portfolio formed by over 80% of bonds and government securities, while non-guaranteed funds apply a diversified investment policy, with a level of assets invested in shares of up to 99% (Figure no. 2).

However, the annualized rate of return does not exceed 10% in Slovakia and 5% in Romania (Figure no.3). It is noted that the index non-guaranteed MPPF in Slovakia have a higher rate of return, while guaranteed pension funds have the annualized return values below 3%. In Romania, the BCR, METROPOLITAN LIFE and VITAL pension funds present the highest values of the annualized rate of return (Figure no. 3).

Figure no. 3. Annualized rate of return of mandatory private pension funds in Romania and Slovakia, April 2020



Source: Author's own processing based on data published by ASF and http://www.manazeruspor.sk/

6. Conclusions

The implementation of pension systems is the result of the compliance to the right of social protection of population, in order to reduce and vanish the level of social inequalities. Moreover, by the financial transfers, pension systems ensure the income needed at retirement and decrease the risk of poverty.

In the context of the trend of aging, the direct dependence of PAYG public pension systems to the active population at labor market represent a threat for maintaining the financial sustainability of them.

The multi-pillar structure proposed by the World Bank and the privatization of pension systems are manners to increase the financial protection of the elderly. Although the multi-pillar structure has been implemented by many states, the privatization of public pension systems has not been a solution for all states, Hungary and Poland taking the decision to nationalize the second pillar of mandatory private pension funds.

Mandatory private pension funds operating in Romania and Slovakia are found in the phase of accumulation of capital, characterized by increasing the participation rate of population and also by a growth of net assets.

Mandatory private pension funds from Romania present a moderate risk, the structure of asset investment being predominantly formed by bonds and government securities. On the other hand, mandatory private pension funds from Slovakia are differentiated into two categories: guaranteed funds, with an investment portfolio consisting mainly of bonds and government securities, and non-guaranteed funds, with mixed portfolios. The annualized rate of return, both in Romania and in Slovakia has modest values, only the index non-guaranteed pension funds implemented in Slovakia having higher rates of return.

The general conclusion of this paper highlights that mandatory private pension funds can be a solution to ensure adequate income in old age, but it must take into account that benefits are influenced by the return of investment. In the conditions of low economic growth rate and moderate returns of financial assets, the financial resources needed to distribute private pensions might be insufficient.

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