

PROCESS OF SYSTEMIC CHANGES IN THE POLISH PENSION FUNDS MARKET

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A b s t r a c t

The paper aimed at assessment of the implemented and proposed changes in the legal environment governing operation of the pension funds in Poland. That included the legislative process in which the legislator approved the solutions aiming at improvement of competitiveness, decrease of costs of the existing system and increase of profitability in the pension funds market. The presented changes (innovations) clearly privileged the position of members in open pension funds. They decreased the fund management fee depending on the volume of assets. The bonus account was established from which the best PTE's can obtain additional profits. The contribution fee was decreased and unified. The negative direct influence of the largest pension funds on the weighted average rate of return was decreased. Additionally, new concepts aiming at streamlining the pension system are developed. They include the e.g. expanding the funds investment opportunities (e.g. in real property) and decreasing the limitations concerning foreign investments.

PROCES ZMIAN SYSTEMOWYCH NA POLSKIM RYNKU FUNDUSZY EMERYTALNYCH

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Słowo kluczowe: polskie fundusze emerytalne, system prawny, innowacje.

A b s t r a k t

Celem artykułu była ocena przeprowadzonych i proponowanych zmian, jakie już zaszły (bądź wkrótce zajdą) w otoczeniu prawnym regulującym funkcjonowanie funduszy emerytalnych w Polsce. Był to proces legislacyjny, w którym ustawodawca przyjął rozwiązania zmierzające do poprawy konkurencyjności, obniżki kosztów istniejącego systemu oraz zwiększenia zyskowności na rynku

funduszy emerytalnych. Zaprezentowane zmiany (innowacje) wyraźnie uprzywilejowały pozycję członków otwartych funduszy emerytalnych. Spowodowano obniżenie opłaty za zarządzanie funduszem w zależności od wielkości zarządzanych aktywów. Wprowadzono rachunek premiowy, z którego najlepsze PTE mogą osiągać dodatkowe dochody. Obniżono i ujednolicono opłatę od składki członków funduszy emerytalnych. Zmniejszono negatywne zjawisko bezpośredniego wpływu największych funduszy na średnią ważoną stopę zwrotu. Dodatkowo powstały kolejne koncepcje mające na celu usprawnienie systemu emerytalnego. Dotyczą one między innymi poszerzenia możliwości inwestycyjnych funduszy (np. w nieruchomości) oraz zmniejszenia ograniczeń w inwestycjach zagranicznych.

Introduction

In 1999 the pensions system reform was introduced in Poland. Next to the existing social insurance institution (ZUS) general pension companies (PTE) and open pension funds (OFE) were established and included in the system. The legislator made a number of amendments in the new pension system operating for several years. It is important that the currently operating system is still dynamic, which means that it is not yet complete and finally closed. So far it is missing one more body that is to take over the funds accrued from the OFE and disburse them in the form of benefits to individual pensioners. The only thing that is known about functioning of those institutions is their mane – pension insurance agency that should start operating in 2009 disbursing the first pensions.

Goal and methodology

This paper characterizes the innovations that occurred in the Polish pension system after introduction of the pension system reform in 1999. It also shows the areas (directions) for potential changes that are currently the subject of experts' discussions. It was attempted to determine the importance of such changes and the reasonability of such changes describing the consequences of introducing them and indicating potential beneficiaries. For that purpose the published data and materials by experts dealing with the financial market, publications of the Insurance Supervision Commission and Pension Funds as well as legal regulations controlling the market of pension funds were used. The analysis was carried out on the basis of secondary sources.

Obtaining information concerning benefits of the accepted legal solutions was the key aspect of the conducted problem research (PYTKOWSKI 1981) in the area of accepted and proposed changes in the pension system.

The operational characteristics of open pension funds

Open pension funds (OFE) are entities forming the second pillar of the new pension system in Poland. According to the law the task of those funds is to accumulate and multiply funds accrued on individual accounts of OFE members intended for pension (*Podstawowe informacje...* 2001).

The pension fund allows grouping of scattered funds from individual payments of the insured into a large capital fund that is invested in financial markets. That offers much more extensive investing options than the traditional banking account. The savings are entrusted to specialists who in turn place them also in those financial market segments to which a small investor has no access. That assures higher income, lower commissions of brokers and decreases the investment risk thanks to the possibility of a significant diversification of the placements.

The minimum rate of return of fund assets is guaranteed. Until recently it was equal to the half of the weighted average rate of return of all open funds during the period of 24 months or a rate lower from that rate by 4 percent points depending on which of those values is lower. If the rate of return of any fund is lower than the guaranteed one, the deficit is covered first from the funds of the reserve account established especially for that purpose to which the funds of the general pension company are transferred and second from its own funds. The next source for coverage of the possible shortage is the Guaranty Fund to which all operating PTEs contribute. The State Treasury is the final guarantor of solvency of the open pension funds¹.

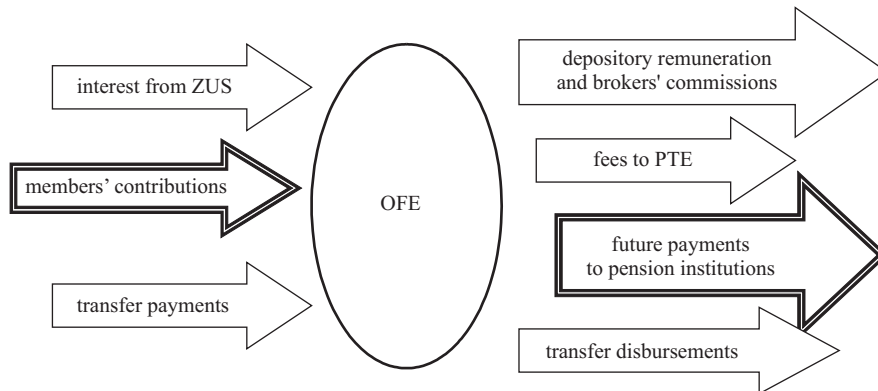


Fig. 1. Diagram of Open Pension Funds revenues and costs
 Source: *Office of Supervision over the Pension Funds* 2001.

¹ Act of 28.08.1997 on organization and operation of pension funds (DzU no 139, item 934 as amended).

The funds available to OFE are used to pay for services of the depository and the costs of operations carried out in the financial market and they can be used for payment of fees due to the company for management of the fund. The fees are deducted only in the form of deducting a specific percentage – from the contributions paid (commission) or directly from the assets (which includes the costs of fund management – according to the previous legal regulation not exceeding 0,05% of net assets per month). OFE also receives the funds in the form of transfer disbursement that accompanies a change of the open fund by the insured person. The company receives the transfer fees in case of early (up to two years) change of participation in the OFE. That fee amounted (before amendments) the maximum amount of PLN 200 and was decreased by PLN 25 for each quarter of membership in a given fund.

General pension companies (PTE) were established for the purpose of creating open pension funds and manage them at a fee. The company is a body of the fund and it can manage only one OFE (the exception is the case of a merger or acquisition of companies).

The basic tasks of each company include:

- increasing the value of the accrued OFE assets,
- winning members for the fund,
- managing the accounting of OFE and PTE,
- fulfillment of the legal information duties,
- cooperation with transfer agent and depository as well as protection of professional confidential information.

The company manages the fund at a fee. The commissions deducted from contributions paid to OFE before conversion to participation units and

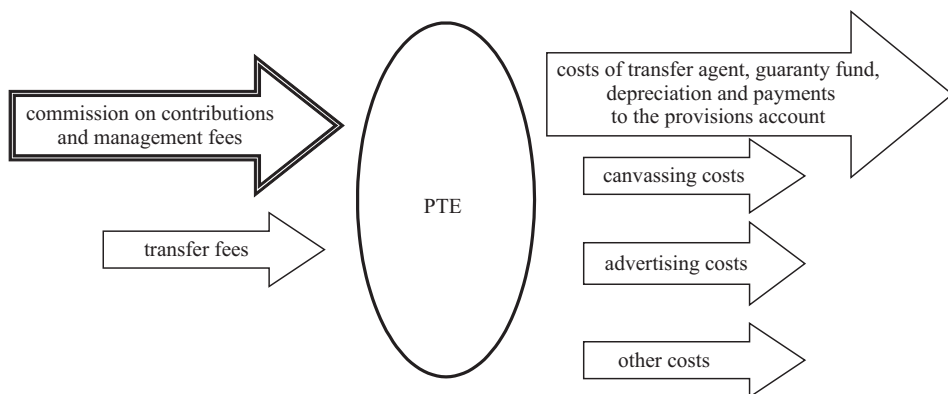


Fig. 2. Outline of revenues and costs in General Pension Companies

Source: Office of Supervision over the Pension Funds 2001.

reimbursement of fund management costs deducted from fund assets represent the largest items of company incomes. The incomes also include the transfer fees for leaving the pension fund by its members before expiration of two years of membership. Figure 2 presents the outline of revenues and costs of General Pension Companies.

Changes made in the pension funds sector

In 2003, amendments were made to the act on organization and operation of pension funds (becoming effective on April 1, 2004) that result, first of all, in financial consequences decreasing the revenues generated by the general pension companies (KOŁOSOWSKA 2004), which, in turn results in lower costs for members of pension funds and increases the effectiveness of investment of OFE members capital (at least according to the assumptions). The most important changes include:

- 1) modification of management fee for fund management,
- 2) establishment of the bonus account in the pension fund,
- 3) application of standard fee on contribution by fund member,
- 4) decrease of penal fee paid by the participant changing the fund,
- 5) change of the method for calculating the weighted average rate of return,
- 6) change in principles of the draw of new members (those, who did not choose the fund themselves).

The management fee for fund management was modified. It was decreased depending on the volume of assets managed (table 1). The percent rate of the fee will be decreasing with the increase of OFE net assets managed (from 0,045% to 0,015% per month). The fund pays direct from its assets the

Table 1

The management fee for fund management up to the net assets value

| Net assets value (PLN M) | | Monthly management fee for fund management up to the net assets value shall amount: |
|--------------------------|--------|--|
| over | up to | |
| | 8 000 | 0.045% of net assets value per month |
| 8 000 | 20 000 | PLN 3.6 M + 0.04% of the amount in excess of PLN 8 000 M of net assets value per month |
| 20 000 | 35 000 | PLN 8.4 M + 0.032% of the amount in excess of PLN 20 000 M of net assets value per month |
| 35 000 | 65 000 | PLN 13.2 M + 0.023 % of the amount in excess of PLN 35 000 M of net assets value per month |
| 65 000 | | PLN 20.1 M + 0.015% of the amount in excess of PLN 65 000 M of net assets value per month |

management fee of the company for fund management according to the following scale².

The bonus account was established to which the pension fund will transfer funds to the cup of 0.005% of the value of assets managed per month. The PTE obtaining the best result will receive the full amount of such funds, the other proportionally less, and the worst one will receive nothing. The percentage bonus ratio is calculated as the quotient of the difference between the rates of return obtained by a given fund and the fund with the lowest rate of return and the difference between the rate of return obtained by the fund with the highest and the lowest rate of return. The calculated ratio is then multiplied by the total amount of funds accrued on the bonus account. The company transfers the amount received to its account and the rest is immediately transferred to the open fund. That solution is to offer a premium to the best PTEs and force them towards more competition for good financial results and better effectiveness in multiplying the future pension benefits.

The single fee charged on the contributions was applied. During the initial years it will amount not more than 7% to decrease gradually towards the ultimate target of 3.5% in 2014 (Tab. 2). Limitation of commission is a significant change influencing the level of incomes generated by the PTEs. Before the change that fee was constant and set even as high as 9% in some PTEs. It should be pointed out that the fee is to be the same for all companies. The uniform system of fees will make fees independent from the membership duration (which occurred before amendments). As of April 1, 2004, the fund collects the fee through deduction from every contribution paid by the member of the amount corresponding to³:

Table 2

Uniform fee on contributions to OFEs

| Fee | Period |
|--------|---|
| 7% | of the paid contribution amount until December 31, 2010 |
| 6.125% | of the paid contribution amount in 2011 |
| 5.25% | of the paid contribution amount in 2012 |
| 4.375 | of the paid contribution amount in 2013 |
| 3.5% | of the paid contribution amount as of January 1, 2014 |

² Ustawa z dnia 27 sierpnia 2003 r. o zmianie ustawy o organizacji i funkcjonowaniu funduszy emerytalnych oraz niektórych innych ustaw (DzU nr 170, poz. 1651).

³ Act of August 27, 2003 on amendment to the Act on organization and operation of pension funds and some other acts (DzU no 170, item 1651).

Introduction, as of 2004, of a uniform fee on contributions to all OFEs should limit the decisions of members concerning migration between funds.

The penalty fee paid by the member migrating between funds and, which is equally important, its form, were changed. The penalty fee in case of changing the fund earlier than 24 months after joining is to be paid by the client from own funds and not, as it used to be earlier, from the funds accumulated on OFE member's account. That fee cannot be higher than 20% of the minimum remuneration. It was fixed at two levels: PLN 160 and PLN 80 depending on the duration of membership in the fund. If the period from the last day of the month in which membership in the fund was obtained until the date of transfer disbursement was less than 12 months, the fee shall amount PLN 160, if that period is more than 12 months but less than 24 months the fee shall amount PLN 80. Also the principles for calculating the membership duration changed as it will be calculated as of the last day of the month during which the membership contract with the fund was signed or during which membership in the fund was obtained as a result of a draw (earlier the membership was counted as of the moment of receipt of the first contribution to the member's account).

The pressure on obtaining the best short-term results possible was somehow limited by the design assuming that in calculating the weighted average rate of return the results of a single OFE cannot be given the weight higher than 15%. That decreased the negative phenomenon of the direct influence of the largest entities (the 3 largest OFE have 70% of assets) on the measure according to which all funds were assessed (GRADZIK 2004). To compensate for that influence in case when the average share of a given fund in the market is at least 15%, for the purpose of calculating the weighted average rate of return of all open funds the value equivalent to 15% is assumed for that fund and the indicators of the average share of the other funds in the market are proportionally increased so that the total of all of them is equal to 100%. Additionally, other adjustments concerning the weighted average rates of return were introduced. The length of base period for determination of the rates of return for individual funds and the average rate was extended from 24 to 36 months. The frequency of the rate of return testing was changed from quarterly to semiannual. That allows greater investment policy flexibility and decreases the risk of not achieving the minimum rate of return.

The principles applying to the draws of new members who failed to make decisions on choice of the pension fund within the specified deadline were also changed. The earlier draws made allocation of members among funds proportionally to the number of already registered members of funds, which generally supported concentration. After modification of the rules the

allocation of new members (in equal numbers) is given to the funds that achieved higher than average rate of return excluding the funds with market shares exceeding 10%. Those solutions by their nature prevent concentration (OTTO 2004).

Concepts for further development of pension funds sector

Among experts discussions continue on what else could be changes (improved) to streamline the operation of open pension funds market. The major directions of those considerations cover:

- 1) expanding the investment possibilities of the funds,
- 2) increasing the limit for foreign investments,
- 3) choice of the concept of operation of pension insurance institutions.

The first change proposed concerns allowing the funds investments other than those in the financial instruments, e.g. investments in real property. Involvement of pension funds in the real property market should have a positive effect on liquidity and transparency of that market as well as expanding the options for financing that market. The growth rates for investments in real property are less dependent on the rates of return on the capital market, which means that including real property in portfolios of funds could decrease the risk of that portfolio. The rates of return for investments in real property in long term exceed those obtained on financial instruments and, as a consequence, including real property among investment options for funds can mean their increased effectiveness (JAJUGA 2004). However, it is doubtful if that will happen. Polish solutions assume, first of all, the system security and daily appraisal of the pension fund unit. For that reason direct investments in real property or venture capital cause a problem considering their daily appraisal. Investing in that type of instruments, however, is not entirely forbidden. Such investments can be done indirectly through closed investment funds the investment certificates of which could be stock exchange listed (EGGINK 2004).

The next issue is increasing the current 5% limit for foreign investments. The current limit hinders geographic diversification significantly. The more so that the EU Directive 2003/41/EC recommends that pension funds should place 30% of their assets outside the country in which they operate. That aims at minimizing the country risk. Simple sectoral diversification does not protect the managed portfolio against currency crisis risk or political risk. Such risk, although low, is still real. The opponents against that innovation present the argument that even the current limit of 5% is not fully used by OFEs. Probably the low interest of funds in foreign

investments is a consequence of the fact that the limit is too low to justify additional analytical and organizational effort of the management. Even if the rate of return on such investments is significantly higher than on the domestic investments, its influence on the rate of return of the entire portfolio would still be minor. It should also be remembered that foreign investments are relatively more expensive than the domestic ones. The additional argument for increasing the limit for foreign investments is that the supply of liquid financial instruments in the Polish market is (or rather will be) too small to respond effectively to the demand represented by open funds. The projections of the Office of the Commission of Supervision of Insurances and Pension Funds forecast that by 2010 the value of OFE assets will amount ca. PLN 170 billion, i.e. roughly 3 times more than in 2004 when the OFEs managed the funds of PLN 57.4 billion. That means that the demand from the OFEs will increase by around 300% while the total supply of financial instruments will increase by around 90% only to the level of PLN 590 billion (*Perspektywy rozwoju*. 2003). On the other hand those in favor of the low limit for foreign investments say that it should not be allowed for future Polish pensioners to finance foreign economies instead of the Polish one. In the interest of members of the funds the funds should be invested in domestic assets only (considering decrease of unemployment and GDP growth). That is a strong argument, although that issue could also be viewed from the other side. Instead of talking about Polish pensioners financing foreign economies we could talk about foreign economies financing future (Polish) pensioners (GRODZIK 2004). As a consequence, it seems inevitable to allow open pension funds investing 20-30% of their assets abroad.

The second pillar of the pension system must include, in addition to the institutions that serve accumulation of pension capitals, i.e. the open pension funds, also the institutions that will disburse benefits from the capital part of the pension system. The Act on organization and operation of pension funds of 1997 calls those institutions the pension insurance institutions without specifying the details of their operation. At present a number of solutions for that problem are offered. The disbursement of pensions could be carried out by entities established especially for that purpose, which, similarly to the general pension companies, would be commercial entities operating on market principles. The other proposal concerns a concept of a system of disbursements based on establishing one State institution as an alternative to the market of private pension institutions. Another concept assumes that the function of pension institutions could be taken by already operating life insurance companies. The pros and cons of those solutions are presented in table 3.

Table 3

Pros and cons of solutions concerning the number of institutions disbursing pensions

| Item | Many entities | One institution |
|---|---|---|
| Establishing the system | Pros: – possibility of using the knowledge and experience of many financial institutions Cons: – low profitability of entities (particularly at the early stage of system operation) | Pros: – possibility of using the existing structures of ZUS – low general costs of commencement and continuation of operation Cons: – elimination of competition mechanism – susceptibility to political influence |
| Servicing of operations involved with entering the system | Pros: – competition increasing service level Cons: – possible high canvassing costs | Pros: – possibility of limiting costs – simplification of retiring Cons: – no competition – low service level |
| System management | Pros: – higher investment effectiveness – immunity to political risk Cons: – no possibility of leaving an ineffective institution | Pros: – no difference in rates of return for individual participants Cons: – political risk (influence of different social groups) |
| Disbursement of pension benefits | Pros: – flexibility in method and time of disbursement | Pros: – possibility of simple combining disbursement of pillars I and II. |

Source: Commission of Supervision of Insurances and Pension Funds, 2005

Conclusion

The paper presents the most important changes that occurred in the legal environment of the Polish pension system after 1999. The main focus in the legislative process was placed on the needs of open pension funds members. The amendments made aimed at decreasing the operational costs of the system and encouraging those managing the funds to obtain higher rates of return.

The innovations made in operation of the pension system should be considered positive and going in the right direction. The major ones include modification of the fund management fee, establishment of the bonus account in the pension fund, application of uniform fee from fund member's contributions, decreasing the fees incurred as penalty by a member migrating between funds, change in the method of calculating the weighted average rate of return and change in the principles of drawing new members for funds by ZUS. The management fee will decrease with the increase in the amount of net assets managed by a fund. The pension companies obtaining the best financial results will obtain additional compensation from the bonus account. The fees covered

from the member's contribution were decreased significantly. In calculating the weighted average rate of return the excessive influence of the largest pension funds was decreased improving as a consequence the position of the smaller funds.

The paper also presents the areas of potential changes in the pension system that are subject to current discussions concerning their rationale. The major items of improvements include expanding the opportunities for investing funds (in addition to currently allowed financial instruments), increasing the limit for foreign investments and choice of the concept for operation of the pension insurance institutions (the payer of pension benefits).

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