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Third pillar of the pension system in Poland

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Abstract: The purpose of the article is to present a proposal for supplementing the existing pillar of voluntary pension insurance so that it becomes an important contribution to increasing future retirement benefits. The article presents recommendations by OECD experts on how to construct a voluntary fully funded pillar of the pension system. It also demonstrates the ranking criteria for evaluating the existing pension systems. The author has described what he considers to be the most effective solutions for stimulating voluntary savings.

The new proposed solution is based on the introduction of automatic participation of employees in a licensed retirement product. The State should support the development of such a product through a system of incentives with preferential treatment of average and lower earners. It is recommended to keep the existing reliefs applicable to individual IKE and IKZE products and to strengthen the incentives applicable to employee pension plans in favor of employees and employers. The key elements of the proposed solution are employers and universal pension fund companies (PTEs) managing voluntary pension funds. It is recommended to apply a tender mechanism to the automatic enrollment of employees in saving programs to improve the competitiveness of operation of the whole market.

Keywords: voluntary DC, pension funds, autoenrollment, tax incentive

JEL codes: G23

1. Introduction

The change of the pension system from defined benefit to defined contribution, introduced in Poland in 1999, caused a reduction of future replacement rates. The purpose of the pension reform was to improve solvency of the pension system without increasing contribution levels. According to the assumptions, the mandatory second pillar was to diversify risk in the savings accumulation phase. Pension payments were to originate from various sources; benefits from the state were to be supplemented by private pension companies. The goal of the third pillar, which was to increase the replacement rate through additional individual rates, has not been accomplished.

The changes introduced in 2014 to the second pillar have materially changed the role of open-end pension funds in funding pension benefits. The main change is abolishment of mandatory payment of contributions. Due to the requirement to file a contribution transfer declaration and the ban on advertising, a small percentage of members will continue to transmit their contribution to OFEs. The capital part of the system will no longer be universal.

In this situation, growth of the third pillar of voluntary pension insurance is very important and necessary; it will make it possible to increase the level of benefits and diversification of sources for future pensions.

When modeling the target structure of the third pillar of the pension system, one must answer a number of questions. What are the mechanisms that should be embedded in the system to break through the inertia and lack of economic education, which prevent people from accumulating assets for future pensions? How should a cost-effective and investment-effective system be designed? The challenge of growing this segment of the pension system is magnified by the fact that after more than ten years of efforts to raise interest of a major group of employers and working Polish citizens with employee pension programs and individual pension savings products, the desired result has not been achieved. Only a small percentage of eligible population has savings in third pillar products and total assets accumulated in this market segment were only 0.84% of GDP.

Experiences from other countries may be helpful in our reflections on the target design of the third pillar in Poland. Pension system is a challenge for most states in the world, since the issues result from global trends of aging societies and a broad range of the recent financial crisis. In many countries, in response to a threat of a pension crisis, changes aimed at increasing the retirement age and introducing a voluntary defined contribution capital pension schemes have been introduced. And even though there is obviously no perfect system that could be used in all countries, it is still worthwhile to look for such elements and features of the solutions used throughout the world that result in higher benefits in a sustainably profitable system.

OECD recommendations on the design of private pension schemes may prove helpful in this respect. One should also learn which key variables of pension schemes are evaluated by experts in creating the Melbourne Mercer Global Pension Index ranking. With each subsequent edition of the ranking, the authors present current recommendations on how to improve the solutions existing in the countries evaluated.

This article presents examples of solutions from other countries that the author believes best describe the challenges of building an efficient capital pillar and which may be an inspiration for the target model in Poland. The presentation of myRa and Save more tomorrow examples and the pension reform in the UK show what key variables of the system may be decisive for the effectiveness of the solution.

The purpose of this article is to present proposals to supplement the existing pillar of voluntary pension insurance so that it becomes an important element in increasing the future pension benefits. The proposed new solution involves introduction of automatic participation of employees in a licensed pension product. The state should support development of this product through a system of incentives with preferences for average and lower income individuals. It is recommended that the existing tax reliefs for individual products such as IKE and IKZE be maintained and stronger incentives adopted for employee pension schemes for employees and employers. Employers and universal pension fund companies that manage voluntary pension funds are the key elements of the proposed solution. A tendering mechanism is recommended for automatic enrollment of employees to the schemes in order to boost competitiveness of the entire market. The cost efficiency of the proposed solution results from involving the entities which currently manage significant assets and have the necessary infrastructure. This paper presents the key elements of the investment process of the new product. A solution for a default allocation path has been proposed and the conditions for individual strategies have been defined. It has also been emphasized that access to funds must be made more flexible; in the event that other important necessities of life have to be funded.

2. Current status and diagnosis

The changes to the Polish pension system, which replaced defined benefit with defined contribution, were aimed at increasing financial stability of the system and were forced by adverse demographic forecasts. They resulted from three parallel tendencies: a quick increase in longevity of the society, low birth rates, emigration rates exceeding immigration rates. Contributions were maintained at previous levels, to maintain competitiveness of the economy, which resulted however in a reduction of future pension benefits. In order to diversify sources of

future benefits, two capital pension systems were created: mandatory pension funds in the second pillar and voluntary pension funds in the third pillar. The capital solutions were to prevent deterioration of benefit levels, through capital market premium over GDP growth rates. An increase in replacement rates was also to be driven by increased individual savings.

Despite the important role of the third pillar in the reformed pension system, it never achieved the expected interest of employees. Overall, at the end of 2013, the third pillar accumulated assets of PLN 13.8 billion (KNF, 2014a), which is the equivalent of 0.84% of GDP.

817.7 thousand people held IKE products, which represented 5.2% of the professionally active population (KNF, 2014b). The value of the IKE market in respect of assets under management was PLN 4.3 billion. In 2013, 57.9 thousand new IKE accounts were created, which is 11.9 thousand less than in 2012. Payments were made to 31.8% of the existing IKE accounts, with the average payment of PLN 3.1 thousand and the average account balance PLN 5.2 thousand.

496.4 thousand people held IKZE products, which represented 3.2 % of the professionally active population. The value of assets accumulated on IKZE accounts was PLN 119.2 million. In 2013, 65.3 thousand people decided to open an IKZE account. Payments were made to 11.0% of the existing IKZE accounts, with the average payment of PLN 1.1 thousand.

At the end of 2013, there were 1,070 active employee pension plans (PPEs) and the value of accumulated assets was PLN 9.4 billion. PPEs covered 375 thousand people, or 2.39% of all workforce. The average value of assets per statistical PPE member was PLN 25.7 thousand and the average basic contribution per member was PLN 3,643.

The main reason for the low level of savings in the third pillar is the public's low awareness of the fact that replacement rates will decline in the future. At the same time, the system was lacking support of tax reliefs which, as the experience of other countries has shown, are necessary though not sole condition required to mobilize pension savings. The experience of other countries shows that another savings stimulating factor is the belief that state benefits will not be sufficient to ensure a decent standard of living after retirement. Respondents in Poland have cited lack of available cash as the main reason for not setting aside any funds for additional pension (Szczypek, Wrzosek, 2012). Almost 60% of respondents hold this belief. 16% claim that they are not thinking about retirement yet and for 13% retirement is too distant a prospect and therefore they do not earmark any funds for this purpose. 9% of the respondents justify their

choice by the distrust of pension products offered by financial institutions. One of the factors fueling the distrust of pension products and unwillingness to entrust funds to financial institutions is limited knowledge on this subject. As much as 37% of Poles claim that they have no knowledge whatsoever on pension instruments and another 34% believe they only have basic knowledge on this subject. More than half of the respondents admit that they would like to know more.

Ever since 2004 when the first pension product, IKE (or Individual Retirement Account), was introduced, efforts have been made to remove those barriers. In 2008, several legislative changes were made, allowing for installment-based payout and withdrawal from IKE or withdrawal of a portion of funds accumulated on the IKE account. Moreover, the limit of contributions to IKE was increased to the equivalent of three average forecast monthly salary in the national economy. According to a report by the Polish Financial Supervision Authority (KNF), the legislative changes introduced in 2008 did not cause an increased interest in IKEs (KNF, 2014b). The number of existing and newly opened IKE and the number of accounts to which contributions were made during the year continued to decline steadily. Moreover, the increase of the IKE contribution limit did not drive a significant increase in funds contributed to IKE. The percentage of those saving on IKEs, since the launch of the product, has never exceeded 6% of the workforce.

Another action from the legislator was to introduce, as of 1 January 2012, individual retirement protection accounts (IKZEs), which enabled a deduction of contribution from the taxable base up to the limit specified in the relevant regulations. In 2014, IKZE was redesigned; the limit on contributions to IKZE was set at 1.2 times the average forecast monthly salary in the national economy and the payouts subjected to fixed-rate income tax of 10% instead of taxation according to the tax rates applicable on the payout date. This was supposed to encourage the potential retirement savers to conclude IKZE agreements. The potential positive impact of the change in the taxation of IKZE payouts is shown by results of a study commissioned by the Chamber of Fund and Asset Managers (IZFiA, 2013). With the current tax rates, 23% of the respondents declared investments in IKZE; at the 10% tax rate, the percentage of those willing to invest in IKZE increased to 35%, while abolishment of all taxation of the savings under IKZE would encourage over half of Poles to start saving.

In recent years, the pension system has been constantly discussed in public. Discussion accompanied the legislative changes in the operation principles of the open-end pension funds. In 2011, it was related to a transfer of a portion of pension contribution from open-end pension funds to individual sub-accounts of the insureds held by ZUS. In subsequent years, the debate focused on the increase of the retirement age and the method of payout from open-end pension funds. In 2013, the government presented a report on the review of the operation of the pension system and the discussion moved towards fundamental changes in the operation of open-end pension funds recommended by the government. Despite the strong presence of pension-related topics in the public debate, this did not cause any significant boost of interest in the third pillar.

Low interest applied also to employee pension plans although, as the 2013 data shows, the number of members and the value of assets and transmitted contributions increased as well. One should remember that, as KNF emphasized in its report (KNF, 2014a), development of the institutions where contribution is funded by the employer, is conditional not only upon the willingness and determination of employers and employees, but also on the actual capacity of the businesses to fund the contributions. This in turn is closely linked to the macroeconomic environment in which businesses operate. In this respect, 2013 was not a good year. Compared to the previous years, the economic growth rate dwindled, while internal demand and investments also decreased. It seems that in such conditions, businesses may withhold their decisions to incur long-term liabilities; therefore, only a small number of entities decided to establish such schemes.

Additionally, experts point to a number of obstacles hindering growth of these pension saving methods. They believe (Pawlak, 2014) that the administrative requirements that an employer must satisfy in order to establish, register and run a pension scheme will discourage them from establishing such a scheme. Employers' duties include execution of company agreements recognized by the trade unions and selection of the financial institution to run the PPE, negotiate the terms and register the plan. Experts propose to simplify the process of establishing a PPE. At the same time, several institutions submitted their proposals of legislative changes that would increase efficiency of the third pillar. KNF presented (KNF, 2014c) a number of proposed changes to the act on employee pension plans and the WSE submitted the recommended changes during the public consultations on changes in OFE (GPW, 2013).

In addition to the low value of assets accumulated in the third pillar, further changes in

OFE introduced in 2014 reduced the capital part of the pension system in Poland. The main change was the introduction of a voluntary transmission of contributions to OFE. Every four years each of the fund members may choose whether or not he/she wants to save in OFE and ZUS or the entire contribution should be registered in ZUS. The requirement to submit a written declarations for those wishing to remain ofe members coupled with a ban on advertising OFEs imposed around the same time weighted heavily on the fact that only 385 thousand members submitted such declarations by the end of June. It is worth mentioning that in order to keep sending contributions to ofe clients were required to take action otherwise by default their contributions would be transferred to ZUS. It was estimated that by the end of July the number of individuals having their contribution transmitted to OFE would increase to 700-900 thousand members, which would represent 4.2-5.4% of the overall number of fund members at the end of May 2014. As a result, the capital second pillar ceased to be a universal solution. Additionally, owing to the transfer of assets from OFE to ZUS and the voluntary nature of contributions to OFE, the share of the capital pillar in the final benefit has fallen significantly. Also, the entire pension benefit would be paid out by ZUS, rather than by the capital the repartition schemes. The assets accumulated in OFE will be gradually transferred to ZUS over a period of 10 years before the fund member reaches retirement age and will be registered on individual accounts, which are the basis for calculating the benefits.

The results of a study conducted by CBOS in May 2014 (CBOS, 2014) show just how big a challenge it is to boost the savings in the third pillar. The report shows that 60% of adult Poles declare that, even after a significant change of OFEs' role in the pension insurance system in Poland, they do not intend to make individual pension savings in the third pillar. It should also be noted that almost two fifths of the respondents are strongly convinced about the latter. The intention to save is declared by 19% of the respondents, while only 6% have already decided.

With the current level of awareness and relatively low disposable income among the majority of the population, there will be no significant increase in contributions to pensions, since the time horizon is too distant. In order to build a strong third pillar of pension savings, we need time and changes in the system.

3. OECD recommendations and rankings

The trend of aging societies is global and therefore a question arises how long-term solvency can be ensured along with adequate pension benefits; this is a challenge for many countries. The financial crisis of 2008, which increased deficit levels and public debt exacerbated the problem even further. Therefore, intensive analyses and studies have been conducted to find the design of an effective pension system to satisfy these challenges. It is obvious that there is no single ideal model that would match the diverse situation in different countries. The clues may include the recommendations developed by experts and the ranking criteria used to evaluate the existing pension systems.

Based on academic research and experience gained from implementing changes in pension systems over the world as well as from the lessons from the latest financial crisis, OECD experts presented their recommendations on how they believed private pension plans should be designed in the Roadmap publication (OECD, 2012). They suggest internal coherence between the accumulation and payout phases (Soldek, 2013). They stress in particular the necessity to improve the incentives to save for retirement. Emphasis is placed on the proper structure of tax incentives, where subsidies for low income individuals and matching of contributions should play an important role. This structure of incentives should boost savings of not only above-average earners, who benefit most from tax reliefs, but also lower income groups. Another recommendation resulting from the lessons learned during the crisis is to promote low-cost retirement savings instruments. OECD experts note that transparency should be supplemented by a tendering mechanism or a default allocation of members to low cost bidders. This is particularly important in mandatory systems and solutions where participation is automatic. Setting appropriate default investment strategies, while also providing choice between investment options with different risk profile and designed for investors with different investment horizons is another challenge mentioned by OECD. The experts noted that this was particularly important since many clients may not want or be able to select the optimum investment strategy. The default option for such clients should be well designed in consideration of behavioral economy. The life-cycle strategy is recommended for the accumulation phase in order to maximize the number of people meeting their pension goal is. An automatic reduction of exposure to risk assets as the saver draws closer to the retirement age is the best way to achieve the capital protection objective. Experts recommend this method as a default option.

At the payout phase, they note the need to create incentives for converting the accumulated savings into a stream of lifelong pension benefits, which are to provide protection against longevity risk.

Experts from Mercer, a company which, in conjunction with the Australian Centre for Financial Studies, has been publishing the Melbourne Mercer Global Pension Index presented the evaluation of and recommendations for pension systems in 18 countries. The ranking was based on the assessment of over 40 ratios grouped in three categories: adequacy, sustainability and integrity. When evaluating pension systems, the experts emphasize that it is the second and third pillar systems that are critical for the provision of adequate pension benefits. The experts analyzed whether the solution in place benefited from tax incentives offered to average income earners to save for retirement, what access to assets clients had before the retirement age, what rights to the accumulated assets the plan member had upon a job change, separation or divorce, and the proportion of the savings used to purchase an annuity. The criterion used to evaluate the system's capacity to increase future benefits was the percentage of investments held in risk assets, including equities and property. The authors of the ranking took note of the regulations, protection of individual members against risks, and communication with fund members.

The Polish system was ranked in the middle in all editions of the ranking. In the most recent publication, the experts recommended raising the minimum level of support available to pensioners and introducing a requirement that part of the retirement benefit must be paid out as life annuity. They also recommended raising the level of household savings and funded contributions in capital funds. Other recommendations included increasing the labor force participation rate among older workers and introducing tax incentives to employee pension plans. The gradual reduction of importance of OFEs and the lack of changes postulated for the Polish pension system will most likely downgrade Poland in the new ranking (Nowak, 2014).

4. International initiatives and experience

The effect of aging societies and the financial crisis forced a number of countries to reform their pension systems in the area of participation, adequacy and diversification. A large part of OECD countries decided to postpone the retirement age.

In order to reduce the excessive load on future generations, capital pension systems were developed in several states. The European Commission recommended support for supplementary pension savings in order to increase pension income (European Commission, 2012). Several analyses note the need to fill the pension savings gap. OECD estimates that the replacement rate from the mandatory pension systems for 17 states as a whole will be 41% for average earners. This means that 13.1% of the replacement rate will have to be funded by voluntary capital systems (OECD, 2013). In Poland, according to the Aviva report (AVIVA, 2010), the "pension gap", defined as the shortage in the annual amount of savings in order to achieve a pension equivalent to 70% of salary was estimated at PLN 275 billion. Statistically, for a Polish citizen retiring in the coming years, this means that he/she should save an additional 13,600 zloty every year.

Among numerous initiatives undertaken to answer the pension challenges, there are several interesting solutions, which may be an inspiration for building an effective voluntary capital pension pillar in Poland. An interesting proposal was presented by President Obama in the beginning of 2014. The myRA account is to be a simple, safe and accessible pension account offered by employers (USDoT, 2014).

It is to encourage low and average income Americans to start saving for retirement. The new product is to be addressed for those who have no chance to participate in an employee pension plan. It is estimated that half of the full-time employed and 75% of part-time employees are not beneficiaries of any company pension plan. Employers will not have to administrate and pay contributions to accounts of their employees. All the employees may pay contributions to their own account, including those with 401(k) company pension plans, provided that their annual income is not higher than 191 thousand dollars. The contributions will be taxed and payout funds exempt from tax. Therefore, there will be no capital gain tax. The funds accumulated in the account will be invested in treasury bonds and we should expect rates of return at the level similar to the Thrift Savings Plan's bond fund, with the average of 3.6% in the period of 2003-2012. Retirement savers will have a guarantee of the state treasury that the value of assets in their account will not go below the nominal value of contributed capital. Even when employers change, the accounts will remain operational and the members will continue to have the right to make contributions. An important feature of the proposal is that the funds from the account can be paid out up to the contributed amount without any penalty. However,== any

payout of profits before the retirement age is reached will be subject to taxation. The minimum initial contribution was set at 25 USD and additional minimum contributions at 5 USD. The members will be able to make contributions up to the limit of 5.5 thousand USD per year. When the account balance reaches 15 thousand USD or has been opened for 30 years, it must be transferred to the Roth IRA account, where the investment of funds remains to be exempt from taxation. An interesting feature of this solution is the central role of employers and their capacity to deduct contributions when paying out the salary. The entire program has been designed as a starter encouraging employees to start saving even small amounts. It is targeted at low and average income individuals. It expands the offer of pension products supported by the state, customizing it to different income segments. Retirement savers will not pay any fees, which is particularly important for the low amounts paid in to the account. The incentive for employers is that they do not have to administrate and incur costs associated with the service of myRA accounts. The automatic deduction of contribution from salary means that saving for retirement becomes very convenient for employees. The main idea of the president's proposal is to encourage those with sub-average income to set aside even small amounts and a conviction that regular and systematic saving may increase future pensions. A similar concept of a simple pension product targeted primarily to lower income groups was presented in October 2012 by the Polish Financial Supervision Authority (KNF, 2012).

It is worth noting that in the annual budget for 2014 the President again included proposals of automatic opening of individual pension accounts (IRAs) for those employees who are not members of company pension funds, as well as a proposal to limit tax exemptions for retirement payments to the wealthiest Americans. According to the President's proposals, employers who do not run a company retirement plan will be required to allow automatic transfers of contributions to IRAs. This will allow 25% of the employed to save money for retirement. The President's arguments in favor of automatic access to IRAs include statistics demonstrating that 90% of the employed who were automatically enrolled for 401(k) employee pension plans, pay their contributions whereas less than 10% of those eligible pay their contributions to IRAs. Although neither the employer nor the employee will have to pay any contributions, enabling access to the account will, in the opinion of the President, allow for a broader use of tax reliefs. Today, the use of tax reliefs is concentrated in the highest earners

segment. It is estimated that in the United States two thirds of tax benefits from contributions paid to retirement accounts are collected by 20% of the highest earners and one third of tax relief goes to the wealthiest 5% of earners. That is why the President's package of changes includes modifications limiting the availability of tax benefits to retirement savers belonging to the highest income segments. A heated debate is underway in the United States about the mandatory enrollment of workers in pension funds. Some experts, for instance Statman and Fink, recommend going a step further and suggest mandatory pension plans as the only effective solution to the crisis situation (Statman, 2013; Steyer, Fink, 2013).

Another interesting idea is the program Save more tomorrow proposed by Thaler and Benartzi (ACA, 2014). Under this program, members of an employee pension fund automatically increase their contributions to the pension fund at each subsequent salary increase, up to a predetermined maximum amount. Similarly to automatic enrollment, members under this program also have an option to withdraw from the automatically increased pro rata contribution to the fund. In such a case, the persons concerned do not experience a decrease in salary due to higher contributions transferred to the fund but have their future salary increases reduced. As the authors demonstrate, based on the example of real companies that have implemented this program, it has turned out to be very effective. In one example, after four salary increases over a period of three and a half years program members increased their contributions from 3.5% to 13.5%, while the contributions paid by employees making their own decisions remained at the same level. 78% of total staff enrolled in the program with automatically increased contributions and 80% of those remained in the program. According to the survey by Aon Hewitt in 2010 (ACA, 2014), 59% of large U.S. companies had in place various forms of automatic increases in contributions paid by employees. This solution allows for overcoming the identified limitations in making retirement saving decisions. The authors indicate that risk aversion and deferring retirement saving decisions instead of acting now are the main obstacles to the accumulation of voluntary pension savings. An interesting feature of the solution where a predetermined path of contributions increases in line with rising salaries is that the positive effect results from inertia and deferred actions, which in this case actually contribute to increased savings.

The conclusions of the paper presenting the Save more tomorrow program concerning the need to overcome the inertia in action and deferring retirement saving decisions through the structures of the target pension system solution were taken into account in the most recent reform

of the pension system in the UK. Since the beginning of 2012, automatic participation of workers in pension programs has been in place, with the possibility of withdrawal by the employee during a period of three months. The fundamental and distinguishing characteristic of the new system is that employers who do not run a company retirement plan are required to enroll their employees in a retirement plan. Initially, the employee's contribution of 1% is matched with an additional 1% of the employee's remuneration paid by the employer. The contributions paid by the employee and the employer will increase gradually, and finally is expected to reach 4% from the employee, 3% from the employer and 1% from tax refunds in 2018. The enrollment of employees in the plan has also been spread into stages ending in December 2018. During the first year of operation of the new regulations, companies employing over 120,000 staff were required to perform automatic enrollments. According to government estimates, the target number of workers covered by the program will reach 10 million people paying annual contributions of £11 billion. To facilitate the automatic enrollment of workers, the government established the National Employment Savings Trust (NEST), NEST is required to accept all workers enrolled by employers. The purpose of the fund is to provide low-cost and high-quality asset management services to those workers whose employer does not offer a company retirement plan. The target group consist of low and medium earners employed in small and medium-sized companies. At the end of 2014, over 3 million workers were automatically enrolled in the funds and the winner among the institutions offering pension programs was NEST with 1 million members. From the beginning of automatic enrollment to the first quarter of 2014, only 10% of eligible workers exercised the option to withdraw from the program. After a period of three years they will automatically be enrolled in the fund once more with the possibility of withdrawal within three months. The number of withdrawals is lower than the 25% estimated by the government, but what should be kept in mind is that those were employees of the largest UK corporations. Also worthy of note is an interesting investment solution proposed by NEST. For members who fail to select their investment strategy, NEST offers default funds in the form of 45 target date funds where the allocation of risky assets decreases as the member approaches his or her retirement age. Any member intending to work shorter or longer than the statutory retirement age may change his or her fund to a fund with allocation corresponding to such a member's planned year of retirement. To establish a desirable habit of saving and to avoid a negative reaction to losses

which may be experienced by members starting their saving routine, NEST offers an asset allocation path consisting of three phases which is unique in the market. The assets of members beginning their saving routine at the age of 22 are invested over a period of five years in accordance with a low-risk strategy. The investment objective is a result not lower than the inflation rate. At the next stage, the asset manager is expected to beat inflation by 3 percentage points per year in the long term. At this stage, the fund invests most of the assets in equities and real estate. In the final stage, which begins 10 years before the member's reaching the statutory retirement age, risky assets are converted into instruments appropriate for the method of disbursement of the benefits. Due to the short period of asset accumulation, the payment of benefits will initially take the form of a single cash payment. For this reason, the fund will invest its assets in liquid revenue instruments such as government bonds, passive bond funds and money market instruments. As the amount of assets will increase in the members' accounts, those members who will be willing to receive life annuities will be offered a dedicated fund hedging against the interest rate risk. For members choosing their own investment strategy, NEST will propose a growth assets fund, a liquidity fund, a fund investing in instruments that meet ethical criteria or a fund based on Islamic law. NEST has also set a new cost benchmark for the providers of pension products in the United Kingdom. The fund charges a 0.3% management fee and a 1.8% fee on the paid contributions, which is to be lifted when the fund reaches an appropriate scale of operation.

Similar solutions adopted in Germany have proven to be effective in terms of universality: approx. 40% of eligible workers save their money in the Riester Pensions. Also in New Zealand nearly 50% of those eligible pay their contributions to KiwiSaver accounts.

5. Solution for Poland

In order to create a universal, competitive, cost-effective and voluntary (in terms of the method of investment) pension pillar in Poland, certain constraints and characteristics of the market should be taken into account at the stage of its designing. The lesson to be drawn from the foreign experience described above is that in order for a solution to be universal, i.e. involving more than 25% of the employed, it is necessary to overcome inertia and lack of education. As regards to education, it is a long-term process. In turn, tax reliefs are an incentive predominantly to higher

earners. An effective method of increasing employee participation in saving funds for retirement is their automatic enrollment in pension plans with an option to withdraw within a certain time limit. The purpose of automatic enrollment to a retirement account is to provide an incentive to begin a saving routine of even small amounts from low disposable income and create a saving habit.

The establishment of a cost-effective solution requires understanding that institutional asset management is a business of scale. The cost of services is affected by the cost of acquiring clients, managing and building the infrastructure. Fixed costs remain unchanged as the amount of assets grows, thus entities having large assets under management and existing infrastructure may offer additional services at competitive rates. That is why the existing institutions and infrastructure should be used to the largest extent possible. Companies already operating in the market with appropriate infrastructure built for the flows and recording of contributions should be involved, because only they are able to achieve positive business results charging clients at a moderate level of fees. Unless companies that need to run a profitable business are interested in the third pillar, it will never develop. Automatic enrollment with a withdrawal option is also a solution that reduces the costs of acquiring clients, which are typically a significant cost item for financial products offered by asset management companies.

Another important element to be taken into consideration in the construction of the target solution is a competitive nature of the offers proposed by service providers. It should be kept in mind that competitive factors in asset management services are: offering an investment strategy tailored to the client's objective and accepted risk; level of fees; and relationship with the client. Providers of asset management services must be able to freely shape their investment strategies in a manner adapted to the market risk accepted by the client. To strengthen competition in this market, the tender mechanism of default allocation of members to low-cost bidders which is recommended by the OECD may be applied. The involvement of employers, having a greater bargaining power than retail clients in relation to financial institutions should be another factor contributing to the strengthening of competition.

The central role in the target solution should be played by a basic pension product addressed to the broadest possible group of employed and self-employed people. The investment and cost requirements to be satisfied by such a solution would be defined in the Act. Proposals

submitted by eligible financial institutions would be evaluated by the Polish Financial Supervision Authority (KNF). The product could be offered by all types of financial institutions which currently are permitted to offer IKZEs, IKEs and PPEs. Saving money in such accounts would be supported by tax reliefs or subsidies dependent on the contributions paid by each member. The Act defines the cap on payments and the rules for subsidies and incentives which depend on the current situation of the state budget. The policy of incentives should be long-term to build trust among the savers. The support system must be clear and comprehensible to savers. Because the assumption is that this product is supposed to be the universal basic product of equal participation in various income groups, the largest incentives should be targeted at the lowest earners. A member exercising the option to withdraw or collect funds before reaching the retirement age would have to repay the tax reliefs or subsidies. The existing pension products would continue to offer their tax incentives and would complement the basic product. The offer of pension products with State support would be varied for different income segments of savers.

Each eligible institution would be required to offer a life cycle strategy consisting of growth and income sub-funds. This would be a default option for clients who fail to select their own investment strategy. For both sub-funds, certain external benchmarks would be specified to compare the results generated by each asset management company at the same level of risk incurred. The proposed benchmark for the growth sub-fund is 80% of the WIG index and 20% of bonds index such as the Treasury BondSpot Poland (TBSP.Index), and for the income fund 20% of WIG and 80% of the TBSP.Index. The sub-funds would not guarantee any specific rate of return. A transfer from the growth sub-fund to the income sub-fund would be effected five years before the saver's reaching the retirement age. The client could accelerate or delay the transfer of funds between the sub-funds by submitting a declaration of a planned retirement. The transfer would thus be flexible, depending on the saver's decision on the completion of his or her professional career. Because the default strategy is offered to people who are allowed to withdraw from the membership, the application of a model of asset allocation consisting of three phases, as is the case with NEST, could be considered. During the first year, the saver's assets would be invested in the income sub-fund, and during the two subsequent years they would be transferred to the growth sub-fund. This would help the fund avoid large fluctuations in the account at a time when savers usually exercise their withdrawal options. The eligible institutions,

in addition to the mandatory default strategy, would be permitted to offer clients, who make their own investment decisions, other investment strategies tailored to their selected level of risk.

Eligible people would be allowed to choose freely from products available on the market and would receive the government support. Those who fail to make their own decision would obtain automatic enrollment to a pension program with an option of withdrawal within 6 months. Three years after such withdrawal, the worker would be re-enrolled in the fund with the right to withdraw within 6 months. The default enrollment would depend on whether the employer of an eligible person runs an employee pension plan or an employee regular saving plan. All employers running an employee pension plan would automatically enroll their employees in it. The account would be transferred to the new employer when a member changes his or her employer. People whose employer does not run an employee pension plan would be automatically enrolled to those voluntary pension funds which win a tender organized by the Social Insurance Institution (ZUS). Such tenders would be organized twice a year based on the investment criterion and the level of costs of service providers. In the initial period, the costs would be the only criterion. Once investment results generated under the mandatory life cycle strategy are available they would be added as next criterion. The highest score for this criterion would be granted to funds outperforming the benchmark. In the event of an insufficient number of entities beating the benchmark, relative performance would be taken into account. A client changing his or her job and starting to work for a new employer who does not run an employee pension plan, would be enrolled in a voluntary pension fund selected in the tender. The implementation of automatic enrollment of workers to voluntary pension funds, as in the case in the UK, could be spread over time based on the size of the employer. An argument in favor of the use of voluntary pension funds, as the default funds for workers whose employers do not run employee pension plans, is the existing and tested infrastructure for the flows of contributions between the private pension fund companies and ZUS. These institutions already have in place IT systems serving more than 16 million employed and self-employed people. PTEs (pension funds societies) manage assets of over PLN 150 billion. Managing the new assets would be an additional service and would result in a marginal cost for these institutions. Another argument in favor of the use of funds managed by PTEs in the target solution would be to enable automatic enrollment of employees without having to establish and run an employee pension plan for all workers. What the proposed solution

anticipates is that as the company plans to become more and more recognizable they will take over from voluntary pension funds certain members saving their money in the basic retirement product. The principle of client allocation to voluntary pension funds through a tender procedure means that from the cost and investment perspective the retirement products offered under voluntary pension funds would become a benchmark for the whole pension market, at the same time increasing its competitiveness. On the UK market, competition among the providers of pension products increased after the launch of NEST's business which set new standards in terms of investment performance and costs.

When determining the target maximum level of fees charged to clients, the typical market level of fees charged by large asset management institutions should be taken into account. Analysis of offers available on the market indicates that at the current level of market development the recommended rate of fee would be approx. 1.5% of total costs to assets as the fee cap. The structure of fees should anticipate in advance that the maximum rates of fees in pension products offered by eligible institutions will be reduced as the amount of their accumulated assets increases.

The institution managing the client's assets at the time of his or her reaching the retirement age would be responsible for the payout stage. The client's assets at the payout stage would continue to be managed in the income sub-fund. Payouts should be offered in three forms: lump sum, installment and annuity. The form of payout should depend on the amount of accumulated assets. The second criterion should be the individual situation of the client in respect of the coverage the longevity risk through benefits from the mandatory pillars. A client with low accumulated capital and a pension from other sources above 120% of the minimum pension would be allowed to pay out all of his or her funds in the form of a lump sum payment. For clients with higher accumulated assets and available benefits above 120% of the minimum pension, payouts should be realized in installments, calculated in accordance with the average life expectancy. These would complement other benefits from the first and second pillars. In a situation where the basic benefits would be below 120% of the minimum pension, the payout should be in the form of life annuity. The institution managing the client's assets would organize a tender of market offers of annuities from insurance companies for clients reaching their retirement age.

The new product structure should provide for greater flexibility of access to accumulated funds if necessary. Accumulation of savings in bank deposits ensures the possibility of quick access to funds when needed. Savers are afraid of long-term investment products, because they are reluctant to freeze money for long periods. One of the possible solutions aimed at increasing the availability of funds would be the absence of penalties and the maintenance of rights to reliefs or subsidies at the time of repayment. At payout, the disbursed funds would be taxed at a rate not greater than that applied to the deduction or any received subsidies would have to be returned. If a saver, before reaching his or her retirement age, repaid all of the previously paid-out contributions, he or she would be permitted to deduct them above the applicable limit or would regain the subsidies returned at payout. Such preferential treatment would change the perception of the product and would support the conversion of household savings from short term into long term.

A greater role in ensuring adequate resources for retirement should be played by employers. Changes in the labor market associated with the aging population should encourage employers to offer retirement solutions as a benefit in attracting the best employees. A number of benefits and advantages should be reaped thanks to the inclusion of employers in the structure of a voluntary pension system. Employers have greater bargaining power in negotiating favorable terms of financial services provided to employees. Employers through regular transfers of contributions by deducting them from salaries and, by acting as an intermediary would assist in overcoming the lack of trust in financial institutions. Thanks to the involvement of the employer, employees gain easier access to information on investment products, performance and options to choose the available investment strategies. All these advantages indicate that employers should receive greater incentives for the creation of employee pension plans. Experts' opinions in favor of the facilitation and simplification of the process of establishment of pension plans as well as the changes recommended by the Polish Financial Supervision Authority and the Warsaw Stock Exchange should be taken into consideration. The inclusion of a greater number of workers in employee pension plans would, in the recommended solution, automatically enable employees to save their own money for retirement supported by incentives provided by the State. The role of employers in the system would be strengthened, if they participated through voluntary contributions in a matching system. The experience of other countries demonstrates that it is an

effective way of stimulating individual contributions paid by employees. Employers may benefit from the experience of the program Save more tomorrow which proved to be effective in increasing individual savings in other markets. Voluntary contributions paid by employers should also receive financial support from the State in the form of tax exemption for the employee and an exemption from social security contributions for the employer.

6. Conclusion

The scale of reforms undertaken by other countries indicates their search for an effective solution to the potential pension crisis. In Poland, in addition to changes improving the operation of the existing products, systemic changes are also necessary. Recommendations and solutions implemented in other countries which have proven to be effective may be applied. It would be essential to make use of the already existing institutional capacity rather than creating everything from scratch. It would be necessary to involve all the stakeholders: the State, the employers, the employees and the financial institutions. Any new solutions being considered should be subjected to public consultation before implementation.

The public debate about changes in OFEs regulations has decreased trust in financial institutions and the capital market. Research and experience of other countries suggest that effective methods of coping with retirement-related challenges are as following: increase number of years due to increase in the life expectancy; accumulate savings and earn premiums in the capital markets. This is why it is necessary to rebuild confidence in capital solutions among Poles. The pension system, including the development of the voluntary capital pillar, is also important for the macroeconomic stability of the country. Generating long-term savings facilitates the financing of investments and, indirectly through the growth of GDP, increases benefits in all three pension pillars.

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III filar systemu emerytalnego w Polsce

Streszczenie

Celem artykułu jest przedstawienie propozycji uzupełnienia dotychczasowego filaru dobrowolnych ubezpieczeń emerytalnych tak aby był on ważnym elementem pozwalającym zwiększyć przyszłe świadczenia emerytalne. W artykule przedstawiono rekomendacje ekspertów OECD jak powinien być zbudowany dobrowolny, kapitałowy filar emerytalny. Zaprezentowano, jakie kryteria oceny funkcjonujących systemów emerytalnych, były uwzględnione w rankingach. Pokazano najskuteczniejsze, w opinii autora, rozwiązania w stymulowaniu dobrowolnych oszczędności. Nowe zaprezentowane rozwiązanie bazuje na wprowadzeniu automatycznego uczestnictwa pracowników w licencjonowanym produkcie emerytalnym. Państwo powinno wspierać rozwój tego produktu przez system zachęt z preferencjami dla osób średnio i mniej zarabiających. Rekomendowane jest utrzymanie dotychczasowych ulg w indywidualnych produktach IKE i IKZE i wzmocnienie zachęt przy pracowniczych programach emerytalnych dla pracowników i pracodawców. Kluczowymi elementami w proponowanym rozwiązaniu są pracodawcy i powszechne towarzystwa emerytalne zarządzające dobrowolnymi funduszami emerytalnymi. Rekomendowane jest zastosowanie mechanizmu przetargów przy automatycznym zapisywaniu pracowników do programów dla podniesienia konkurencyjności funkcjonowania całego rynku.

Słowa kluczowe: dobrowolne fundusze emerytalne, automatyczne zapisywanie, zachęty podatkowe



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