Bulgaria sets up liberal pension regime

Nikola Abadjiev analyses the lengthy reform of Bulgaria's pension system and argues changes to the Social Insurance Code are creating a new liberal investment regime for pension funds

One of the most important and successful reforms to have taken place in Bulgaria in the transition to democracy and market economy is related to the pension system. In spite of quite a complicated economic and social situation, the reform of the pension system, which normally causes considerable problems, is moving forward.

The reform began in 1994 with the establishment of the first voluntary pension funds and was implemented between 1999 and 2003. As a result of that, Bulgaria has a new and working three-pillar pension system, including a mandatory and voluntary supplementary pension, which is already showing its social and economic advantages.

The country has eight licensed and fully operational pension insurance companies, which manage 24 pillar II and III pension funds. Over three million of its citizens hold individual accounts in these funds where they are accumulating resources for their pensions.

At the end of the first six months of 2006, 3,085,082 people had invested in pension funds. This figure constitutes a 8.5% increase in members compared to the same period for 2005. The pension funds' net assets showed an increase of 34.4%, more than BGN1.27bn (€649m).

The three types of funds achieved very good returns due to their investment policies. Between July 2004 and end of June 2006 the average return for the universal funds was 7.59%, occupational funds registered 7.98%, and voluntary funds 8.47%.

Despite the conservative legislation laid down under the Social Insurance Code and the resulting limitations, funds still achieved a certain level of success. Bulgaria must gradually reject those conservative investment models and the state should identify investment instruments that will encourage opportunities. The financial resources accumulated should then be used more effectively for the development of the country's economy.

The liberalisation of the existing investment regime should be done gradually and should also be accompanied by even greater guarantees for the assets of the fund members. In fact, changes made to the Code in the beginning of 2006, are creating a new liberal regime for the investments of pension funds.

Industry-driven reform

In practice, the reform in Bulgaria was not initiated by the government but from the lower levels. The first supplementary pension funds in Bulgaria were created as public limited companies with shares in 1994 and 1995, on the initiative of financial institutions, banks, trade unions and insurance companies.

In 1997, the Bulgarian Association of Supplementary Pension Security Companies was set up. This was a very important stage in the pension reform, because the country was able to use the full potential of the pension funds. It also gave the government the possibility to take part in the pension reform.

In 1999, the law on supplementary pension insurance was drafted and adopted. Then, in 2000 the law on the supplementary mandatory pension system was introduced.

Other significant stages include: in 2000, the special state supervisory agency was set up and the pension companies were licensed; between 2001 and 2002, the occupational and universal pension funds began collecting contributions and in 2003 the new Social Insurance Code was adopted which in practice elaborated on the existing legislative base and reinforced the philosophy of the pension reform implemented in Bulgaria.

Prior to the establishment of the state supervisory agency in 1999, there were a number of social insurance problems. There was easy access to the system, a lack of funds to pay the benefits, inadequate financial coverage and a high level of unemployment. There were unfavourable trends in the economic situation, social injustice, high taxes on pension funds and a low level of pensions.

The main characteristic of the system prior to 1999 was that it was based on the pay-as-you-go principle – the redistribution of funds between those who were working and the pensioners. In 1997, Bulgaria found itself in a deep economic crisis, and consequently the pension system suffered. These new circumstances created an incentive to achieve a consensus regarding reform of the pension system. On that basis, in 1998 the government supported the idea of creating a three-pillar system and also adopted the philosophy of implementing a radical reform of the system.

The main objectives of the reform were: a higher level of social justice, an increase in the level of protection for the population and improvement in the material conditions of pensioners, a fortification of the structure of the pension system and diversification of the methods of social security for pensions.

In order to achieve those objectives, a deep comparative analysis was carried out of the potential strategies for implementing this reform.

The first alternative was to carry out the reform within the framework and limits of the existing pay-as-you-go system. However, analysis showed that the disadvantages of the system far outweighed its benefits.

The second was to completely abolish the first pillar. But due to the tradition of social security in Bulgaria and the potential conflict between the generations, it was impossible to switch completely to the individual capitalisation system.

The third was the winning combination of the positive features of a modernised public pay-as-you-go system, the advantages of a fully-funded mandatory supplementary system and a voluntary supplementary system.

The Bulgarian model has a first pillar – the mandatory social insurance system, a second pillar – the mandatory supplementary pension insurance and a third pillar – supplementary voluntary pension insurance. The second pillar has two types of funds: the universal pension funds set up for those born after 1959 and the occupational funds which are, for example, for certain categories of workers who work in difficult conditions and are entitled to retire at an earlier age.

The Bulgarian social insurance system is set up as a logically bound matrix. One of its advantages is the three pillars of pension insurance are mutually related. There is a very good partnership between the public sector and the private pension funds.

Since this year, including additional forms of pension insurance such as the professional pension schemes, initiated by the employer or by collective labour contracts, should be realised very carefully.

The employer may influence end products much more, that is, the workers' or resulting pension. These might be one-time compensations, compensations in case of death, pensions for life. The terms for transfer of rights (for instance when changing jobs) are also important and are set in the collective labour contract or in an agreement between the employer and the personnel. The employer can also influence the way pension assets are managed in these schemes.

The Bulgarian model

The special independent state supervisory body for pension funds was created in 2000. In 2003, this body was incorporated in the structure of the Financial Supervision Commission, which supervises all non-banking financial institutions in the country, including pension funds.

There are some features specific to the Bulgarian pension model which differ from those adopted by other countries. In particular, these are: retaining a more important role for the public pay-as-you-go system; a gradual increase of the coverage of the fully-funded system by transferring an increasing portion of mandatory contributions towards it; establishing the possibility for each company to manage three supplementary pension funds; mandatory payment of contributions in occupational (100% paid by the employer) and universal pension funds. In the case of universal pension funds, the distribution of the payment between the employer and the worker is currently 65% and 35% respectively, and the law provides that this ratio should reach 50% each.

The Bulgarian pension system allows for interaction between the public and private systems. Employer and member contributions for the pillar II funds are collected by the National Social Security Institute and are then transferred to private pension funds, while members and employers make direct payments into the pension fund for pillar III. Adopting this scheme for collection of contributions is one of the significant factors in the success of the Bulgarian pension reform.

The priorities and challenges for the next stage of development of the Bulgarian pension system are: the reinforcement of the privileged participation mechanism, growth of the specific weight of capitalisation, strengthening the role of the universal funds, increasing the contribution rate for supplementary funds, daily asset valuation and the rationalisation of the switching process.

The successful activity of the pension funds in Bulgaria is fundamental for the country's economic development.

■ *Nikola Abadjiev is the chairman of the Bulgarian Association of Supplementary Pension Security Companies (BASPSC) and one of its founding members*