

Polish pension reform pay-out phase outline & latest news



by

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**EFRP, CEEC Forum
Budapest, 24 March 2009**

Brief history (1)

Major reform introduced in 1999

- **Pillar I: Notional CD**
 - (contribution of 12.22% of salaries)
- **Pillar II: Fully Funded CD**
 - (contribution of 7.3% of salaries)
- **Contribution base limited to 250% of average salary**
- **Workers pension system supplemented by old-fashioned system of widow pensions, disability, orphans etc.,**
 - (financed on the PAYG basis by separate contributions)

For each worker entering new system in 1999:

- **Pension rights accrued before 1999 formed the „initial capital” of individual account in pillar I**
- **Individual account in pillar II started from zero balance**

Brief history (2)

Access to the new system in 1999:

- mandatory for workers under 30
- voluntary for the age range 30-50
- not available for older ones
- **Percentage of those in the age 30-50 who decided to enter was a smoothly decreasing function of age:**
 - from: +-90% of all eligible aged 30
 - to +-5% of all eligible aged 50
- **First females retiring in 2009 and males in 2014**
 - 2009: few thousands of them, small accumulated amount per head
 - Next years: quickly increasing number, increasing amount per head

The game played at retirement

(presented already in Brussels)

Prior to retirement:

- investment risk is borne by OPF's members
- savings are inheritable (OPFs bear no mortality risk)
- a member can change an OPF

At retirement a member converts accumulated savings into life annuity (another admitted product?), making choice:

- of a product (if there is any choice)
- of a provider (if there are many)
- or deferring the decision (if admitted to)

Once savings are annuitised the game for the retiree is over as:

- life annuity is an irrevocable contract

The game is not known in most existing pension systems because:

- *there is single annuity provider, or:*
- *both phases are serviced by the same Pension Fund, so the choice of a provider is made much earlier by choosing the employer*

Major challenges for the mechanism designer (1)

(presented already in Brussels)

Challenge 1:

- how to cope with huge non-diversifiable risk stemming from:
 - uncertain long-run rate of return on investments
 - error of prediction of trends in increasing longevity

Major response:

- risk sharing between life annuity provider and annuitants

Minor response:

- defer purchasing life annuities until 65 by admitting temporary programmed withdrawal (serviced by OPFs) for those who are eligible to retire earlier

Major side-effect of minor response:

- temporary solution simple and easy to be implemented
- few years more to design and discuss details of final solutions

Major challenges (2)

(presented already in Brussels)

Challenge 2:

- **how to prevent life annuity providers:**
 - to focus too much on acquisition of new business
 - at the expense of ignoring interests of continuing annuitants?

In other words:

- **how to make sure that the provider follows the fortune of annuitants?**

Or:

- **how to make sure that the portfolio of contracts in force is attractive enough to be transferable to another provider?**

Response:

- **ensure that profits are not made at inception but rather are made gradually during the whole contract duration**

Major challenges (3)

(presented already in Brussels)

Challenge 3:

- how to avoid adverse selection and costly acquisition targeted at „good risks”, that would arise as:
 - a member chooses between competing life annuity providers
 - differentiating annuity rates by risk factors other than age is prohibited

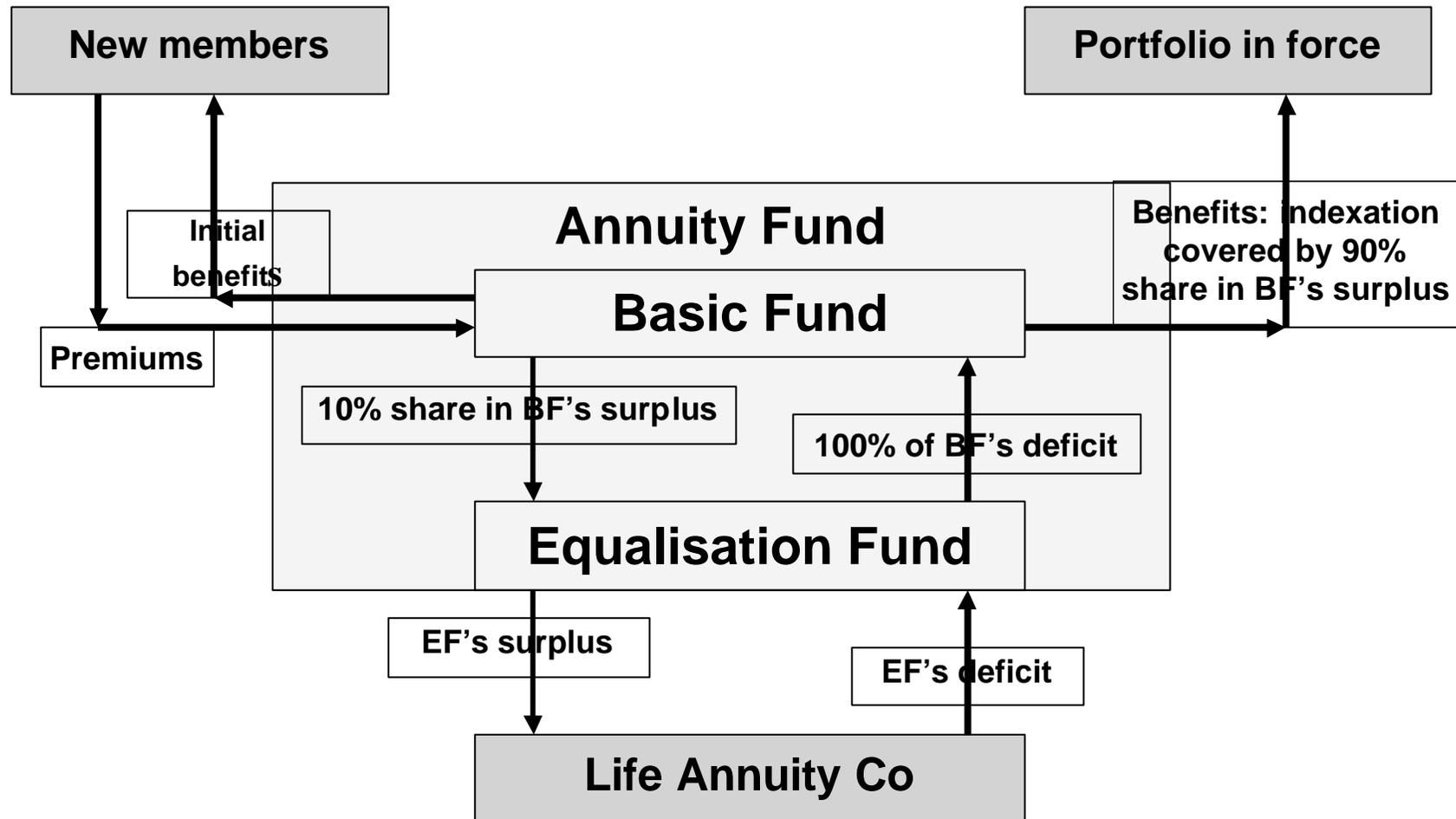
Responses:

- centralised distribution
- no choice of a product, in order to avoid signalling that someone is a „good risk” through the choice made
 - such signal is given by the choice of programmed withdrawal when life annuity is an available option, or:
 - if annuity fixed in nominal terms is preferred to well indexed annuity

Generally: free choice between products that differ by the degree of protection against longevity risk makes this protection expensive
- special solutions reducing incentives for life annuity providers to seek after easy profits made on:
 - attracting as many males and as few females as possible
 - attracting persons with poor medical prognosis

Separated entities: Annuity Fund and Life Annuity Co

(presented already in Brussels)



Risk sharing (1)

(presented already in Brussels)

Basic Fund balanced at the beginning of year:

$$\text{Assets} = \text{Liabilities}$$

Changes of assets and liabilities during the year result at the end of year in:

$$\text{Surplus} = \text{Assets} - \text{Liabilities}$$

- **When Surplus < 0:**
 - deficit is covered by transfer of assets from Equalisation Fund
- **When Surplus > 0:**
 - at first 10% of Surplus is delivered to Equalisation Fund, so that:
Lasting Assets = $(1 + x) \times \text{Liabilities}$...
 - all annuities are indexed then by the rate x ,
 - accordingly, reserves increase by the factor $(1 + x)$.

In both cases the opening balance for a new year is cleared:

$$\text{Assets} = \text{Liabilities}$$

Risk sharing (2)

(presented already in Brussels)

10% share in surplus and 100% share in deficit seems to be extremely asymmetric.

However:

- **it is allowed to use BF's surplus from a given year:**
 - **at first to reimburse losses from last two years by adequate transfer of assets from BF back to EF**
 - **only the lasting part of the surplus (if any) is shared with annuitants in proportions 1 to 9.**
- **reserves are calculated at 1% technical interest rate so that surplus will be positive as a rule, and negative incidentally**

Risk sharing, CIT, and capital requirements *(presented already in Brussels)*

- **Equalisation Fund should be greater than 2% and smaller than 5% of Basic Fund Reserve**
 - the gap below 2% is filled by the Life Annuity Co
 - excess above 5% is transferred to the account of LAC
 - as a result, covering losses made in bad years by profits made in good years is exempted from fiscal asymmetry (as far as Equalisation Fund fluctuates within the range of 2% - 5% of BF's reserve)
- **Solvency Margin equals 6% of Basic Fund reserve**
 - can be covered as well by LAC's own assets
 - as by assets held by the Equalisation Fund

Removing gender disparity risk

(presented already in Brussels)

At the end of year the Clearing House sets the coefficient b such that:

$$\sum_{i=1}^n SR_i = b \sum_{i=1}^n UR_i$$

where SR_i denotes reserves based on gender-specific life-tables,

- UR_i denotes reserves based on unisex life-tables,
- and both concern only contracts written by i -th LAC during the year

Clearing takes a form of transfers of assets:

- surplus ($b \cdot UR_i - SR_i$) of i -th LAC is transferred to the Clearing House
- deficit ($SR_i - b \cdot UR_i$) is compensated by transfer from CH to i -th LAC
- balance of transfers from and to the Clearing House is zero.

Economic meaning:

- LACs are exempted from this part of risk stemming from gender disparity that results from multiplicity of providers.
- However, some part of risk remains, and this is exactly that risk to which even the exclusive single provider would be exposed

Poor health at retirement

(presented already in Brussels)

On the side of members this is a problem of social fairness:

- **savings inheritable before annuitisation**
- **totally lost in case of death just after**

For the mechanism designer this is a problem of incentives for undesirable behaviour of players

Solution:

- **Life annuity supplemented by life insurance:**
 - **with sum assured equal to premium paid just after inception**
 - **decreasing then linearly to zero in 3 years**

The solution works better when mandatory, because then incentives for undesirable behaviour disappear on both sides

Optional solution makes members more comfortable, but:

- **it does not remove incentives for the provider to look for people seriously ill and informed poorly enough to make a false choice**
- **signalling will result in annuities without life insurance being expensive**

Latest news (1)

Two acts presented by government to the parliament in the autumn 2008:

- **Act on pensions derived from pillar II savings**
 - sufficient to regulate temporary phased withdrawals serviced by existing Open Pension Funds for members under 65, encompassing also basic definitions and rules of granting lifelong pensions afterwards
 - Approved by Parliament and signed by President
- **Act on Annuity Funds and Life Annuity Companies**
 - necessary for regulating functioning LACs, their financial system, and crucial for efficient increase of pensions due to investment returns
 - Approved by Parliament, but President refused to sign it

Latest news (2)

- **Major arguments of President (his advisors?)**
 - Lack of guarantees that lifelong pension's benefits are secured against inflation risk
 - Lack of guarantees that the number of private entities launching LACs will be large enough to ensure competition (necessity to launch the state owned LAC)
- **Propects:**
 - **Bad:** difficult battle for efficient solutions ahead of us
 - **Good:** some general solutions are settled already by the first act. This may help focusing the debate on system design and efficiency and stay away from a number of other issues that prevented to move case forward
- **By the way: a politically difficult problem of old group privileges (mainly in terms of entitlement for early retirement) has been solved recently**