



## Adopting a regional approach to occupational pensions in Central and Eastern Europe

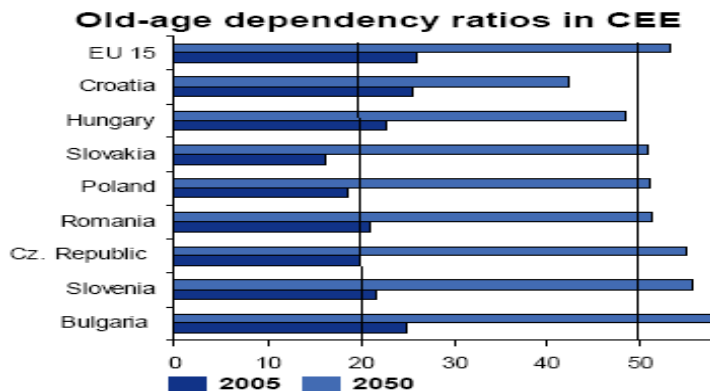
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In the 1990s, multinational companies were increasingly attracted to Central and Eastern Europe by its competitive mix of lower costs and well trained personnel. However, as the region has prospered, it has become more difficult for companies operating in the area to recruit, motivate and retain their employees. Over the past decades, the role of the state in providing pensions has shifted with the introduction of mandatory private systems. In spite of the ongoing effect of the financial crisis, the need for supplementary pension plans has increased, and the number and diversity of such products has risen accordingly. In order to attract personnel, occupational pensions have become an increasingly important weapon in the company armoury.

Following the collapse of communism in 1989 and 1990, the former communist states of Central and Eastern Europe (CEE) quickly re-established ties with the rest of Europe. Ten CEE countries joined the European Union in May 2004 (Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, and Slovenia) and two joined in January 2007 (Bulgaria and Romania). Although these countries have distinct histories, cultures and economies, they also show some important similarities, also with relation to their recently reformed pension systems.

As in many other regions of the world, people in Central and Eastern Europe (CEE) are now living longer, while fertility rates are falling. This trend will result in a substantial increase in the old age dependency ratio (the ratio of retirees (aged over 65) to the working population (aged between 15 and 64) supporting them). At the moment, the old age dependency ratio in the CEE is about 20%; this number is expected to rise to 50% by 2050. This means that presently each retiree is supported by five people of working age, whereas in 2050, each retiree will be supported by only two people.

*Chart 1: old age dependency ratio in CEE and EU15 (source: United Nations)*



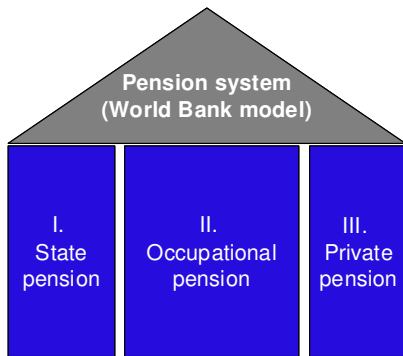
The need to adapt social security systems to the new economic environments in the CEE countries has led to a wave of major pension system reforms across the region.

### Reforming pensions in CEE

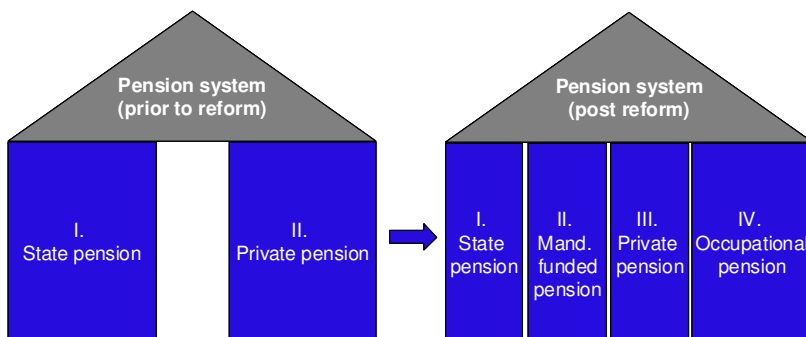
In order to explain the relationship between state social security systems and private pension systems, the World Bank's three pillar pension schematic is often used. However, to explain the relationship between the state and private pension systems in Central and Eastern Europe, we have used a four pillar adaptation of the World Bank schematic.

In Western Europe (EU 15) and the USA, the three pension pillars can be defined as follows:

1. State pension
2. Occupational pensions
3. Private pensions



In CEE, a different model is applied. Depending on the progress of pension reform in a particular country, we can best speak of either a two pillar (prior to reform) or four pillar (post reform) model. Before pension reform in the CEE countries, the pensions were primarily provided by the state under a Pay-as-You-Go system, although there were some provisions for individual savings. Thus there was essentially a two-pillar system, consisting of state pension and private pension. In the four pillar (post reform) model, the former state pension was split into a state pension (first pillar) and a mandatory funded pension (second pillar). In addition, occupational pensions are being introduced.



The main difference between the former and new pension systems in most CEE countries is the mandatory funded second pillar (with the exception of the Czech Republic, Lithuania and Slovenia). The mandatory funded second pillar systems were introduced using a 'carve-out' method, in which total social security contribution remained at the same level, but a share of the contribution was transferred to fund the second pillar. At the same time, some countries, like Poland, also moved from a Defined Benefit approach to a Notional Defined Contribution (NDC) system in the first pillar.

Table 1 Shifting from state pensions to mandatory funded pensions (source: OECD)

Percentage of gross earnings	PAYG State pension - Pre-reform	Year pension reform	PAYG 1st Pillar Post reform	Mandatory funded 2nd Pillar
Kazakhstan	10	1998	0	10
Hungary	28	1998	22	6
Poland	19.5	1999	12.2	7.3
Latvia*)	20	2001	12	8
Croatia	19.5	2002	14.5	5
Estonia	22	2002	16	6
Russia	28	2002	22	6
Slovakia	18	2005	9	9
Romania**)	22.5	2008	20.5	2
Czech Republic	26	n.a.	26	0
Slovenia	24.4	n.a.	24.4	0

NDC systems impose the calculation method of funded systems on public pension schemes by giving participants a hypothetical account containing all contributions made throughout their working lives, credited at a certain rate of return. At the time of retirement, pension benefits are calculated by dividing the sum accumulated in the notional account by the life expectancy. In other words, NDC systems establish a strict relationship between contribution and benefits. From a classification perspective, therefore, this new system could be seen as a second pillar system. Other countries like Latvia, Lithuania and Romania, are steadily raising the percentage of contributions for the second pillar in order to increase the mandatory part of pensions savings.

### Ongoing pension reforms

Following the introduction of mandatory funded pensions in Chile and other Latin American countries, countries in Central and Eastern Europe also implemented similar systems. As shown in the table above, Kazakhstan was the first post communist state to follow the Latin American reforms, followed by Hungary in CEE. Romania was the latest CEE country to introduce this new second pillar.

### Further CEE developments – the need for private supplementary plans

Apart from the creation of the second pillar, which in some countries will continue to gradually expand, there are other changes being implemented in order to place the CEE Pay as You Go systems on a stronger footing. The changes include reducing early retirement provisions, changing benefit calculation formulas, limiting occupational privileges, changing the indexation of benefits, and increasing the age of retirement (as a retirement age of 55 or 58 used to be common in the CEE countries). Although these changes will lead to a better long term position for the state retirement funds, they also mean that retirees can no longer expect to receive the same level of retirement provision as before. In addition, the high level of emigration recently experienced by many CEE countries, in particular Poland, has also meant that special measures need to be taken to ensure that sufficient retirement provisions are made by the state.<sup>1</sup> These developments have all increased the need for private supplementary pension plans.

<sup>1</sup> According to the Polish Ministry of Labour and Social Policy (2008), there are presently 1.2 million Poles working abroad (out of a total population of 38.5 million). The Ministry's research indicates that 20% of emigrated Poles wish to stay abroad permanently, 20% intend to return home and 60% are undecided. The uncertainty over whether or not such a large number of people will return to Poland makes it difficult to make plans for sufficient retirement provision.

## Moving towards a four pillar system

As a result of the changes to the state provisions, a fourth pillar has either already been added or is in the process of being added in most CEE countries. This is primarily to cover occupational pensions but also to allow for additional private pension savings. The EU's requirement for the IORP directive<sup>2</sup> to be implemented in CEE has also led to the creation of fiscally incentivised occupational pensions either with respect to private savings (in Romania) or to occupational pensions and additional private pension savings (in most other CEE countries).

## Introducing Lifecycle Asset Allocation

In the changing pension environment in CEE, Lifecycle Asset Allocation is an interesting tool, as it encourages the use of different types of funds, while safeguarding investments towards retirement. Lifecycle Asset Allocation has already been introduced in Hungary, and in Poland consultants are increasingly asking for Lifecycle Asset Allocation products. Such products are still not available in other CEE countries, however, due to legislative restrictions. In time, we are likely to see this concept being implemented more broadly.

## Multinational companies and pensions in CEE

Over the past few years, Central and Eastern European countries have attracted many international businesses. Hungary, Poland and the Czech Republic can be considered as the front runners, with Slovakia and Romania following. Companies have been drawn to the region for many reasons, including the competitive salary levels, the availability of highly qualified employees, and the proximity to developed markets.

## Attracting – and retaining – employees

In order to attract, motivate and retain good personnel, it is important that businesses not only pay their employees competitive salaries but also support them with suitable benefits. More recently, competition for the best professionals within the CEE region has intensified and continues to increase in spite of the ongoing effect of the financial crisis. Employee benefits are an important tool in the war for talent. For multinational companies operating in the region, finding the right pension plan in this highly complex environment is not always easy. Below, we run quickly through the regulatory environment of the five major countries on a country-by-country basis. The overview shows multinational employers which products are available as an employee retention tool.

### Hungary

As Pension Reform took place in 1998 and the fourth pillar for voluntary individual retirement accounts was created in 2006, the pension system in Hungary serves as an example for other CEE countries. In 2002, the binding minimum requirements for Voluntary Pension Funds (VPF) were abolished. Due to its less rigid regulations, Hungary has been able to embrace the Lifecycle investment concept.

- Retirement age has been set at 62 for both men and women as from January 1, 2009.
- The mandatory and voluntary pension fund (referred to as PPF and VPF) are quite well used, where as the fourth pillar (NYESZ), offered mainly by banks has a low take-up rate.
- Employers pay mainly into VPFs due to the fiscal advantages. In 2007 the members increased to 1.8 million (1.8% increase compared to the year before).

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<sup>2</sup>The IORP Directive (Dir 2003/41/EC), the Institutional Occupational for Retirement Provision Directive, adopted in June 2003, provides a prudential framework to secure workplace pensions.

### Poland

The first pillar was transformed into a Notional Defined Contribution account. The second pillar, consisting of the Open Pension Fund (OPF), individual retirement account (IKE) and the third pillar occupational pension plans (PPE) are tax qualified but with no employer solutions. The fiscal advantages are small and the regulations rather strict. The Polish investment market is highly sophisticated.

- Retirement age has been increased to 60 for women with 20 years of contribution and to 65 for men with 25 years of contribution.
- The second and third pillar (the funded pension on a mandatory and voluntary basis) were introduced in April 1999.
- Very few employers use the company pension plan within the system due to the low tax incentive on offer. In addition, many still do not consider company pension plans to be necessary.

### Czech Republic

The pension provision is built by the state Pay-as-you-Go system in combination with the Voluntary Supplementary Pension. Pension companies offering this product can offer only one pension plan. The product is heavily regulated and the state contributes extra premiums to this type of product. Early withdrawal is set at 60 and both a lump sum and annuity payment can be offered.

- Retirement age has been gradually increased to 65, for both men and women, applicable as from 2030.
- No mandatory funded second pillar exists as such.
- Employer-paid pension fund benefits are mainly provided by voluntary pension funds, which are required by law to deliver positive returns. Actual annual performance for 2008 lay around 0%.

### Slovakia

In Slovakia, pension reforms were implemented in 2005. The present pension system is very similar to the Hungarian system. The strictly regulated Voluntary Pension Fund offers fiscal advantages for both employer and employees. Life Insurance products are also very popular, even if they are only tax qualified for the employees.

- Retirement age has been increased to 62 for both males and females. The gradual increase has been completed in 2006 for men and will be completed in 2015 for women.
- Third pillar, the voluntary pension fund has already been introduced in 1996, whereas the second pillar, the mandatory pension fund came into place in 2005 only.
- Employers and employees contribute in the third pillar. No fixed contribution rates are set. Employer's contributions are tax deductible up to 3% of contribution.

### Romania

The most recent pension reforms in CEE have taken place in Romania. As from the beginning of 2009, Romania created a second pillar. Out of all CEE countries, Romania's second pillar mirrors most closely the Western style second pillar, geared particularly to occupational pensions. Life insurance benefits for companies are increasing.

- Retirement age have increased to 65 for both men (with 35 years of contribution) and women (30 years of contribution) to be completed in 2015.
- The third pillar system has been recently completed with the addition of the second pillar, the mandatory pension, in May 2008. Third pillar, voluntary pension fund, has been completed in May 2007.
- Employer's contribution to VPF has had a slow start due to the low level of tax relief provided. Doubling the tax-free contribution limit as from January 1, 2009, has increased use. However, more fundamentally, many still do not consider supplementary pension plans to be necessary.

### The advantages of creating a unified regional pension strategy

Despite the many differences between the CEE countries, there are similarities to make it worthwhile for companies to approach their pension strategy in CEE on a regional basis. All supplementary pensions in CEE are Defined Contribution; all plans are either fully funded or insured plans; and almost all plans are used to provide cover for all company employees. Executive-only retirement plans in CEE are still rare, but increasing.

Many consultants presently focus primarily on the local fiscal situation in each country, when providing advice on pension constructions. However, although such advice is necessary, multinational companies can also benefit from taking a broader, more regional approach that will enable them to enhance their overall control and governance. A thorough analysis of the regional situation helps companies to design a unified regional strategy, while still taking national variations into account.

#### **AEGON Global Pensions – taking a regional approach to CEE pensions**

In Central & Eastern Europe AEGON offers the following pension products.

- AEGON Hungary: Voluntary Pension Fund and a range of Life Insurance Products.
- AEGON Poland: Group Savings Scheme on the basis of a non tax-qualified individual investment regime.
- AEGON Czech Republic: Voluntary Supplementary Pension Scheme and a series of Life products.
- AEGON Slovak Republic: Voluntary Pension Fund and a Life Insurance product.
- BT AEGON in Romania: Life Insurance Savings products.

The need for appropriate company pension solutions across CEE is increasing. In order to help multinational companies to design and implement efficient and appropriate plans for their employees across the region, AEGON Global Pensions combines local and regional expertise.

The needs and wishes of multinational employers are central to AEGON Global Pensions approach. For example, employers may value having flexibility across all their plans in the region more than optimising specific tax advantages in a particular country. With our powerful combination of local providers and a central point of contact, AEGON Global Pensions can help assist our clients to create a truly regional approach. In addition, AEGON Global Pensions can provide consolidated reporting, monitor all plans, and deliver professional advice from AEGON's experts in the region.

Multinational companies have been quick to realise the enormous potential of the CEE region. AEGON Global Pensions solutions can help these companies attract and retain employees while retaining control over their pension provisions and investments.

Interested? Please contact AEGON Global Pensions at [aegonglobalpensions@aegon.com](mailto:aegonglobalpensions@aegon.com).