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Pension Market Trends and Regulation in Central Eastern Europe and Asia

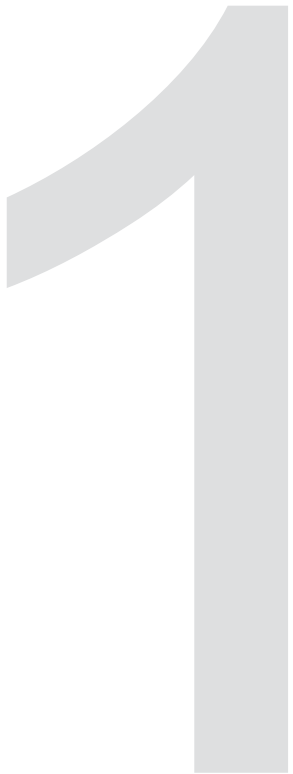
Alexander Börsch, Allianz Global Investors

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Macroeconomic and demographic overview



Both regions show a strong macroeconomic performance, however per capita wealth is modest

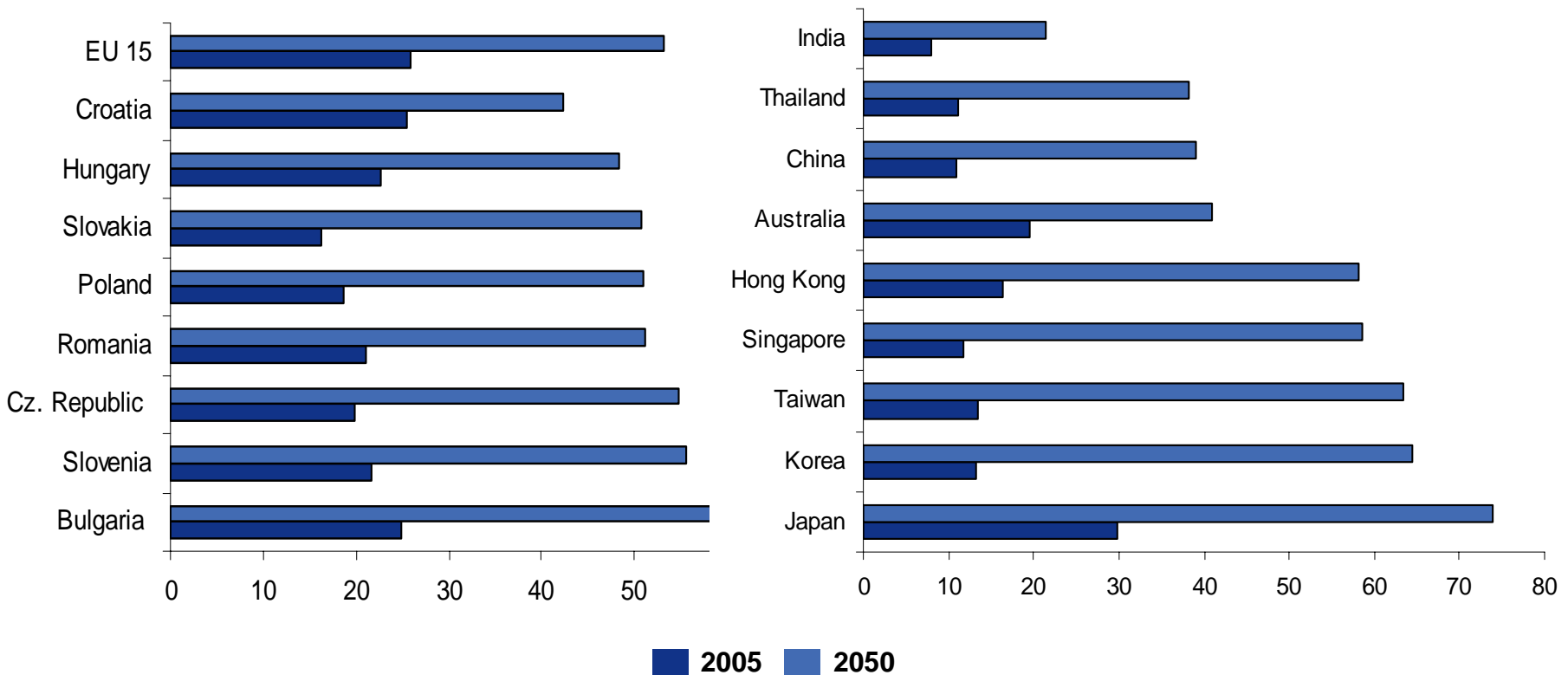
Macroeconomic indicators for CEE and Asia [2006]

Eastern Europe	GDP per head [EUR]	GDP growth 2001-2006 [%]
Bulgaria	3,270	5.1
Croatia	6,989	4.6
Czech Rep.	11,450	4.3
Estonia	9,745	8.0
Hungary	9,290	3.8
Latvia	7,051	7.7
Lithuania	6,957	7.4
Poland	7,204	3.4
Romania	4,686	5.6
Slovakia	8,848	4.0
Slovenia	14,843	3.6

Asia	GDP per head [EUR]	GDP growth 2001-2006 [%]
Australia	32,053	3.2
China	1,535	9.8
Hong Kong	20,333	4.7
India	593	7.4
Japan	25,921	1.5
Singapore	22,983	4.0
South Korea	14,370	4.6
Taiwan	12,025	3.2
Thailand	2,483	5.1
Ø EU-15	27,745	1.8

The demographic challenges are severe for most countries in CEE and Asia

Old-age dependency ratios in CEE and Asia



Source: Allianz Dresdner Economic Research, United Nations

Public pension systems in CEE and most parts of Asia were either completely state-run or under-developed up to the early 1990s, economic transformation had to encompass old-age provision

Pension reform and regulation in CEE



Pension systems in CEE have been reformed to varying degrees – most countries with a funded 2nd pillar

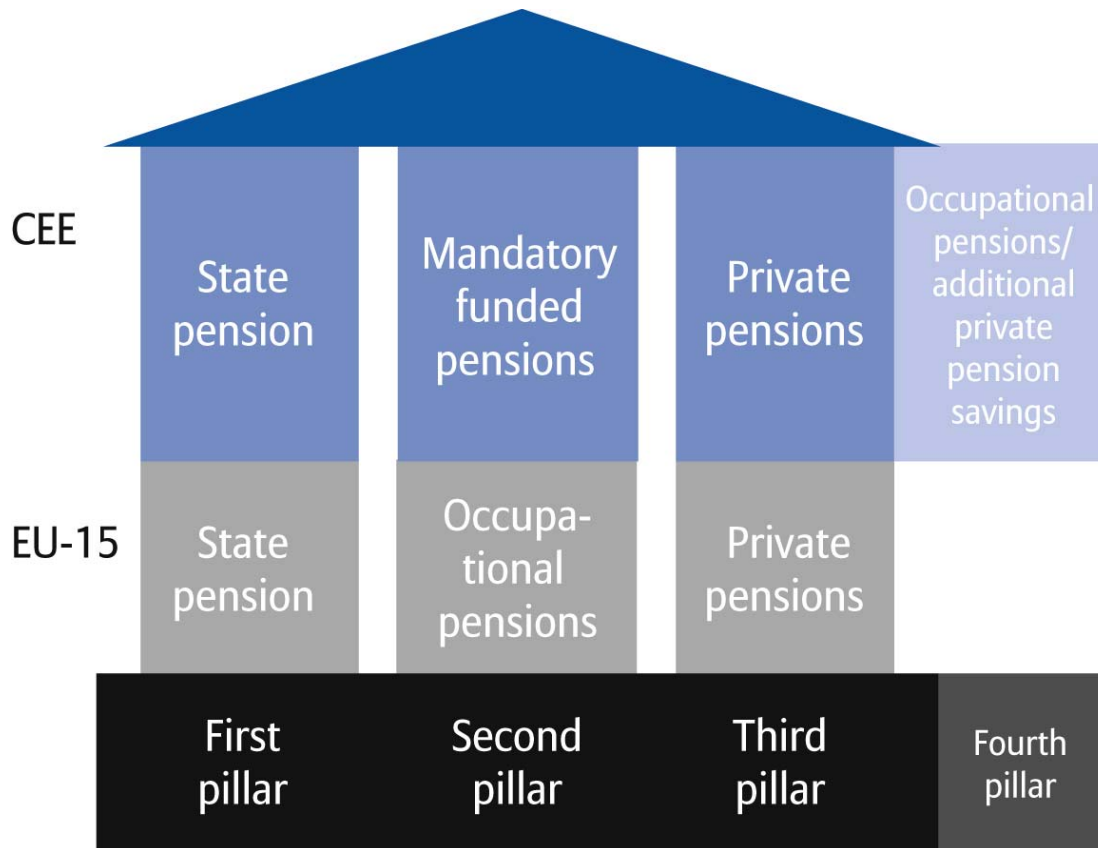
Design of CEE pension systems

	Notional Defined Contribution system	Reformed Pay-As-You-Go System
Mandatory second pillar	Poland Latvia	Bulgaria Croatia Estonia Hungary Slovakia Romania
Voluntary second or voluntary third pillar only		Lithuania Czech Republic Slovenia

- 8 out of 11 countries introduced a mandatory second pillar
 - Exceptions: Czech Republic, Slovenia, Lithuania
- Pension reforms in CEE generally followed the World Bank reform model
- The first, public, pillar was reformed in all countries. Measures included:
 - Increasing retirement age
 - Reducing incentives for early retirement
 - Stronger link between contributions and benefits
 - Scaling back privileges for certain occupational groups

Consequently, the shape of CEE pension systems differs significantly from Western ones

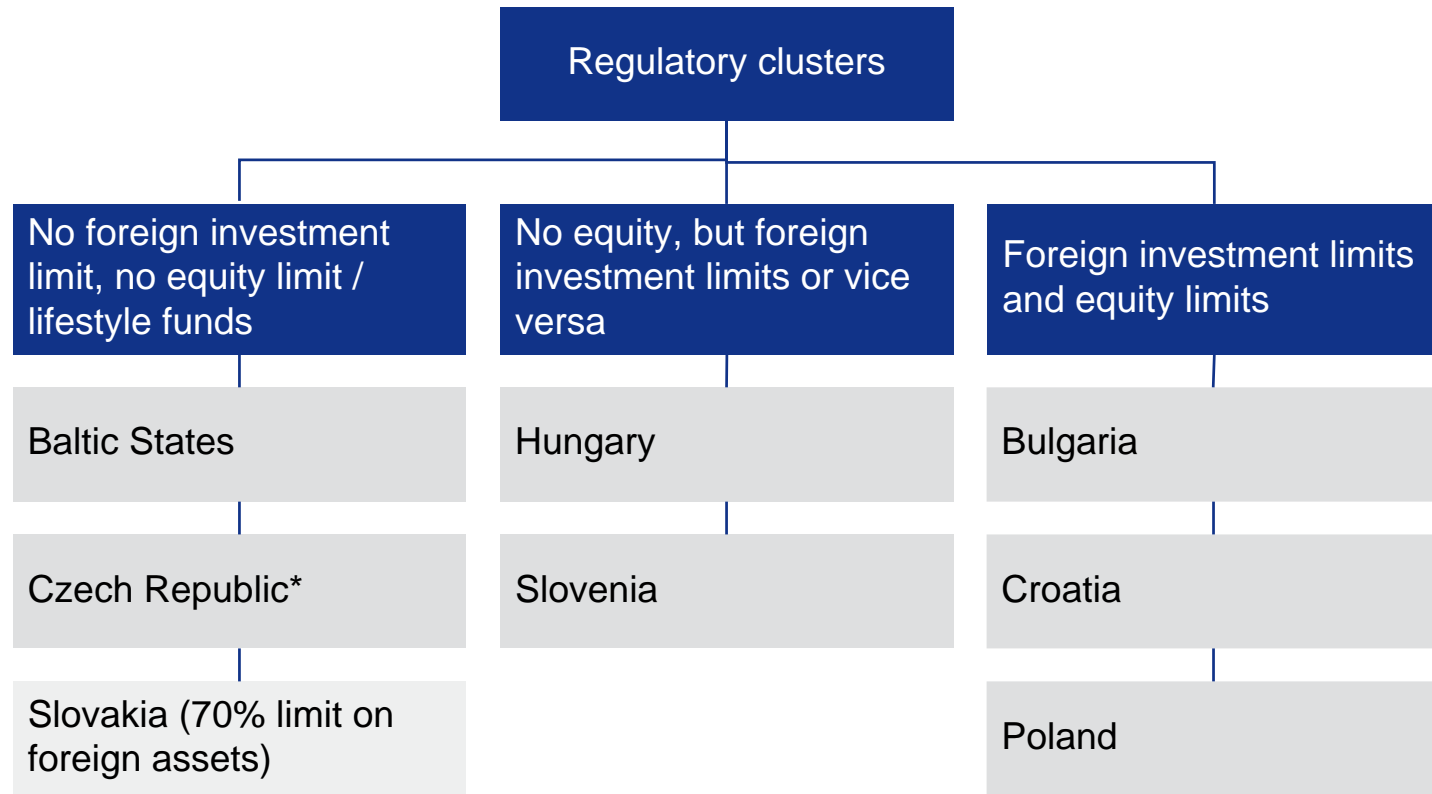
Differences between CEE and EU-15 pension systems



- Main difference is in the 2nd pillar
 - Mandatory individual accounts in CEE, managed by private pension funds and financed by a share of social security contributions. Mandatory for labour market entrants, while existing employees could choose to join
 - (mostly) voluntary occupational pensions in Western Europe
- As a new development, 4th pillars emerged in Bulgaria, Romania, Poland and Lithuania that either encourage Western-style occupational pensions or additional private savings
- According to the World Bank, net replacement rates of mandatory pillars will be between 60% and 90% of individual average earnings in CEE (OECD average: 68%)

Regarding limits on equity and foreign investments, three groups of countries can be distinguished

Patterns of mandatory pension fund regulation in CEE



 There is a trade-off between local capital market development and efficient pension fund investing

* Third pillar
Romania's foreign investment limit to be determined; equity limit is 50%

Relative minimum return guarantees are the most often applied type of guarantee

Return guarantees in CEE



Absolute return guarantee

Czech Republic

Relative return guarantees

Bulgaria

Croatia

Poland

Romania

Slovakia

Slovenia

No return guarantees

Estonia

Hungary

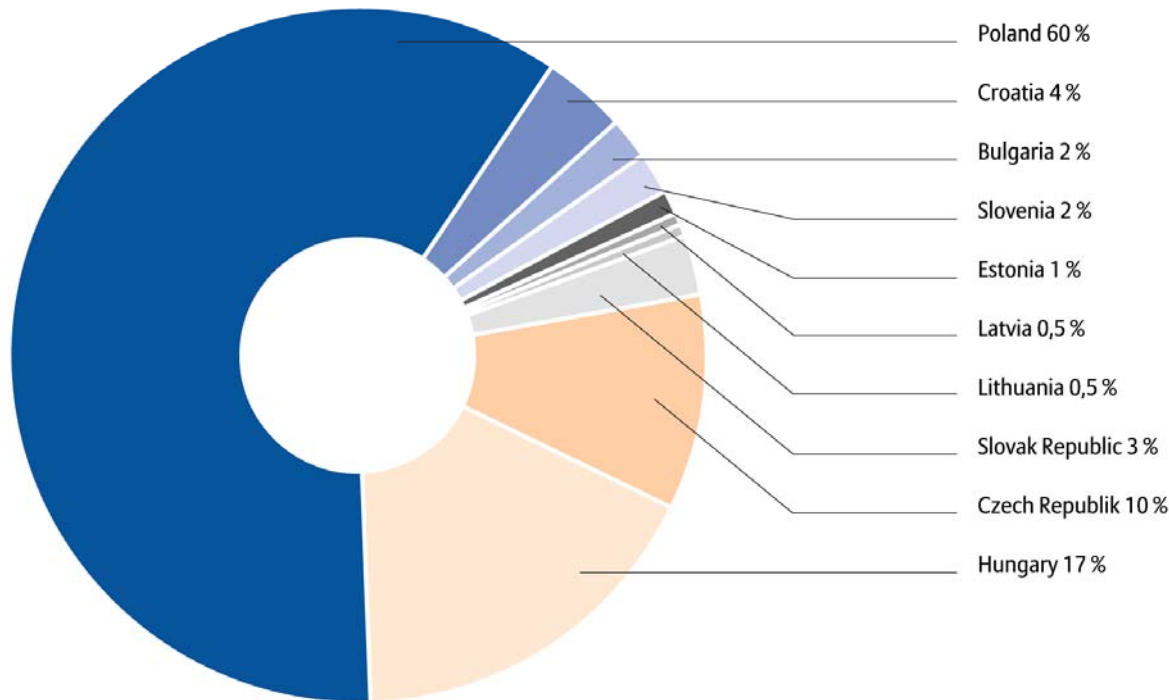
Latvia

Lithuania

2nd and 3rd pillar pension assets amount to EUR 51bn – Poland is the biggest market

Distribution of pension assets between CEE countries 2006

EUR 50.8bn in assets under management in the 2nd und 3rd pillars



Sources: National Statistics, Allianz Dresdner Economic Research.

- The three biggest markets (Poland, Hungary, Czech Republic) account for 87% of all CEE pension assets
- Asset distribution between 2nd / 3rd pillar:
 - 2nd pillar: EUR 41.1bn
 - 3rd pillar: EUR 9.7bn
- Differences in pension assets mainly due to:
 - Varying dates of 2nd pillar introduction
 - Different 2nd pillar designs (contribution rates, age groups included)
 - Country size



In 2015, pension assets in the region will, according to AllianzGI / Allianz Dresdner Economic Research, amount to EUR 245bn – fastest growing bigger countries will be Bulgaria and Romania

Pension Reform and Regulation in Asia



Asian pension systems are highly diverse

	Basic shape of pension system
Australia	3-pillar-system, mandatory occupational pillar
China	Emerging 3-pillar-system, funded accounts as pillar 1B, voluntary occupational pensions
Hong Kong	Social safety net, mandatory occupational pensions
India	Limited social safety, civil servants pensions, mandatory funds for private sector employees
Japan	3-pillar-system, new DB and DC schemes
Singapore	1-pillar-system with funded accounts in the Central Provident Fund
South Korea	3-pillar-system, new corporate pensions system
Taiwan	Social safety net, pensions for public servants, mandatory pensions for private sector workers
Thailand	PAYG pillar, civil service pensions, voluntary occupational pillar (mandatory scheme planned)



Dwindling family support, caused by industrialisation/urbanisation, requires formal pension systems

Nevertheless, there are some common reform trends

Main pension reform trends in Asia

Main trends	Examples
<p>Shift from severance pay / defined benefit schemes to defined contribution</p>	<p>New occupational DC schemes (China, Japan, South Korea, Taiwan, Thailand)</p> <p>New DC public servant scheme (India)</p>
<p>Implementation / increasing coverage of 1st pillar public pensions</p>	<p>China, Thailand, Taiwan (planned)</p>
<p>Increased outsourcing of public pension fund assets to private companies</p>	<p>China, Japan, South Korea, Taiwan</p>



Voluntary 3rd pillar pensions underdeveloped mainly due to missing tax incentives

Reforms in China stick closely to the World Bank’s 3-pillar-model

Design of the emerging Chinese pension system

Pillar	Contribution rate [%]	Target replacement rate [%]	PAYG or funded	Mandatory or voluntary	Status
1A (PAYG)	Enterprise:20 Individual: 0	35	PAYG	Mandatory	In operation
1B (Individual Accounts)	Enterprise:0 Individual: 8	24	Funded	Mandatory	In operation*
2 (Enterprise Annuities)	Enterprise: N.A. Individual: N.A.	20-30**	Funded	Voluntary	In operation
3	Individual: N.A.	N.A.	Funded	Voluntary	Not finalized

Pension coverage rates

- Urban pension system: 42%
- Rural pension system: 9%

National Social Security Fund

- Reserve Fund to bolster demographic development (established in 2000)

Current reform projects:

- “Refilling” pillar 1B
- Pilot projects to cover migrant workers / larger parts of the rural population
- General harmonisation of the pension system (tax exemption rules for EAs differ considerably as do contribution rates)

Source: Hu (2006), MOLSS (2006), and SDPC of China (2006)

* in operation but empty in many cases **estimated by the State Development Planning Commission

The newly established Enterprise Annuities are exclusively DC schemes and operate under quantitative regulations

Main characteristics of Enterprise Annuity scheme

<p>Framework</p>	<ul style="list-style-type: none"> ▪ Fully funded DC schemes (established 2004) ▪ Managed according to the trustee model (internal or external) ▪ Managing assets requires license
<p>Regulation</p>	<ul style="list-style-type: none"> ▪ Investment regulation <ul style="list-style-type: none"> - At least 20% in money market instruments - At most 50% term deposits, contractual deposits, government/ financial/corporate bonds, convertible bonds and securities. - At most 30% stocks, investment-linked insurance products and equity funds. Among these, investment in equities should not exceed 20% ▪ Fee caps for trustees, custodians, administrators and investment managers
<p>Market developments</p>	<ul style="list-style-type: none"> ▪ By 2006, 263 enterprises in China had introduced 'new' Enterprise Annuity schemes that covered 940,000 participants and total assets of RMB 11 billion, one nation-wide plan is in operation (2006)

India's reform agenda is less ambitious than China's, but change is underway

Patterns of pension reform in India

Current shape

- Limited social safety net
- Several schemes for public servants
- Three schemes for private sector employees (opt-out option for employers)
- Voluntary occupational schemes
- Public Fund for voluntary retirement savings

Main challenges

- Financial pressures from civil servants' DB pension schemes
- Coverage of unorganised sector workers (current coverage: 12% of population)

New Pension System

- Mandatory DC scheme for all new central government civil servants, most state governments intend to join
- Open to all citizens on a voluntary basis
- Choice between three funds with different asset allocations
- Access through “points of presence”, which direct contributions to a Central Recordkeeping Agency
- Current situation:
 - Relevant law has not been passed, but supervisory authority already established
 - Voluntary part not effective
 - Mandatory contributions held by the central government

Conclusions

- Both regions are heading towards the World Bank model, albeit to varying degrees and with different speed. The CEE countries more or less completed their reforms, while the Asian emerging markets are in the midst of it
- Public PAYG systems have been downsized in CEE, while some Asian countries are in the process of establishing them
- As a result of pension reforms, funded pensions of the defined contribution type will account for a substantial part of retirement income for future retirees in Central and Eastern Europe as well as in Asia.
- Regulation needs to strike a balance between the desire to develop national capital markets and efficient pension fund investing, especially regarding investment regulation

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