Demographics, financial crisis & pensions
How to help the system?

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The Social Impact of the Crisis
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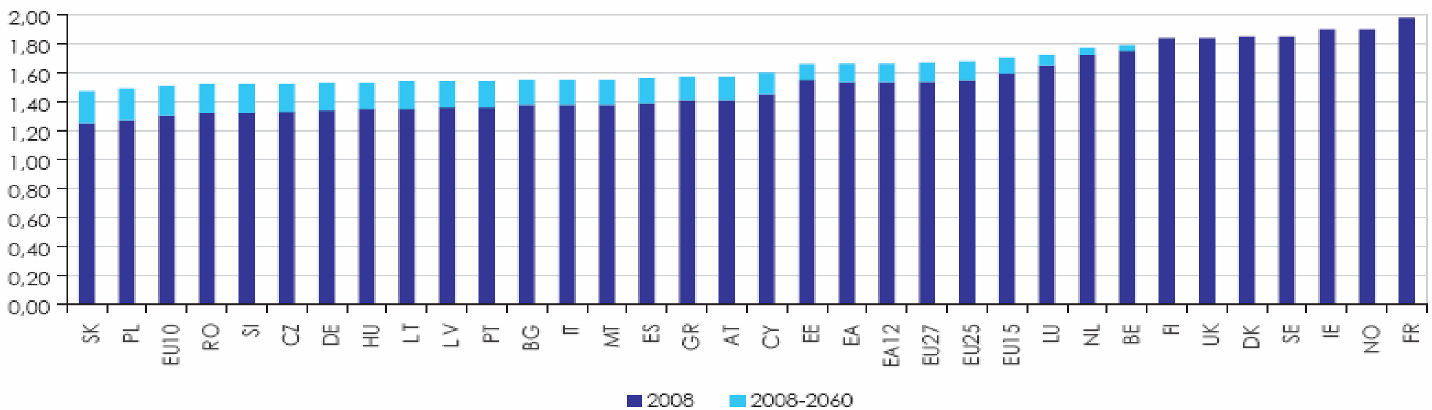
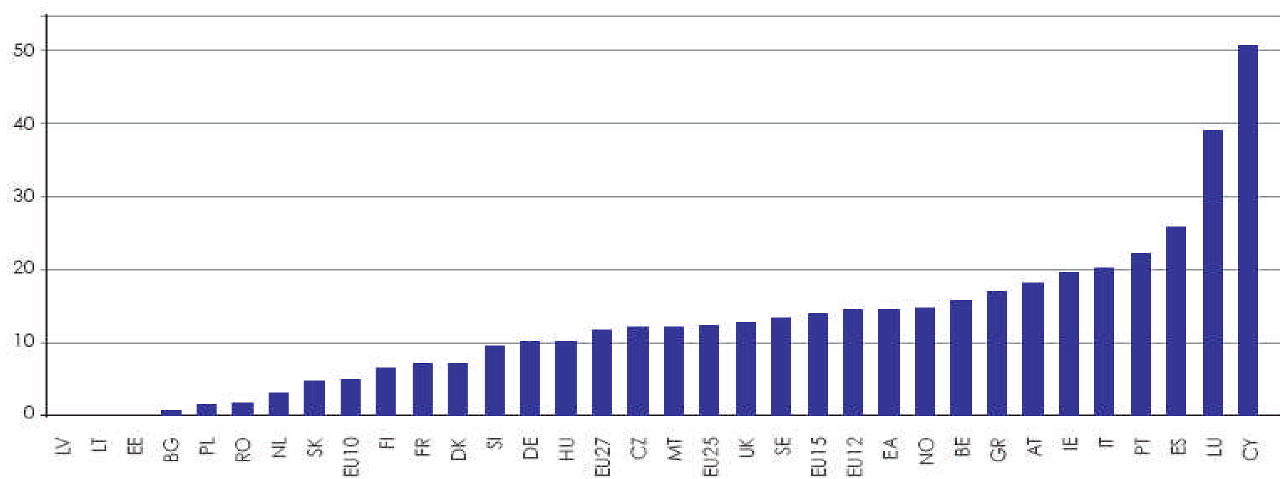
Projections of life expectancy in EU 2008 – 2060

Europe's population is declining (lower fertility rates, less immigration

Graph 5 - Projection of total fertility rates in EUROPOP2008 (number of births per woman)



Graph 10 - Projection of net migration flows in EUROPOP2008 over the period 2008-2060 cumulated as a percentage of the population in 2008

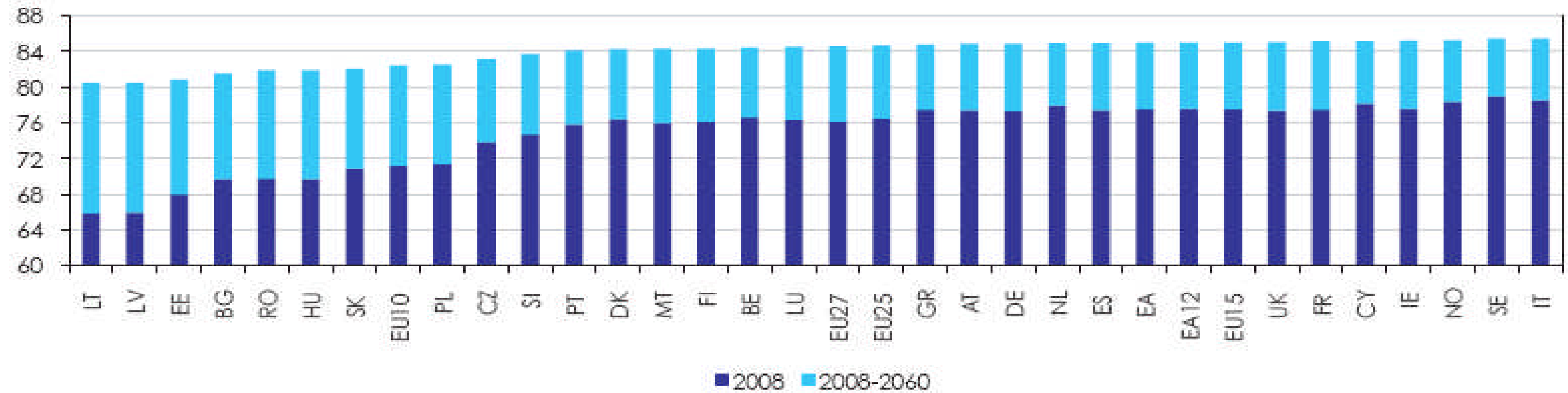


EU 2009 Ageing Report

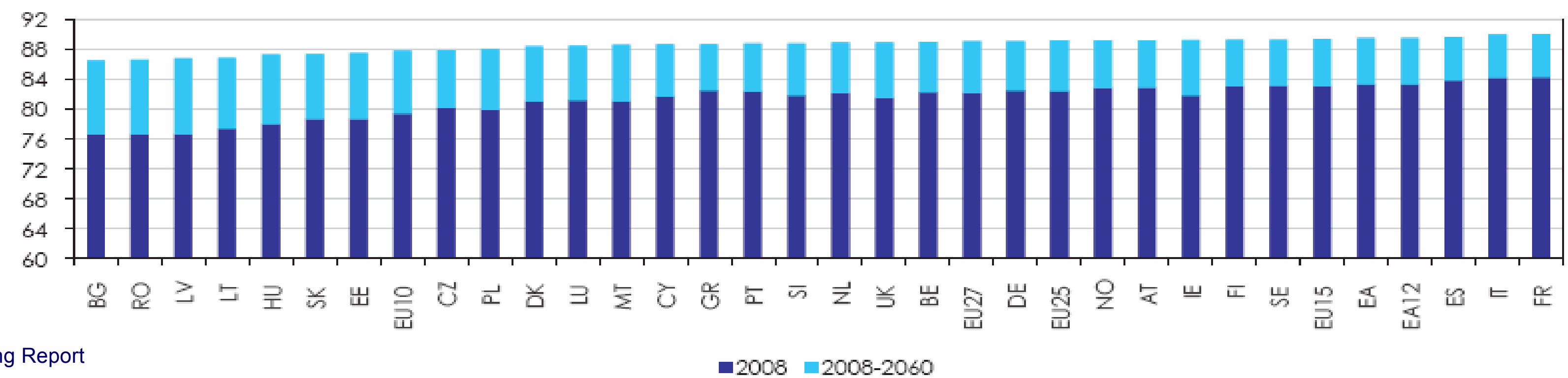
Projections of life expectancy in EU 2008 – 2060

And aging

Graph 6 - Projection of life expectancy at birth in EUROPOP2008, men (in years)



Graph 7 - Projection of life expectancy at birth in EUROPOP2008, women (in years)



EU 2009 Ageing Report

Demographic change is transforming the EU

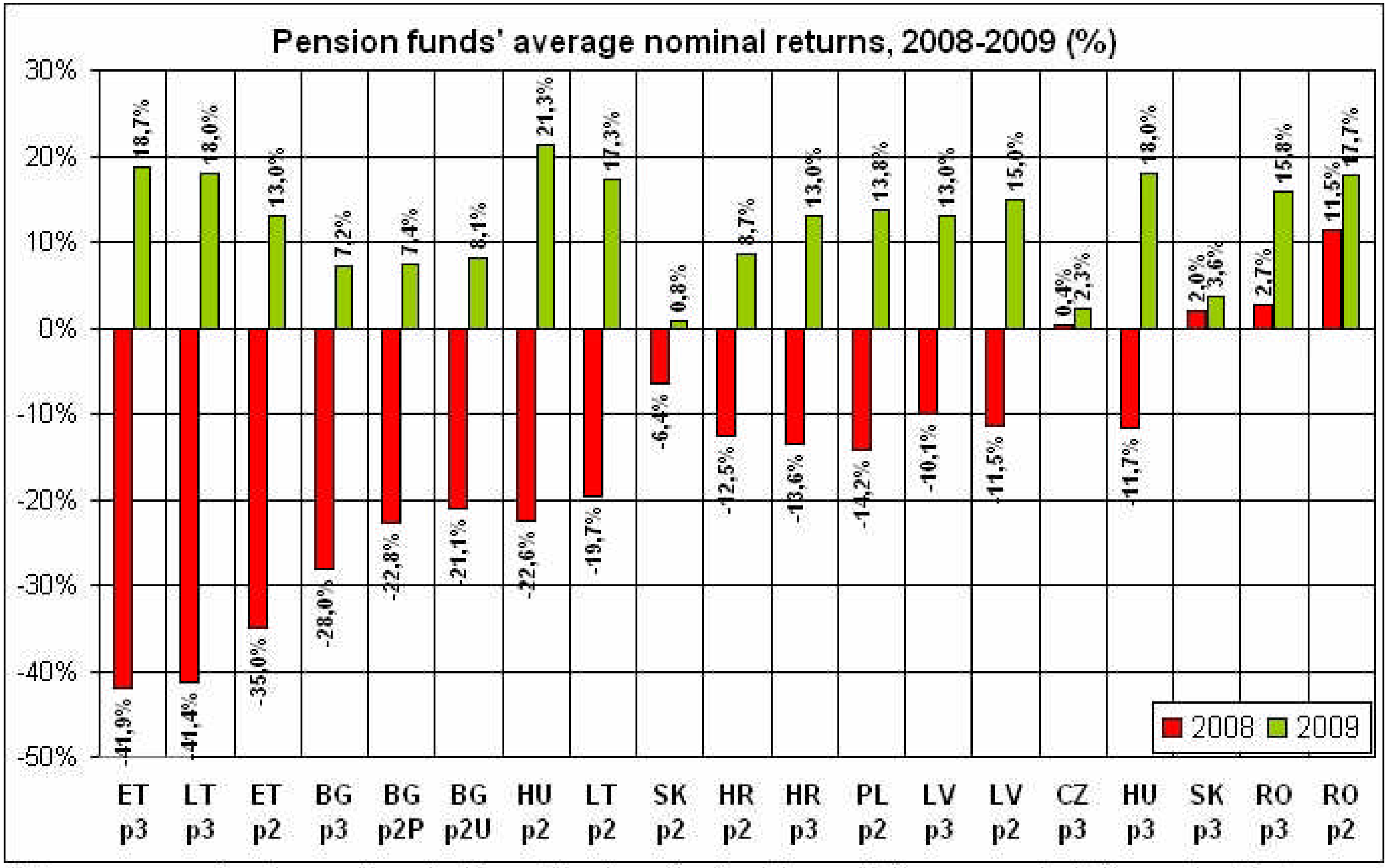
- Population of EU as a whole will be slightly larger in 2060 than today, but older:
  - 2008: about 495 million - 2035: about 520 million - 2060: about 506 million
  - Shrinking employment by about 19 million people (by 2020)

- 2008: half of the population is <u>40</u> years-old or more; in 2060: <u>48</u> years or above
  - In 2060: more than twice as many elderly above 65 than children below 15
  - In 2060: the number of very old people might amount to 80% of the number of children

- The ageing process can be characterised as ageing from the top
  - Being active, healthy, participative well into old age: a realistic prospect for Europeans
  - Dependency ratio in Europe: ⟹ 2008= 4:1 2060= 2:1
    - Romania 1990= 3.3:1 2009= 0.94:1 2050=0.4:1 (Now public sector 20% deficit)

- How will living standards be affected as each worker has to provide for the consumption needs of a growing number of elderly dependents?
  - Taken into account that Europe is in the midst of the deepest recession in decades
  - This puts an unprecedented stress on workers and companies
  - It has a major impact on the sustainability of public finances
  - It had a major impact on the returns of pension funds…

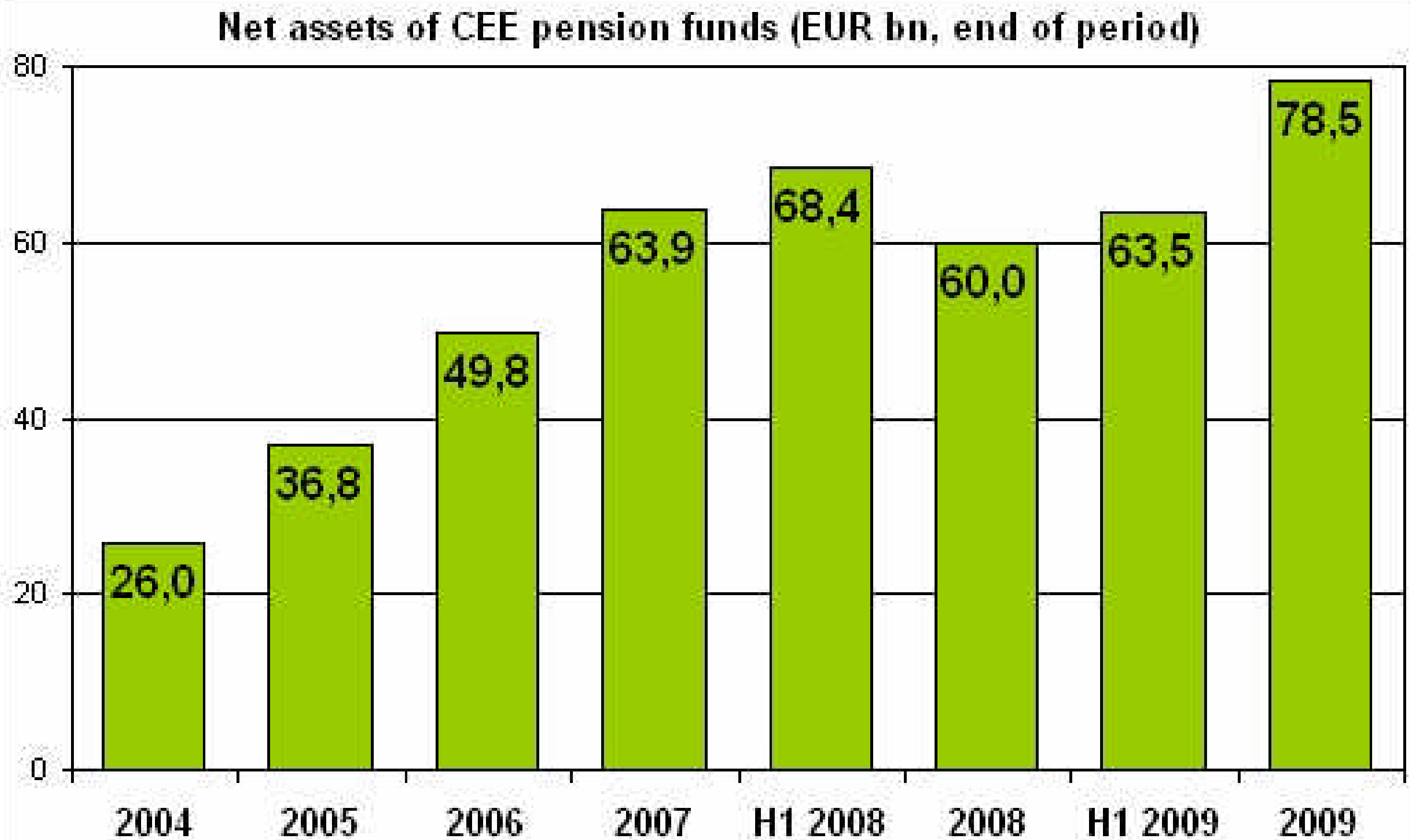
Strong returns in 2009, after the drop in 2008



Data sources: national supervisory bodies, national pension funds' associations, own calculations and estimates.

Pension funds in the 10 CEE countries manage savings for >40 million participants

Yet, CEE pension funds are quickly emerging



Data includes 10 CEE countries: BG (p2+p3), CZ (p3), HR (p2+p3), ET (p2+p3), LV (p2+p3), LT (p2+p3), PL (p2), RO (p2+p3), SK (p2+p3), HU (p2+p3).

Data sources: national supervisory bodies, national pension funds' associations, own calculations and estimates.

CEE average returns:
-13,5% in 2008,
+12,9% in 2009,
-2,4% combined.

Funds still have a (short) way ahead to complete recovery.

Combined assets grew in 2009 by 30.7%, compared to an average annual growth of 23.4% in 2004-2008;

Yet we see a wave of reform reversals in CEE

- In spite of a relatively quick investment recovery, private pension systems in CEE were hit by **reform reversals** & **political decisions** (see appendix)

- This happened regardless of previous or current performance of pension funds
  - ➢ Political risk is much more of a threat than investment risk

- Reform funding was reduced by contribution cuts, investment performance was hindered by political decisions
  - ➢ All this greatly reduced private pension systems' **adequacy** and affected the property rights and best **interests** of millions of pension-plan participants

- Question
  - Do governments want to protect private-pension-plan participants from investment losses?
  - Or do they just want more money for the state pension systems?
    - ➢ Which were more affected by the crisis than the private pension system

Political risk: the biggest obstacle for development of private pensions in the region

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And what about the principle of non-discrimination?

Risk differentiation keeps private insurance in balance

- The principle of non-discrimination:
  - Comparable situations must not be treated differently; different situations not treated the same
    - It would be contrary to the aim of the proposal to implement the principle of equal treatment between persons on a minimum level within the European Union.
    - At the same time it would create an obstacle for cross-border activities of the insurance industry.

- Differentiating according to risk exposure: a vital condition for providing insurance services

- Private insurers treat customers according to the risk they represent e.g. age or disability; differentiation of risks is not arbitrary or capricious
  - Those with greatest expectation of claim have greater incentive to buy – others will abstain
  - Share of those with greater expectation to claim increases in pool: inequality between premiums paid and claims borne within pool
  - Insurance premiums increase: economic “exclusion” of large groups of the population

Differentiation according to risk exposure is not unfair discrimination but a necessary pre-condition for the functioning of private insurance

- Statistics compare **number** of individuals within a risk group versus a standard group

- Insurers have to consider – in addition
  - Differences between general population and population considering insurance cover
  - Sums assured determine the ultimate claim amount (not number of claims)
  - Medical advances, growing experience and risk differentiation allow insurers to offer risk-adequate terms to ever more individuals (life insurance)

- Private insurers need a wide range of sources for a comprehensive risk assessment
  - Actuarial / statistical data, medical reports, research and experience

- A risk is only insurable, if it can be correctly assessed and priced on the basis of the above-mentioned information sources.

A restriction of these sources:

- Would lead to an asymmetry of information between consumers and insurers,
- Would prevent correct risk assessment and pricing
- Lead to higher premiums and less private insurance solutions for consumers

Impact of crisis on companies and customers

- The biggest impact of the crisis was on the (decreased) level of contributions, due to un-employability, not on the returns of the pension funds in CEE

- Crisis has reshaped competitive landscape
  - Simpler business models and products
  - ‘De-risking’, banks scale back riskier activities, bigger capital and liquidity buffers
  - Big institutions restricted or broken up
  - Although growth will return, the desire for stability may come at a price

- Customers:
  - Have lost money and do not know who to blame
    - Especially older people probably don’t have enough time to compensate these losses
  - People will have to be weaned off the expectation that pensions will become ever more generous and health care ever more all-encompassing
  - Meanwhile workers themselves, who have built up savings in pension funds, are being forced to rethink their pension plans and even defer their retirement
    - Since they now live so much longer and mostly in good health, they will have to accept that they must also work for longer and that their pensions will be smaller
  - In long term: customers will become more risk educate and demand transparency
  - In the medium term: they may want simplicity and avoid complexity

Conclusions (1)

- Demographic challenges in EU – ageing, lower fertility rates, changing dependency ratio – bring major economic, budgetary and social challenges
  - Structural reforms are needed for ageing societies; expensive demographic transition
  - As the working population will shrink; the productivity as source of economic growth should be increased
  - IMF and World Bank support pension reforms

- State pensions systems only are not sustainable
  - Expensive demographic transition
  - Pension reforms needed and have to be consistently implemented: continue and/or improve it further ⇒ never return to the old situation!
  - Sustainable pensions for citizens = state + private (mandatory + voluntary)

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Conclusions (2)

- Unemployment has been the biggest effect so far of the financial crisis
- Budgetary impact is different per country
- For political reasons governments predominantly have a short term horizon
  - Yet they need to look at the country and population benefits for the present and future generations
- Political risk: the most important risk for pension funds in Central and eastern Europe ⇒ We have to understand, prepare and act!

Proposed solutions

- Need for sustainable, clean pension reforms with full commitment of the politicians in each country
- Focus on the welfare of the present and future generations
  - Long term regulations, actions, investment rules, etc
- Adjustments of the retirement age and add extra support for them:
  - Give more opportunities to the elderly people to continue work (e.g. part time), invest in training them, flexible working programmes, increase people participation and employability
- Introduce and support supplementary pension schemes
  - With an adequate tax regime
- Cooperation public and private sectors
  - Private sector can and is willing to help and has the expertise to do so
- Involve all stakeholders in a constructive debate
- At EU level:
  - A pan-European approach at EU-level
  - Coordination, exchange of best practices, scientific and political fora

Finding the right balance

- Optimal regulation for private pension sector has a long term approach and should facilitate that the market can work
  - Strong regulation is necessary: pensions is about long-term savings (**trust is crucial**)
  - Regulation should be independent of day-to-day politics: the system needs stability, no volatility or opportunism
  - Adequate tax regime
  - Make it attractive enough for providers to make a profit
  - Do regular operational audits and ‘rate’ pension providers: investment return, transparency etc
  - Create limits to commission for agents and brokers
  - Regulation must create a level playing field and protect customers against too risky asset allocation
  - Allow for sufficient assets in international stocks and bonds
    - Spread risks, less ‘over-investing’ in local economy, good investment is key for a PF (even more than cost awareness)
  - Regulation-imposed yield guarantees for short term should be eliminated

We ‘need a balance between risk management, protection, return on investments and affordability

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Appendix - Regulatory changes in pensions in CEE

- **Polish pension fund (as of January 2010)**
  - Decrease entry fee (-50%) accelerated 2014 - 2010
  - AuM fee capped at PLN 15.5.m per month (used to be PLN 10m)
  - Proposal to decrease the pillar II premium that are sent from the pension fund administrator (ZUS) to the PF's. ZUS intention is to do part of the asset management in-house.

- **Romanian pension fund**
  - Freeze of contributions for Pillar II at 2% of gross salaries in 2009 instead of growing by 0.5% each year to reach 6%. The draft Romanian budget for 2010 was approved at the end of 2009, indicating the increase in the Pillar 2 contribution level to 2.5% (one year later than initially planned).
  - Draft law on Guarantee Fund for Pillar II and III. PF's need to contribute: 1% of share capital and an annual fee equal to 0.3% of net asset value.
  - Ongoing changes of new participant allocation rules for Pillar II. The regulator introduced a norm which eliminates companies with over 20% market share (ING & Allianz) from the lottery sales.
  - Discussions on offering a 0% guarantee also on transfers (next to on maturity & death)

- **Slovakian amendment in Pillar II make system economically unsustainable**
  - Management fee: down with 66% (implemented in Q2 2009)
  - 6 month return guarantee (came into force in 2009)
  - Discussion on contribution decrease reducing the contributions to 2/3 of current level.

- **Slovakia Pillar III:**
  - Decrease in fund management and surrender fees likely to be applied in 2010.

- **Hungarian pension fund**
  - Cap on AUM fee from 80bp to 40 bp gradually from 2011.
  - Minimum account value at retirement, consisting of the sum of the allocated premiums increased with the cumulated inflation.
  - Discussions on removing the tax deductibility of the voluntary corporate pensions