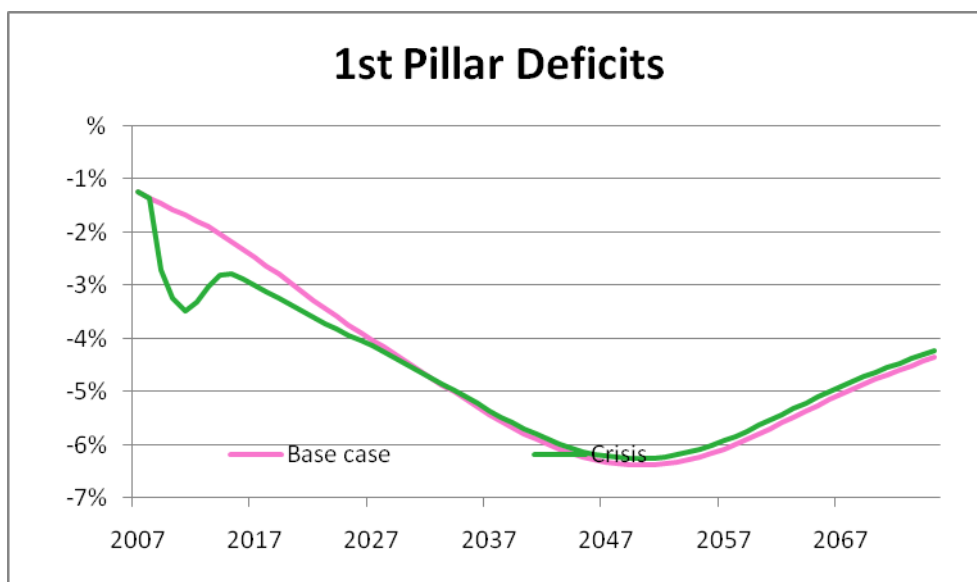


SECTION 3. THE REAL CRISIS IS YET TO COME

Despite the pain countries have endured during the global financial and economic crisis, the impact of this crisis pales in comparison to what the countries are soon to face as the region continues to age. It is sobering to look at the impact of the most severe version of the global financial crisis next to the impact of the demographic crisis to come, as shown in Figure 5. Future pension system deficits are expected to be threefold what is currently being experienced in the worst hit countries and are expected to remain at that level for more than 20 years before slightly improving.

Figure 5: Projected Balance of the Pension System over the Next 60 Years



Policymakers need to be cautious that their response to this crisis does not exacerbate the next one.

In past crises, governments have responded to rising unemployment by loosening early retirement and disability restrictions. Increased retirement now will shift the baseline deficits even higher as potential revenues decline and expenditures rise. Raising contribution rates in some types of systems raises liabilities for the future. Transferring second pillar contributions to the first pillar also involves an increase in future liabilities for the first pillar.

A. FIRST PILLAR REFORMS: IMPROVE FISCAL SUSTAINABILITY BEFORE THE BIG CRISIS HITS

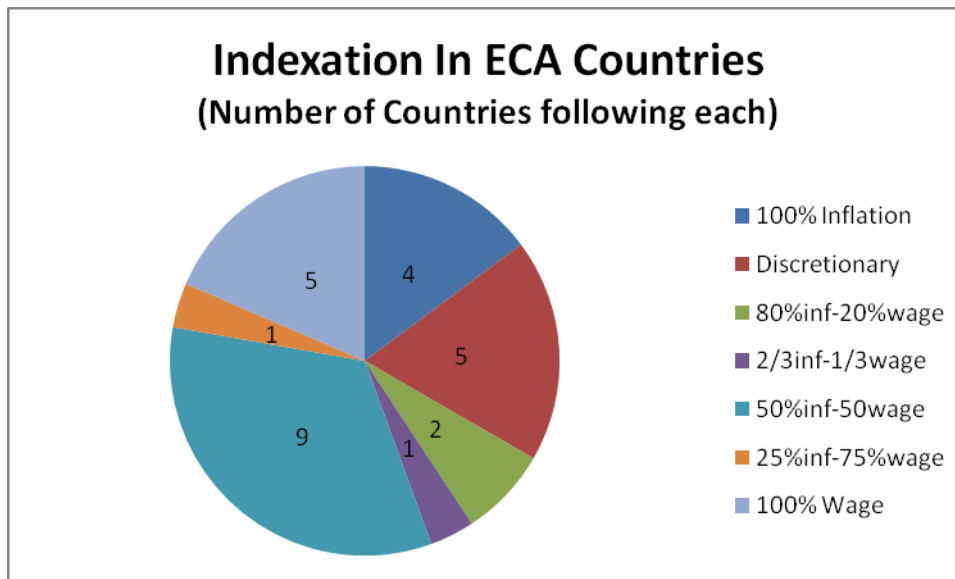
The big crisis shown above arises from the unfavorable demographics facing most of these countries, but also from some of the policies they are following. Prior to 1990, most of these countries had pension systems which were unaffordably generous, particularly in light of the aging to come. Most countries, in one way or another, have improved their pension systems. Substantial reforms took place in the late 1990's and early years of this decade, often as much as was politically feasible at the time, and policymakers took a rest, knowing in most cases that they had not reached fiscal sustainability, but recognizing that they needed to give the public time to absorb the substantial changes already made. Without these reforms in place, the demographic crisis would have looked much worse.

Crisis provides an opportunity for reform. In some cases, as the economy improved and fiscal pressures fell, generosity began to increase again. The crisis provides the opportunity to revisit these pension reforms and put policies in place that will help workers and pensioners cope with the crisis to come. What policies would be helpful?

i) Moving to inflation indexation

Most countries in the region maintain some element of wage growth in the pension increases granted to pensioners after retirement, although international best practice and practice in both EU and OECD countries has shifted toward inflation indexation. Pre-reform, most of the countries indexed pensions to wage growth. Box 2 shows the current indexation arrangements in the region. As shown in Box 2, only four of the

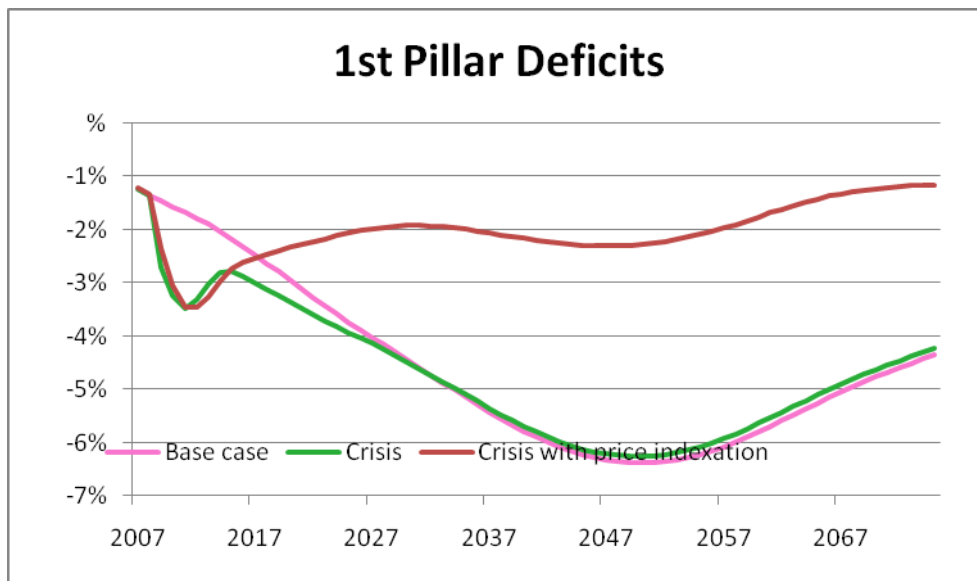
Box 2: Regional Indexation Arrangement



twenty-seven countries for which there are data follow the international best practice. The other twenty-three countries continue to include at least some element of wage growth in the indexation of pensions after retirement. Moving to inflation indexation during the crisis would better protect pensioners in the short run by maintaining their purchasing power, but at the same time, move the pension system to better fiscal sustainability for the long run, in short a rare win-win proposition.⁴

Figure 6 shows the impact of moving to inflation indexation in this hypothetical country. While there is a very small initial fiscal cost, given that full wage indexation should reduce real pensions in the short run, the benefit is better protection for vulnerable pensioners in the short run and major fiscal improvements for the long run.

Figure 6: Projected Pension Deficits with Move to Price Indexation



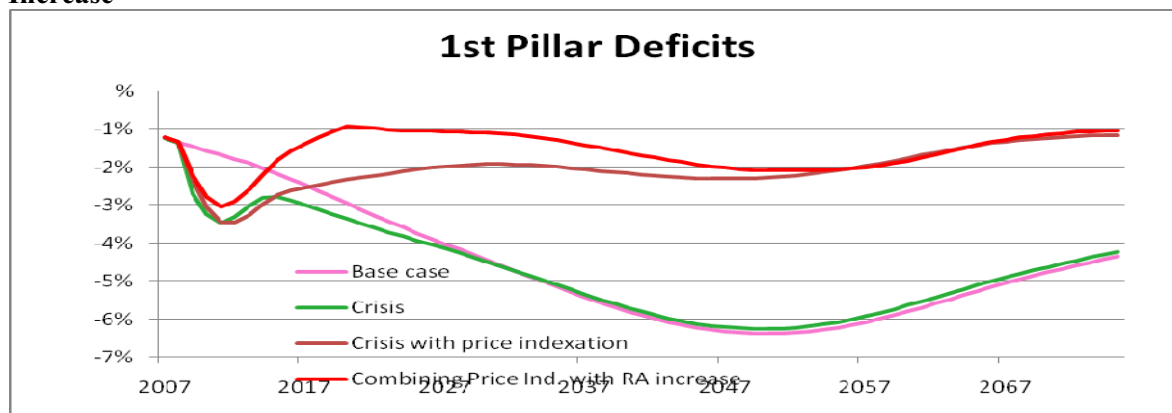
ii) **Raising retirement ages.**

While most OECD countries have already raised retirement ages for both men and women to 65 or beyond, most ECA countries continue to allow men to retire younger than 65 and continue to allow women to retire even younger than men. Average retirement ages are even younger than statutory retirement ages with half or more of new retirees retiring younger than the statutory retirement age because of early retirement privileges granted for many occupations pre-transition. While male life expectancy is significantly lower than in western Europe, especially in countries like Russia, the expected duration of benefits is longer for men and even more so for women than in western Europe. If retirement age was raised to 65 at the rate of 6 months per year,

⁴ International best practice suggests that wages pre-retirement be revalued using average wage growth, while pensions after retirement are indexed to inflation.

along with the move to price indexation, the impact on the long run would be even more substantial as shown in Figure 7.

Figure 7: Projected Deficits with Both Inflation Indexation and a Retirement Age Increase



iii) Promoting public awareness of pension issues.

With the aging of the population (the coming demographic crisis), people will increasingly have to save additional money for their own retirement if they want more generous benefits. Financial literacy schemes and information awareness campaigns are important to build public understanding of the need for reforms and the need for individual savings to complement public pension benefits.

B. SECOND PILLAR REFORMS

The crisis also unmasked some particular vulnerabilities of the second pillar pension systems in the region: (i) vulnerability of benefits during accumulation and decumulation stages to vagaries of financial markets, (ii) regulatory limits which discourage risk-taking and result in lower returns to participants, and (iii) the need for stronger capital market development.

i) Provide better insurance for the funded benefits

Lifecycle pension portfolios provide different portfolio allocations for individuals in different stages of the lifecycle, with younger individuals more heavily invested in higher-risk, higher-return equities and older individuals in lower-risk, lower-return government bonds, and optimize the expected value of future pensions. Many countries

in the ECA region, including Poland, Bulgaria, Croatia, Macedonia and Romania allow pension fund managers to offer only a single portfolio. Due to regulatory restrictions and competitive behavior, portfolios end up being very similar among different funds. As a consequence, individuals with different portfolio needs face a single portfolio option. This solution is sub-optimal from a lifecycle perspective, imposes risks for generations that are close to retirement age, and does not generate sufficiently high returns for younger generations.

Two other potential measures countries could consider are (i) providing a basic guarantee for the contribution of participants, such as a zero rate of return and (ii) increasing flexibility on the timing of converting fund balances into annuities to avoid forced selling of assets and conversion if the age of retirement coincides with a period of low asset values. The first measure would help raise confidence in the pension system for those individuals who have seen their asset values drop dramatically. In the second, individuals could choose the date at which they convert their balances to annuities rather than being forced to convert them on the date at which they reach retirement age. Better insurance from measures like these and the switch to life cycle portfolios will prevent the need for allowing older cohorts to switch back to the public system during times of crisis.

ii) **Accelerate regulatory and supervisory reforms that result in better rates of return**

Many of the current regulatory and supervisory practices do not provide the necessary investment options, investment regulation, performance criteria, and economic incentives to diversify the portfolio.

Less restrictive regulatory limits that encourage appropriate risk taking. Subject to proper supervision, regulation should encourage investments through low cost collective undertakings that promote international portfolio diversification. The excessive reliance on performance measures (e.g. minimum return guarantees, non negative returns), restrictions on international portfolio diversification and limitations for investing through collective undertakings (UCITS funds) may discourage pension fund managers from taking risks, which affect the rates of return they can provide participants. While the use of a minimum relative return guarantee is widely used among countries with second pillars, in some countries the parameters are too strict. In addition, some countries have added absolute return guarantees and compliance with a self defined investment strategy. The combination of these three factors is likely to bring portfolios towards conservative strategies. As a way of ensuring long-term sustainability of pension portfolios, regulation should allow for international portfolio diversification. Collective undertakings are an efficient way of diversifying portfolios at low cost. But pension fund managers will invest through these more expensive instruments only if the fees are paid by the fund.

Lifting unprofitable restrictions on administrative fees. Although high fees charged by pension fund managers are still a problem in some CEE countries, tight caps might discourage sound investments by pension funds. All ECA countries have imposed caps on fees charged by pension fund management companies (PFMCs), and in practice fees

typically reflect the maximum allowed by the regulation. While in some countries fee structures have resulted in healthy profits for PFMCs, in others such as Slovakia and Romania, tight caps on fees have been an impediment for the development of the pension industry. In these cases PFMCs have not put enough emphasis in diversifying portfolios and offering attractive alternatives in retirement savings to contributors. Pension fund managers are currently discouraged from investing in assets other than low-yielding fixed income instruments because of the additional costs incurred in investing in other assets which are not covered by the restricted fees.

Flexibility in valuation methodologies during periods of illiquidity. Last, but not least, valuation methodologies should be prepared to deal with episodes of illiquidity and should avoid unfair transfers of wealth among contributors. As financial markets have turned illiquid, we see important challenges in the area of asset valuation. In order to avoid opportunistic behavior during the crisis by PFMCs, valuation rules should allow fair comparison of returns among different pension funds. Mark to model can temporarily replace the practices of mark to market, but supervisors should strengthen their efforts in insuring consistency in the use of modeling for asset valuation. Mark to market should be resumed as soon as the market recovers liquidity.

iii) **Build a financial market for inflation-indexed bonds**

Although pension funds may help to develop the domestic capital market, governments should also take proactive measures, including the development of an inflation indexed bond market. Development of the domestic capital market reduces the dependence on foreign financing, but also offers necessary instruments for pension funds and life insurance companies that are difficult to purchase in offshore markets, including long term inflation indexed bonds. The development of the domestic capital market requires a proactive approach from governments in the provision of financial infrastructure and in promoting the issuance of government inflation indexed bonds.