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LEGAL AND FINANCIAL ASPECTS OF THE DEVELOPMENT OF PENSION FUNDS IN POLAND

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Abstract

The aim of the article is to show the impact of pension reform in Poland on the development of pension funds (OFE). The focus is on an analysis of pension funds the functioning of which in recent years has been subject to extensive modifications. It also investigates the level of knowledge about social insurance in Polish society. As a result of a review of the literature and documents published by Poland and EU member states, a synthetic study of legal and financial aspects regarding the development of Open Pension Funds (OFE) during a period of intense systemic changes in Poland is offered. The article expands and organizes knowledge about the functioning of pension funds in Poland and makes it possible to look critically at their development and the transformations leading to the liquidation of Open Pension Funds. The described results of these analyses are of a partial nature and constitute a fragment of broader research carried out by the authors.

Key words: Pension fund; system; reform; pension insurance.

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1. Introduction

Currently, pensions and related benefits received by the insured constitute a very important and, at the same time, uncertain phenomenon.

A pension is a basic element providing income during old age, after the end of the working life of insured persons. That is why it is so important that the benefit received by pensioners is high enough to make it possible to live with dignity. In addition to the pension guaranteed by the state, in which the managing institution is the Social Insurance Office (hereinafter "ZUS"), there are also pension funds, which are intended to increase the benefit received at retirement age.

In recent years, the aging of societies has accelerated more rapidly, resulting in longer-term retirement benefits. With changing demographic and economic conditions, the need for system reform is inevitable. Therefore, Poland and other countries have endeavored to improve their pension systems, trying to develop the capital element of the system, which is not exposed to demographic conditions as much as the pay-as-you-go element. Each future pensioner can choose any fund, based on its effectiveness; the assets of pension funds are valued every day, which offers an opportunity for customers to choose a better form of investment.

The following article presents legal and financial conditions for the development of pension funds in Poland and their activities in the years 2012-2017.

The aim of the article is to show the impact of pension reform in Poland on the development of Open Pension Funds (hereinafter "OFE"). The focus is on the analysis of pension funds, the functioning of which in recent years has undergone extensive modifications.

2. The Reform of Open Pension Funds

The basic assumptions of the pension reform of 1999, concerning the replacement of the system with a defined benefit, that is, a defined contribution system, have not changed. The introduced Open Pension Funds, however, proved costly, and their inefficiency necessitated the introduction of profound changes.

The reform of 2013 resulted in the transfer of Treasury Bonds from OFE to ZUS, thereby liquidating the OFE bond element. Voluntary participation in open funds and the so-called "safety catch" were introduced. The fees collected by the Universal Pension Societies, which managed the OFE, were also reduced.

The Act of 6 December 2013 introduced changes to the pension system, which entered into force on 1 February 2014 [Act on the Amendment of Certain Acts in Connection with the

Definition of the Rules for Payment of Pensions]. On its basis, every member of Open Pension Funds has the opportunity to choose whether a part of his or her pension contribution, to the amount of 2.92% of gross remuneration (from 2015, this is 3.3%), will be transferred to an OFE or in its entirety to ZUS. From 1 April 2014 to 31 July 2014, every member of an OFE was able to submit a declaration of willingness to continue to pay part of the contribution to an OFE. From 2016, every four years within this period, a person may submit such a statement to ZUS.

Pursuant to the above Act, on 3 February 2014, OFEs were to redeem 51.5% of the accounting units from the account of each OFE member as of 31 January 2014, and were to transfer them to ZUS into individual sub-accounts. Analyses show that 49.5% of assets were transferred to the Social Insurance Office, while the remaining 51.5% are assets that remain in Open Pension Funds.

Up to the end of January 2014, 51.5% of assets that went to OFE were designated for the purchase of securities and Treasury Bonds. Part of the pension contribution was transferred by ZUS to OFE, which resulted in a lack of funds for payment of pensions, and, thus, the necessity of their financing by the state. As a result, the state had to incur a debt to send resources to Open Pension Funds, so that later the funds would buy back this debt in the form of government bonds [OFE Reform] As a result, on 3 February 2014, OFEs transferred PLN 153.15 billion to the Social Security Office, reducing public debt by 9% of GDP, as well as accounts of members of the Open Pension Funds [Rutecka 2014]. The value of these assets was recorded on the individual ZUS sub-account of each participant in the pension system as of 31 March 2015. Funds accumulated in sub-accounts will be subject to valorization until the insured retires and the valorization is to be calculated according to the growth rate of GDP.

OFE members were able to decide between 1 April and 31 July 2014 whether their pension contribution would be fully transferred to the Social Insurance Office: around 60% into an individual account in the first pillar, and 40% into a sub-account; or predominantly to the Social Insurance Office, i.e., 85%, with 15% going to an OFE [OFE reform]. The premium transferred to an Open Pension Fund and to the sub-account in ZUS comes entirely from the premium paid by the insured. As a result of the change in regulations, pension contributions were divided for insured persons who decided not to transfer part of it to an OFE. Whereas for members remaining in an OFE, the contribution to the second pillar changed; after the reform, according to the Act of 25 March 2011, this amounted to 2.92%, whereas the contribution to Social Security was 16.6% (12.22% going to the individual account in ZUS and 4.38% to the sub-account in the Social Insurance Office). In the years 2015-2016, the ZUS contribution was divided into:

- 12.22% allocated to the individual account of the insured in ZUS;

- 4.0% allocated to an individual sub-account maintained by ZUS.

Another element of the pension reform, is the “safety catch,” which transfers funds from the OFE member’s account to the Social Insurance Office every month for ten years before the insured reaches retirement age. Its purpose is to protect against a collapse of market rates at retirement, which could result in a lower level of benefits paid out. The “catch” applies both to those who remain in ZUS and those paying a contribution to an OFE. As a result, the Social Insurance Office collects all funds and pays out one life-time retirement, valorized every year. The right to inherit funds accumulated in an OFE will be available regardless of the decision to participate in this fund. The payment of the funds, according to the regulations, is invested [Act on the Organization and Functioning of Pension Funds]:

- in the spouse of the insured;
- in persons nominated by him/her;
- in heirs;
- in members of the insured’s family;

In addition, a new provision was introduced on the inheritance of funds held in the sub-account in ZUS within three years of retirement. The payment of funds to the person so entitled occurs in the form of a one-off cash payment by the Social Insurance Office. Premium fees in an OFE initially did not have a specific upper limit, so some PTEs even collected 10% of the premium. Since 2004, this has been limited to a maximum of 7% of the pension contribution. In 2009, the government reduced this limit to 3.5% and, currently, from the beginning of 2014, it is 1.75%.

3. The Situation of Pension Funds on the Polish Insurance Market

In the years 2012-2017, the changing legal environment had a significant impact on the operation of pension funds. As a consequence, regulations relating to the investment policies of pension funds were introduced:

- the maximum share of OFE assets in deposits denominated in foreign currencies was fixed: in 2014, this was 10%, in 2015, it was 20%, and in 2016, it was 30%;
- an obligation was imposed to maintain at least 75% of OFE assets in shares in 2014, with a subsequent reduction of the threshold to 15% in 2017, until its total liquidation;
- there was an increase in the issuer’s share in securities from 5% to 10%;
- investment in treasury instruments was forbidden; there was an increase in the volatility of investment results of OFEs, occasioned by the transfer of 51.5% of assets to ZUS.

From 2012, the unemployment rate in Poland was lower than in the European Union as a whole, and in 2017 it reached the level of 5.8%. The drop in unemployment in 2012-2017 may indicate that Poland was able to cope during the turmoil in the financial markets. At the end of December 2017, more than 16.1 million members belonged to OFEs, i.e., in the previous three years, the number of fund members decreased by around 0.5 million. The list of open pension funds together with the number of their members is presented in table 1.

Table 1. Numbers of members of OFEs in 2012-2017

| OFE | Number of members in 2012 | Number of members in 2013 | Number of members in 2014 | Number of members in 2015 | Number of members in 2016 | Number of members in 2017 |
|---|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| AEGON OFE | 947,048 | 941,343 | 929,012 | 921,408 | 913,870 | 1,829,746 |
| Allianz Polska OFE | 553,666 | 592,987 | 1,082,471 | 1,076,996 | 1,072,203 | 1,059,560 |
| Aviva OFE Aviva BZ WBK | 2,672,860 | 2,676,355 | 2,666,951 | 2,649,332 | 2,630,996 | 2,577,179 |
| AXA | 1,162,223 | 1,163,758 | 1,158,243 | 1,152,169 | 1,146,650 | 1,130,771 |
| Generali OFE | 1,006,344 | 1,010,280 | 1,005,926 | 1,000,455 | 995,026 | 980,396 |
| MetLife OFE (dawne Amplico) | 1,269,898 | 1,537,349 | 1,601,115 | 1,591,605 | 1,584,708 | 1,554,170 |
| Nationale- Nederlanden OFE (dawne ING) | 3,010,238 | 3,060,317 | 3,081,495 | 3,077,790 | 3,061,745 | 3,013,549 |
| Nordea OFE | 888,272 | 925,414 | 994,487 | 989,883 | 982,175 | -,* |
| Pekao OFE | 342,820 | 342,029 | 338,415 | 335,450 | 332,885 | 327,025 |
| PKO BP Bankowy OFE | 657,837 | 956,945 | 949,906 | 943,153 | 937,435 | 922,924 |
| OFE Pocztylion | 595,930 | 594,833 | 589,365 | 585,526 | 582,334 | 573,374 |
| OFE PZU "Złota Jesień" | 2,222,853 | 2,229,848 | 2,224,300 | 2,208,375 | 2,188,092 | 2,133,884 |
| OFE Polsat | 300,789 | | | | | |
| OFE Warta | 311,504 | 346,256 | | | | |
| Total | 15,942,282 | 16,377,714 | 16,621,686 | 16,532,142 | 16,424,842 | 16,102,578 |

*Nordea OFE was liquidated on 17 November 2017, and its assets were transferred to AEGON OFE.

Source: Authors' own materials

Members of pension funds were acquired [Dąbrowski, Pomarański 2010]:

- on the primary market, i.e. from people who had just begun to be eligible for social insurance. This consisted in the insured's signing a contract with any OFE, or through allocation of the insured to a fund by lottery;
- on the secondary market, by taking over members of other funds, via a transfer session.

An important influence on the method of acquiring members of OFEs was the fact that from the beginning of 2012, Universal Pension Societies have not been able to carry out acquisition activities for an OFE, and membership agreements are concluded and signed only by way of correspondence. As a result, the number of people who independently made the selection of a fund significantly decreased, thus increasing the number of those who were allocated to an OFE by way of lottery. From 1 January 2014, the lottery allocation of pension funds as a way of receiving membership in an OFE was abolished. Thus, with respect to persons who had not made any selection, contributions were transferred entirely to the Social Insurance Office.

In 2012-2017, about PLN 37.5 billion came to Open Pension Funds from membership fees together with interest on tardy payment of premiums. The largest amount of contributions was transferred to OFEs in 2013 and exceeded PLN 11 billion; the least amount was transferred in 2015 - slightly over PLN 3.1 billion, as presented in table 2:

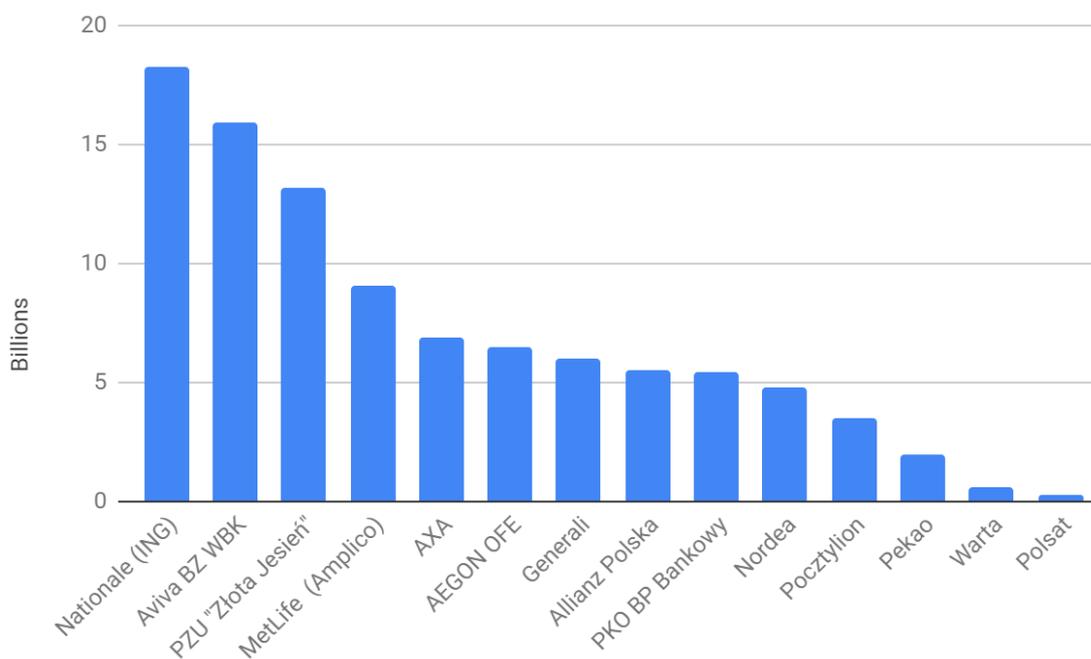
Table 2.

| Year | Contributions with interest (PLN millions) |
|-------------|--|
| 2012 | 8,410,296,004.42 |
| 2013 | 11,054,378,652.66 |
| 2014 | 8,325,308,678.64 |
| 2015 | 3,154,236,317.37 |
| 2016 | 3,654,635,265.56 |
| 2017 | 3, 663,680,585.47 |
| Suma | 38,262,535,503.80 |

Source: Authors' own materials

The discrepancy in the amount of premiums paid to OFEs within the 2012-2017 period is due to the fact that, until the end of 2012, 2.3% of the contribution to OFEs was deducted, while in 2013 it was 2.8%. In January 2014 3.1% was paid; for February it was 2.92%; and for July only those members were considered who had declared their participation in the fund in the period from April to July 2014.

Figure 1. Contributions made to OFEs in the years 2012-2017



Source: Authors' own materials

The highest amount of premiums in the period 2012-2017 was made to the Nationale Nederlanden OFE to the sum of PLN 18 billion, and to Aviva OFE Aviva BZ WBK to the sum of PLN 15.8 billion. The lowest receipts from contributions in the period analyzed were recorded by Pekao OFE, OFE Warta, and OFE Polsat (a total of nearly PLN 3 billion), of which the last two funds ceased to function after 2013.

Payments of funds to OFEs in 2014 caused a drop in the value of net assets of funds. This situation is illustrated in table 3. The decrease in net assets in the years analyzed amounted to nearly PLN 130 billion, which was mainly influenced, pursuant to the newly introduced act, by the transfer of OFE funds to ZUS on 3 February 2014 to the value of PLN 153.2 billion.

Table 3.

| Year | Value of funds' net assets |
|------|----------------------------|
| 2012 | 269,596,467,329 |
| 2013 | 299,272,473,054 |
| 2014 | 149,054,602,080 |
| 2015 | 140,496,147,445 |
| 2016 | 153,433,837,152 |
| 2017 | 179,529, 919,341 |

Source: Authors' own materials

Additional costs that affect the reduction in the value of assets in pension funds include [Fees charged by OFEs]:

- management fee - this is a fixed amount established by statute and cannot be higher than 0.045% of net assets in the month;
- a payment from pension contributions - a distribution fee; this applies before the conversion of contributions into settlement units and cannot exceed 3.5%;
- a payment on transfer withdrawal – this is charged to members belonging to the fund for not less than twenty-four months, and is PLN 80 or 160.

In connection with the transfer of all capital from OFEs to ZUS, periodical pensions were paid by ZUS, which caused a fall in the value of Open Pension Fund assets [Rutecka 2014].

4. Perspectives for the Development of Pension Funds

Recently, there has been much talk about the future of Open Pension Funds, and this is because of the government's greater interest in the assets of open pension funds. The current government is planning to make major changes to the pension system and to make a move away from the capital system that is currently in operation possible.

In February 2014, the Treasury securities held in OFEs were redeemed. This decision was optimal from the point of view of the country's economic situation. In 2014, a so-called "transfer window" was opened, thanks to which participants could express their willingness to continue to participate in OFEs, by choosing the right fund for them. Almost 2.6 million people made this decision. After the redemption of treasury securities, most of the assets of Open Pension Funds were shares. The lack of good solutions related to investment led to increased interest in foreign shares; however, it can be said that the results of OFEs still depend on stock market conditions and government decisions. Shares of companies listed on the stock exchange since 2013 have shown a downward trend. Those shares cannot be

redeemed, because this would have an adverse effect on the stock exchange, and could also make it necessary to bring some companies into public ownership.

In order for the changes in life insurance for the elderly to be secure and to protect the system's stability, the following conditions should be observed [A Review of the Operation of the Pension System 2017]:

- net returns from insured premiums cannot be lower than they currently are;
- a solution must be found to the issue of the “risk of a bad date” – this occurs when OFEs buy shares on the stock exchange from their members, and when share prices fall, and, thus, the value of a pension is reduced, something over which future pensioners have no influence;
- a long-term increase in the balance of the pension fund in ZUS;
- reducing the growing public debt that arises because of the current system;
- developing the country's economy by improving the quality of investment of funds from pension contributions;
- distribution of the impact of the defined contribution system on the labor market, as well as treating the paid contributions for retirement as a kind of savings;
- ensuring the scope of the system favors professional activity on the labor market;
- maintaining the stability of the Polish capital market over time.

The liquidation of the non-share part of OFEs is a change that demonstrates the transfer of Treasury Bonds held from OFEs to ZUS. The ban introduced on investing in government bonds, and a minimum rate of return have been abolished, as has the State Treasury's covering any deficiency [Act on the Amendment of Certain Acts in Connection with the Determination of Rules for Payment of Pensions]. These changes positively affect public debt statistics, but they are a significant threat to the existence of a capital pillar and for the development of positive effects for the economy and future retirees. The stability of public finances is also threatened, both in the short and medium term, and the risk increases related to the financing of public debt.

A further change involves the transfer of assets to the Social Security Office, those assets belonging to members who have not submitted a declaration stating that they will remain in the selected open fund. This can lead to the effects described below:

- investors' losses and lack of market stabilization - high losses may occur for investors, participants in Open Pension Funds, the State Treasury, and ZUS, which holds assets transferred from OFEs;
- the risk of long-term recession in the market - there may be a drop in the equity market;
- a limiting of capital available for domestic companies - Polish companies may lose the opportunity to raise capital on the capital market;
- the risk of slowing down the development of the economy - the weakening of the stock exchange and investors (OFEs) may lead to a weakening of the economy;
- withdrawal from the Warsaw Stock Exchange by some investors - some investors may opt out and the WSE may lose foreign investors' interest.

All these effects may lead to a temporary improvement of the financial situation, while in the long-term it may destabilize the pension system, as well as leading to a liquidation of the capital pillar, which may, in the future, lead to a deterioration of Poland's economic situation.

It can be expected that an inflow of resources to funds along with a change in their risk may result in an increase in the quality of fund management. Factors that may affect benefits include: looking for instruments that would hedge portfolios against risk; a rapid reaction to market conditions in the process change; and investment in foreign securities with a lower exchange-rate risk.

Transferring savings from open pension funds to a sub-account in the Social Insurance Office is the so-called "safety catch", which does not entail a reduction in the portfolio of shares in an OFE. The assumption is that a large part of the funds allocated to the functioning of this mechanism will be financed from dividends on shares and coupons on bonds. Assuming that economic growth will occur, and, thus, the development of companies holding shares in Open Pension Funds, and hence high dividends, there may be an increase in the proportion of shares in OFEs, which will positively affect asset management. However, high dividends on shares may increase their value.

Significant reduction of the role of the second pillar of the pension system may have an important impact on the capital market, which may result in the development of a third pillar, as a real security for funds for old age. There is an increased interest in investing in Employee Pension Programs, Individual Pension Accounts, and Individual Pension Security Accounts, which may in the future neutralize the negative effects of limiting the role of Open Pension Funds.

To sum up, all these factors will depend on the number of people who declare their willingness to participate in the second pillar of the pension system, which is connected with the amount of assets in the system. The existence of open pension funds on the Polish market makes it possible to develop a market economy model that will not be completely controlled by foreign or state-owned companies, but will consist of private companies with head offices in Poland. This is of great importance and will have a great impact on economic growth, the development of the level of modernity in Poland, as well as possibilities associated with breaking out of the “middle income trap” [Kawalec et al. 2017: 17].

5. Prognoses and directions of change in the Polish social security system

Foreign experts believe that the pension system in Poland is safe and fair, while several Polish experts criticize it. However, the Polish pension system requires some adjustments to improve its functioning. The system should be adapted to a changing demographic and economic situation. Changes in the pension market should include:

- introduction of a multi-pillar structure;
- the development of employee pension programs and the development of a system involving individual saving for old age;
- a raising pensioners’ awareness of the current pension system;
- an increase in the retirement age;
- the introduction of a guaranteed minimum pension;
- adjusting the investment portfolio to the age of a retiree by applying generational funds (a solution applied in Sweden);
- incentives for a longer working life for older people;
- detailed information on the status of a pensioner’s account.

The Polish pension system is characterized by low financial stability, which is why a reform of the system is needed to improve its current status.

It is obvious that in order for this improvement to take place it would be necessary to increase the role of the capital part of the system. Tax incentives on the part of employers could be an appropriate solution to encourage employees to participate in occupational pension schemes. In addition, the capital assets in the system should be increased. These changes would be aimed at reducing the financing of pensions on the part of the state. Such a situation, which can be considered as optimal and safe for the Polish system, would create

opportunities for greater confidence on the part of the insured, and, thus, increase the working life of older people.

In Poland, the role of the second pillar in the pension system is limited. Thus, the situation tends toward a total absorption of risk by the state. This is not a safe situation, because with a multi-pillar system, the risk is divided among the state, employers, and citizens. The payment of benefits from various sources gives some hope that in the future retirement benefits will be higher. Despite a bad demographic situation, the participation of Poles in the second and third pillars is very low.

The financial stability of the Social Insurance Office depends mainly on the situation on the labor market. Unemployment is falling, which increases the demand for labor, and may be accompanied by higher retirement benefits paid in the future. However, the demographic situation is deteriorating, as more and more people are in a post-productive age. The average retirement age in 2012 was 59 years, which is definitely lower than in other European Union countries. For the sake of the stability of the system, the main goal is to improve the employment rate. For this to happen, it would be necessary to modify labor law and encourage retirees to work longer, inter alia, by reducing tax burdens or by introducing activation programs for older people.

Another factor that would improve the system is the extension of work experience. The expected life expectancy of Poles is increasing, so by that token the retirement age should also be increased so that the activity of employees on the labor market is longer and the payment of benefits from the pension system is lower. This would result, for example, in the payment of higher benefits. With the current level of income from pension contributions, such a solution may be very likely in the future.

The functioning of the Social Insurance Office is directly dependent on the financial condition of the state, which guarantees the payment of retirement benefits. The weak condition of the state budget may disturb this balance, resulting in the insolvency of the system. At present, there is not enough money to pay benefits, so the state subsidizes the Social Security Fund, because, without such subsidy, benefits would be much lower. A risk of a loss of stability can also be seen in the cost of servicing public debt, as well as the probability of the growth in this cost. Despite this, current forecasts do not indicate this, because Poland has low inflation and a large inflow of investments. It is necessary to find an optimal source of investment to offset any losses, but the risk should be assessed by the insured themselves.

6. Conclusion

The greatest challenge facing the Polish pension system is the progressive aging of the population and diminishing fertility. The increasing age of the population, together with a

lower fertility rate, lead to discrepancies between people of working age and people in a post-working age. These problems result in uncertainty and a threat to payment of retirement benefits in the future, which is why it is necessary to react to these changes appropriately far in advance.

This article presents the impact of pension reform in Poland on changes in pension funds during the years 2012-2017. It offers an analysis of Open Pension Funds.

The pension system in Poland has been subject to numerous changes in recent years, which has led to the public's fear of the future and the security of their income in old age. Therefore, it is necessary to attempt to achieve an optimal state for the system, which will guarantee the safety and balance of payment of benefits to future pensioners.

There are many different solutions to the problems of pension systems in the world. It is, thus, necessary to seek out those methods that would be applicable in Poland. However, currently it is difficult to find the "golden mean" of the ideal pension system. Therefore, in the future, attempts should be made to analyze further changes in the development of pension funds, so that the system guarantees a high and a secure retirement pension.

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