Another angle of the pension system reform: how can the private pension system boost financial system development?

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**Introduction**

A robust and modern financial system is a key factor that helps maintaining financial stability and provides raising capital to finance and develop an economy. Its soundness is expressed by the ability to cope with eventual shocks and crises, and *savings and investments* are the two capital flows that provide funding at both, macro and micro economic levels, to corporate businesses or individuals.

The basic pillar of the national financial system is the banking sector, while the other components are less developed and are represented by the non-banking financial sector and the capital market. At the same time, the banking crisis of 2014-2015 showed that resilience of commercial banks determines stability of the overall financial system, and the process of banking disintermediation is able to curb economic growth, distort monetary policy and/or feed pressures on public finances.

Also, the financial data for 2016¹ year prove that financial intermediation is impaired by some structural deficiencies, although banks accumulate excess liquidity, these still remain relatively expensive, with low maturity and finally unattractive to the real economy. In these conditions, to recover and develop, the financial system needs modern mechanisms and tools, in particular long-term financial resources that could support long-term investment projects. Moreover, amid relatively short maturity of bank deposits, low interest of companies in capital market and limited access to foreign capital markets, private pension system is still the most viable solution for long-term development of financial resources.

Thus, we find that although the pension system reform has recently intensified, it does not provide any incentives for development of the private pension system, and this study seeks to bring back to the public attention the importance of the private pension system, the gaps hindering its development, and solutions to strengthen social equity and provide a decent life in the post-active period. Also, some long-term liquidity is needed, resources collected through private pensions could also be a starting point for development and modernization of the domestic financial market.

**What is the private pension system and why we need it**

According to the international approach², in terms of financial market, the private pension is a savings product designed to assure people during the post-active life, in addition to the state pension, which can be mandatory (Pillar II) and optional (Pillar III). Individually, it seeks to ensure individuals with the income needed for a decent living after retirement, and collectively it aims dividing in a balanced and fair way the burden of population aging process between people active at the moment and those in the post-active period.

**Why pension system cannot rely just on a single pillar - the public pension system**

The private pension system is meant to complement, rather than to replace the public pension system (Pillar I), a system that in many countries of the world faces major deficits as a result of economic, demographic and social changes. Being often used for election purpose, public pension systems have become a powerful source of macroeconomic instability, a constraint to growth and sustainable development, and an inefficient and inequitable income provider for people in post-active life. Moreover, emphasized recent volatility of economic, demographic, social and political factors shows that ensuring a

¹ The year 2016 has the lowest rate of financial intermediation in the last 10 years, the bank credit amounts to only 27% of the GDP
sustainable pension system needs ongoing reforms, which vary from country to country, and without any clear particularities that can be presented as a safe and good example to follow. In these circumstances, the pension system reform is one of the biggest challenges for any government, especially for the traditional pension system, type pay-as-you-go (PAYG), that is based on the principle of solidarity between generations and involves a strong dose of collectivism.

Such a PAYG system is typical to Moldova as well, the reform of which has been in the attention of the government for a long time, aiming at finding an optimum social and economic (and otherwise political) solution that would ensure both sustainability of the system in time and acceptance of society. After years of instability that followed proclamation of independence and along with stabilizing public finances, the prerequisites needed to start some complex and structural pension system reform appeared, the reform of 1998 aimed at indexing and increasing pensions, along with increasing the retirement age up to 65 years old for both men and women, and establishing a clear relationship between paid contributions and calculated pensions. However, it has kept the single level redistributive pension system (PAYG) and after a few years increasing the retirement age was given up for lack of a clear political will. Even so, the need to continue reforms in the field, and stimulation of development of a private pension system has been always supported by several experts, who based on some actuarial and econometric studies reveals seriousness of the situation and not positive prospects of the current system at all. In this respect, the latest statistics reveal sharp activation of demographic factors (especially population aging and massive exodus of economically active labour force) and decreasing rate of wage replacement (pension and wage ratio).

Thus, reform of the current pension system becomes inevitable. However, the current reform that seeks to increase the retirement age, eliminate various benefits for some categories of insured people, change of indexing formulas and calculation of pension (introduction of the principle of valorisation) is welcome and absolutely needed. But without boosting development of additional pillars of the pension system (mandatory private pensions - Pillar I, and optional private pensions - Pillar III) long-term sustainability of the pension system cannot be ensured.

The need to develop a multi-pillar pension system

At the international level, the most widespread model for a modern pension system is that one designed by the World Bank and proposed for developing countries, a system that has been already successfully implemented in countries such as Romania, Bulgaria, Poland, Croatia, Hungary, in the former Soviet states - Lithuania, Latvia, Estonia, or in the CIS member states - Russia, Kazakhstan, Kyrgyzstan. It is called multi-pillar system, and respectively, in addition to the already existing pillar (state-managed pension) the system is completed by two groups, both private ones - mandatory and optional (Figure 1). In these conditions, being transposed on several pillars, the pension level rises and pressure on public finances tends to weaken while reducing poverty among the older population that is ensured with several pensions at the same time.

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1 Price of solidarity between generations and the optimum patter of reform of the pension system, Adrian Lupusor, Expert-Grup, Chisinau, 2012 http://expert-grup.org/media/k2/attachments/Pretul_solidaritatii_intre GENERATII_si_modelul_optim_de_reforma_a_sistemului_de_pensionare.pdf


4 World Bank. Averting the Old Age Crisis (Oxford University Press, 1994).
Thus, international experience shows that pension system reform by providing a multi-pillar system involves initially strengthening of the PAYG system and then expanding and adding two additional sources of pension (Pillar II and Pillar III) in addition to the state public pension (Pillar I). Pillar II is called the pension system managed by the government or a private company, and is formed of a part of mandatory individual contribution of the public pension system, accumulated on an individual account opened at the pension fund administrator. Pillar III is called the optional pension system managed by private companies, and is based on individual accounts and voluntary membership, which distinguishes it essentially from Pillar II.

**What factors hamper development of the private pension system and what we consequently lose**

Although the possibility to introduce additional pillars in the national pension system has been always in the attention of authorities, economists and public opinion, this segment of the financial market is still weakly developed (or even misses), without any clear prospects for the next period. At the moment many barriers, both legislative and cultural ones, hamper development of the private pension system in our country. According to a study of Expert-Grup\(^5\)(i) low level of confidence of population in private pension funds; (ii) underdeveloped capital market, and (iii) regulatory restrictive framework (particularly fiscal one) are the main impediments for its expansion.

Thus, reluctance of people related to this financial instrument derives from the negative experience generated by the collapse of investment funds created in the 90’s, unfamiliarity with this product or cultural perception that children or relatives, and the state should support the person arrived at old age. According to sociologists\(^6\), unlike the developed countries where the idea of the private pension system appeared and developed, it is talked about the existence of a responsible individual who knows that caring for his/her life

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and future is in his/her own hands, in post-communist and post-socialist countries the collectivist culture still persists, the hope that in the future others will care for everyone, primarily family and relatives.

Also, in case of possible development of activities of Pillars II and III, the only potential investment tools for the moment are the state securities for short and medium term, and/or bank deposits, that following an increased demand would most likely lead to decreased returns generated by them. However, emergence in the national financial circuit of long-term liquidity will implicitly lead to development of modern financial instruments (ex. corporate bonds), and boosting of investment activity in projects with long-term recovery.

Not least of all, adoption of the legal framework for Pillar III⁷ has not been accompanied by the required adjustments to other interdependent organic laws such as the Fiscal Code, the Civil Code or the State Social Insurance Budget Law. Therefore, besides deficiencies of the content, this law is contrary to other laws, and without implementing a set of natural fiscal incentives for both private funds and beneficiaries. Moreover, international experience has shown that no country has managed to effectively implement the private pension system without it being supplemented by some tax incentives.

However, given the general specificity of private pensions, we find that in the absence of their development, both financial market at the macro level and individual population at micro level, are devoid of any benefits that somehow inhibits the economic development and people's confidence in the prospects of the national financial system. Thus, in the prospect of some reforms aimed at stimulating the interest and development of Pillar II and III of pensions, several advantages can be listed:

- **Creation of long-term financial instruments (long money).** A weak element of the domestic financial market is the lack of some financial instruments that could finance the economy in the long term. The financial resources available in the market are mainly represented by bank deposits up to one year, which inhibits granting of long-term investment loans or mortgage loans for individuals. Thus, the bank intermediation model is largely based on granting loans for working capital, the repayment of which starts even the next month. Consequently, such intermediation increases pressure on liquid assets and cash-flow of businesses, frequently absent for potential investments. Given the long period of maturity, which characterizes the mechanism of private pensions (some 30-40 years), development of Pillars II and III of pensions would lead to creation in the national financial system of some long-term resources that would both support financing of public and private investment projects, while having at least a 5-year maturity.

- **Creation of new saving tools.** Domestic financial market hardly offers an alternative to those who want to save, rather than to form bank deposits. Primarily for convenience, they are easy to create, are tax-free and relatively easy to use, if necessary. Second, they are safe even if the bank deposit guarantee framework is poor⁸, depositors have never lost the submitted resources, even during the banking crisis of 2014-2015. However, the large stock of deposits attracted by banks and the impossibility of turning them into sustainable loans, namely because of maturity, creates certain imbalances in the financial market, thus entailing excess liquidity, low interest rates below inflation level or even inflationary pressures through the currency exchange rate or aggregate demand. In this respect, private pensions are a modern saving tool that can correct imbalances of financial market.

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⁷ Law no. 329 of 25.03.1999 on Non-State Pension Funds;

⁸ Safety of bank deposits is given by the fact that they are guaranteed by the Fund of Guarantee of Deposits in the Bank System (FGDBS) who undertakes to repay to depositor’s amounts deposited up to 6000 MDL where a bank would face financial problems.
• **Elimination of pressure on state pension fund in the long term.** Although in the short term introduction of Pillar II would deprive the public pension system (Pillar I) of some financial resources (the main reason why that decision makers are reluctant to creation of Pillar II), in the long term this will reduce increasingly higher pressures on the public pension fund. Thus, if at the time of introduction of Pillar II social insurance contributions are shared, when beneficiaries of Pillar II reach the retirement age the payment obligations are also shared (that is often overlooked by opponents of Pillar 2). At the moment, to cover state social insurance budget deficit, additional consistent resources are annually allocated from the state budget\(^9\). Also, the increased pressure of the current pension system on economically active people is revealed as they contribute to the public fund through 2 parallel channels: (i) social insurance contributions and (ii) other types of taxes paid to the state budget. At the same time, increase in the number of retirees along with decrease in the number of contributors to the pension fund will further lead to higher imbalance between revenues and expenditures of the pension fund.

• **Elimination of social pressure and raising the living standards in the post-active life.** Given the pessimistic perspectives of demographic trends and labour force, it becomes clear that the pension provided by the state will not be able to provide any sufficient income maintaining the living standard of people they have in the active life. In this context, private pension is a supplement to the state pension and provision of a decent old age, as the funds collected by administrators are to be invested in the safest instruments. However, following the change of motivation of contributors, the social pressure could be mitigated as well, as everyone would have the possibility to save for him/herself as much as he/she wants. Thus, contributions to Pillar II and III are not redistributed, but accumulated on people’s own accounts and then re-invested in safe financial instruments and with interest. Also, the fact that the contributor holds property rights to these contributions, unlike Pillar I, is important. Therefore, they will have an entirely different motivation to pay contributions, hence discouraging the practice of wages in envelopes and generating more financial flows in formal sector, including in the budget and public pension fund.

**Conclusions and Recommendations**

The shocks of the bank fraud that hit public finances, and the need to sign a new funding agreement with the International Monetary Fund, have brought to the fore the need to reform the current pension system, or in such situation increasing deficit of the state social insurance budget and the mandatory health insurance funds cannot guarantee long-term sustainability of public finances. The draft reform was approved by the Parliament in late 2016 and provides for a new way of calculation and indexation of pensions, increasing the retirement age and the mandatory length of pensionable service, as well as elimination of a number of benefits for some insured categories. **However, the reform provides neither incentives for development of the private pension system, nor any vision on development of the multi-pillar system in the long term.**

In this context, even if increased retirement age counterbalances for a period acceleration of population aging and reduction of the ratio between contributors and retirees, it will not be able to maintain sustainability of the pension system in the long term. Moreover, postponing some complex reforms and stimulating development of the private pension system (Pillar II and III) will increase the bill paid by

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\(^9\) In 2016, to eliminate the deficit of BASS about 3.65 billion MDL were transferred from the state budget, or about 24% of the total funds allocated for state social assistance. Of these, 0.73 billion MDL were allocated to protection of older persons.
economically active population, which involves significant opportunity costs. Experience of developed countries with an advanced social protection system shows that private administration of pensions had much better results than state administration of the same and quality of life of pensioners was closer than the active period. Moreover, development of Pillars I and II of the pension system led to correction of some structural imbalances in some economies, such as creation of investment resources with long maturity or saving tools that can manage excess liquidity and reduce the effect of negative interests.

For Moldova, even if public finances at the moment cannot counteract loss of a part of social insurance contributions (essential for stimulation of Pillar II), other actions may be taken into account in order to boost development of private pensions. Since 2012, Expert-Grup presented a comprehensive study on the need to reform the national pension system and the optimal way to do so. Also in 2015, the main deficiencies and constraints of the public pension system were analysed and a series of measures for intervention and policy recommendations to enhance sustainability and increase its efficiency were proposed. Thus, even if by the end of 2016 a number of amendments to pension legislation have been adopted, many of the previously prepared recommendations aimed at developing the multi-pillar pension system, still remain relevant:

- **Creation of Pillar II of pensions since 2020** - as referred to above, the state pension pursues providing a minimum subsistence income to persons in post-active life, and the income for a decent living is to be complemented by creation of Pillar II of privately managed pension. Upon reaching the retirement age the pension calculated on the basis of contributions paid and interest accrued from investing in financial instruments (basic principle of Pillar II) will complete the minimum state guaranteed pension. In this regard, we recommend implementing Pillar II of pensions progressively, since 2020, just after strengthening Pillar I. Thus, 0.5% of the contribution paid by employer and employee is to be annually re-transferred to a personal account of contributor until it reaches 3% paid by the employer and 3% paid by employee;

- **Improvement of the legal framework related to private pension funds** - even though Moldova has a law governing private pension funds, and namely Pillar III, lack of required amendments to the Tax Code, the Civil Code or the State Social Insurance Budget Law inhibits for the time development thereof. In these circumstances, tax deduction of contributions payable to the private pension funds (Pillar III) and ensuring implementation of a set of fiscal incentives for non-state funds and beneficiaries, will boost development of this sub-segment of the domestic financial market.

- **Strengthening of the regulatory framework on activity of private pension funds.** At the moment, there is no legal framework covering activity of Pillar II, and that one governing Pillar III (private pension funds activity) is obsolete. Therefore, a unified regulatory framework that will govern Pillar II and Pillar III of pensions needs to be defined. Besides the incentive aspects referred to above, the legislation shall ensure safety, efficiency and integrity of their management by funds.

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