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Pension fund governance in Hungary in an international context

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Introduction: voluntary and mandatory pre-funding

1. Before World War II, the Hungarian pension system was built on mandatory pre-funded, privately managed occupational schemes. After massive losses through the war and the subsequent hyperinflation, a national pay-as-you-go scheme was introduced. Private plans were excluded after the communist takeover. The legislation reopened the way to private management in the pension industry no earlier than 1994 for voluntary, supplementary savings and in 1998 for mandatory contributions. Although management of voluntary and mandatory funds are legislated separately, much of the rules equally apply to the two branches. They are supervised by the same agency. Yet, demand, supply and control over the fund management differ significantly because most often voluntary funds are initiated by the employer whereas the mandatory branch puts the burden of managing savings for old age on the employee.

2. Supervision of pension funds by government agencies is justified by economizing on monitoring costs and economy of scale of risk pooling. Without such intervention contributors should spend supraoptimal amount of resources on monitoring and rely more on their family network for old age security. Government supervision cannot be perfectly replaced by private rating agencies either, for cooperation of the fund management with the rating agency cannot be enforced by law.

3. Supervision of this kind requires active government in particular as contributions managed by private funds or mutual savings associations are not always voluntary but frequently mandated by legislation. This mandate threatens with undermining the credibility of no-bail-out promises of government, softens the budget constraints of pension funds and in many countries leads to direct state guarantees on future pensions. Protection of future tax payers demands a more thorough monitoring.

4. A key issue of pension fund governance and market structure of the sector is whether the mandate is on the shoulder of the employer or the employee (see Vittas 1998). This question turns up in social security in a different way where sharing contribution between employee and employer affects only the tax awareness of the former (Csontos, Kornai and Tóth 1998) but both parts of the contribution take the form of a payroll tax. Allocation of the mandate of accumulation for old age, however, has an impact on the number of pension funds, market concentration, restrictions on fund membership and control mechanisms over the fund man-

agement. This will be demonstrated by international examples and comparisons between the voluntary and mandatory private pensions in Hungary.

Private pensions in Hungary

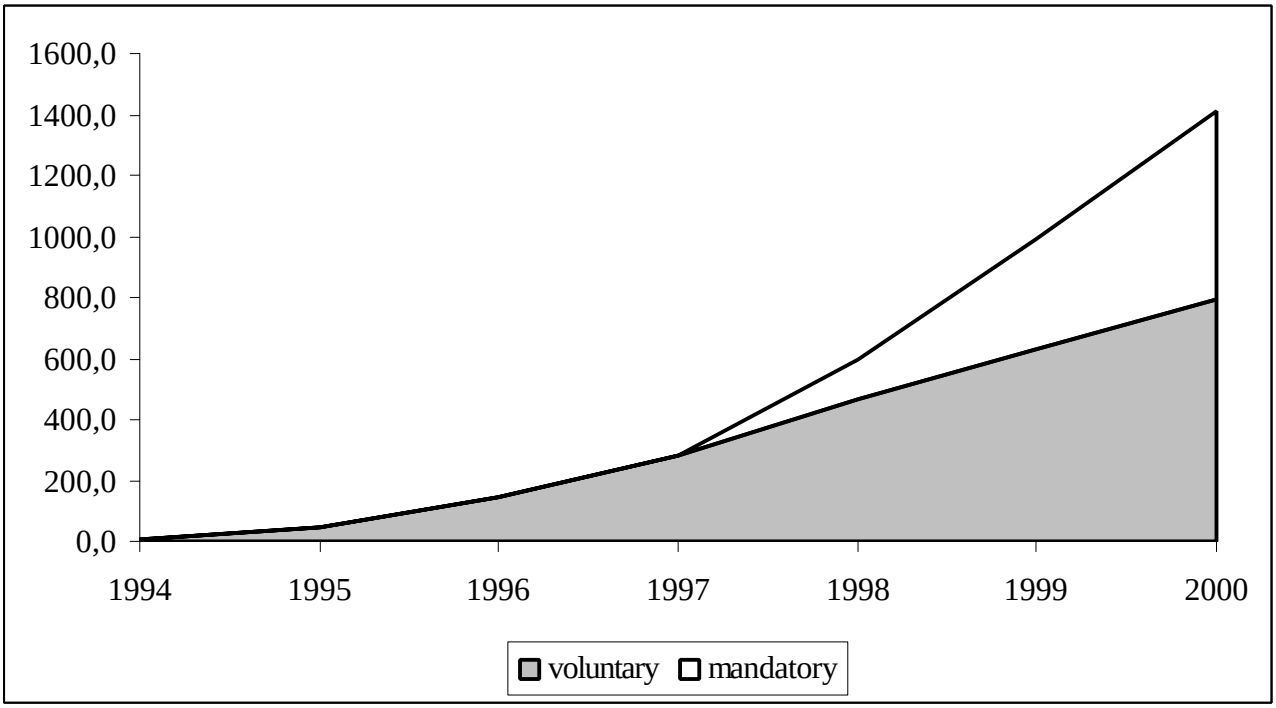
5. The program of a supplementary private pension pillar was approved by Parliament in 1991. Legislation had been completed by 1993 and the first funds were established in 1994. Anecdotes of the founding period say that legislators wanted to induce a social movement for self-provision for old age hoping that the new funds would also strengthen public awareness of pension issues, self-responsibility and long term calculations (EHPM 1998). This may explain why the legislators opted for special property rights structure of the funds. These funds are not owned by employers or financial corporations but the members themselves like mutual savings associations. This form is also wide spread in Germany, a traditional benchmark for designing social institutions in Hungary (on the first experiences with voluntary pension funds see Vittas 1996, and Gál 1999).

6. The package law that reformed social security and reintroduced pre-funding into the mandatory scheme was passed in 1997 and came to effect on January 1, 1998. It established a new pre-funded tier managed by private companies (on the analysis of the pre-reform situation and the reform alternatives see Palacios and Rocha, 1998, on a description of the Hungarian pension system in the 1990s see Gál, 2001). The funds were to get about 20 (6/31) percent of contributions of those who switched which should have grown to about 25 percent (8/31) in two years. The new government elected in 1998 decided to temporarily freeze the original distribution levels between the two pillars of the mixed system at approximately 20:80 percent (6/31, currently 6/28). Fund membership was optional for those who have earned pension rights in the old system but obligatory for new entrants of the labor market. The option had been left open for 20 months. According to the transition rule, reduction in the accrual rate (from 1.65 percent of lifetime earnings for every service year to 1.22 percent) due to redirecting a part of contributions to the private funds was calibrated to the rate of partitioning contributions between social security and the private funds (1.22/1.65 ˜ 1-(8/31)). However, benefit reduction has been extended to service years earned prior to the reform as well when all contributions were paid to social security. In this way, the legislators wanted to assure that the practical age limit of switchers is low. Indeed, age distribution of the fund members is skewed, younger cohorts are overrepresented (on the effects of the pension reform see Si-

monovits, 1999, and Rocha and Vittas, 2000, on a generational accounting of its impact on long term stability see Gál, Simonovits and Tarcali, 2000).

7. Voluntary funds collect a rapidly growing amount with a typical quarterly periodicity that produces an end-of-the-year rush in contributions. The total assets reached $790 million by the end of 2000. Mandatory funds manage $615 million. (See the dynamics of pension reserves in Figure 1.) After the introductory period, the voluntary market grows or contracts with income, public trust in the financial markets, sales of competing products, and policy changes. The mandatory market depends on public trust only in the switching period, provided that switching from pay-as-you-go to pre-funding is optional at least for some cohorts like in Poland, Hungary and most Latin-American countries (Müller 2000). Its future size is influenced only by growth of income and potential policy changes.

Figure 1
Accumulation of reserves in private pension funds in Hungary (million $)



8. As mentioned above, the choice of switching or staying was open only for the active labor force, employed and unemployed, about 4 million people. At most 1.3-1.5 switchers were expected for the end of the switching period plus some new entrees of the labor market. Estimates of the total size of the market, based on average wages took annual contributions to the

funds to 0.4 percent of GDP at the start to grow to about 1 percent as the system matures. By the end, the market proved larger. The number of voluntary switchers was about 1,9 million, roughly 25 percent higher than the highest official expectations. Combined with new entries this makes up to 55 percent of the working population. The total accumulated assets of the funds have reached the value of the reserve funds of life insurance premiums, and made 6 percent of total household savings (PSZÁF 2001).

9. Growth of income affects voluntary and mandatory funds disparately. Voluntary supplementary savings grow with the number of saving households and the disposable income of savers. An analysis of the social composition of voluntary fund members (Gál 1999) showed that they have about 60 percent higher per capita household income than non-members. The income difference appears significant in every 10-year cohort so it cannot be fully traced back to the age-earnings profile even though fund members are 6 years older on the average than the rest of the non-pensioned adult population.

In contrast, members of mandatory funds are younger to the average and their wages do not differ significantly from theirs (Janky 1999). On the other hand, wages subject to payroll taxation may grow faster in the future than the economy, as their proportion to the GDP is significantly under the OECD average to which it may be expected to reach. This fact shows up in a different way, too. As demonstrated by Kézdi and Köllo (2000) age-earnings profiles got much flatter in the 1990-s than they were before in Hungary and they are currently in other OECD countries. As devalued older cohorts will eventually leave the labor market these profiles are likely to regain the original slope.

10. Public trust in the actors of financial markets has different impacts on the voluntary and the mandatory branches. In case of the former, people choose between different means of savings for old age. If the atmosphere of confidence is missing which is typical for newly emerging financial markets due to lack of education and reliable independent monitoring, people do not save on the financial markets but invest in real estate, gold, jewelry, or foreign currencies. This is frequent in the transition countries of Eastern Europe where the construction of financial markets is often disrupted by bank runs, sunk assets and political tensions around pyramid schemes. A further way to avoid financial markets may be to invest in family values and children which may be an explanation for low coverage in many Latin American, Caucasian and Central Asian countries.

In the case of mandatory funds, the question of the means of saving is reduced. There are just two options: to invest in accrual rights of a pay-as-you-go social security scheme or in the assets of a pension fund. In Hungary, the underestimation of voluntary switchers show a clear distrust in social security. In addition, a closer analysis of public preferences show, that people do not take the two pillars of the system as competitors. If bad news shake one or the other, public doubts increase for the other as well (TÁRKI 1998).

11. The future size of the market also depends on the political economy of pensions, too. As mentioned above, the Hungarian government decided to reduce the size of the pre-funded pillar by freezing contributions at 6 percent of gross wages instead of raising it to 8 percent as planned originally. As for voluntary savings, they are particularly sensitive to tax exemptions. In Hungary, employee and employer contributions are both tax exempt up to a certain limit. According to some estimations 75-85 percent of contributions would have otherwise been paid as tax or social security contribution to the government.

12. Voluntary funds compete with substitutes, such as endowment life insurance, that influence the growth potential. Mandatory funds do not have close substitutes. That dissimilarity also raises analytical questions. How to delineate the market? How large is it? What is the precise definition of the product? We will come back to this below.

Mandate and market concentration

13. Market concentration, or indeed, the number of pension plans is influenced by the nature of mandate on saving for old age, whether it is imposed on the employer or the employee. First, if they are mandated, large companies would establish their own occupational schemes especially if the rules allow self-investment. We will come back to the problems of self-investment later. In addition, entry costs, in particular costs of recruiting members, are much lower with a target group of a couple of ten thousands than millions. That also raises the number of potential competitors. Moreover, individual members are more mobile than groups between funds. That makes recruiting an ongoing, costly process in pension systems that mandate the individual to find a pension fund. For instance, this effects is taken responsible for driving the administrative costs of the Chilean system high. In contrast, group membership is less fragile so recruiting ceases at the end of the introductory period in employers mandated systems.

A company that decides to join a pension fund rather than establishing one of its own has the experts if not to build but to find the proper alternative. That makes branding, another heavy cost component, much cheaper. In contrast, funds that try to attract millions of individual members must spend much more on advertising and direct marketing. Entry costs to the open fund market are also frequently set high by the regulation. Funds are required to deposit an entry capital (in Colombia, $4.000.000, see Sólyom 2001).

For these reasons, a pension plan initiated by the employer, due either to its own induction or the law, makes the number of pension plans relatively large. If the subject of the mandate is the employee, the market will likely be more concentrated.

14. Empirical evidence supports this hypothesis. In the United Kingdom, where occupational schemes hold almost 80 percent of assets accumulated by pension funds (Association of British Insurers 2000), there were more than 128.000 different plans in 1994 (Davis 1997). More than 122.000 plans covered less than 100 people. By contrast, in Chile the burden of mandatory pre-funding is put on the employee with no involvement of the employer whatsoever. Here, the number of pension funds is only 8; the largest 3 covers 78 percent of all members. A Herfindahl-index calculated from the SAFP figures give 2490 that reveals a high degree of concentration (Sólyom 2001).

Table 1
Concentration of funds and fund members by size of funds
Hungary, 1999. III. quarter (%)

	voluntary funds	members of voluntary funds	mandatory funds	members of mandatory funds
– 5.000	75	10	28	1
5.001 – 20.000	13	17	38	7
20.001 – 50.001	12	72	16	8
50.001 – 100.000	0	0	19	83
100.001 –	100	100	100	100

Source: ÁPF (1999).

15. Similarly in Hungary, there exists a clear disparity in concentration in the markets for voluntary supplementary and mandatory pre-funding. Whereas the former is usually initiated by the employer due to tax exemptions, the latter imposes the mandate on the employee. See the

distribution of funds and fund members in these two types in Table 1. The rate of voluntary versus mandatory fund members is 1:2, yet, the average size of voluntary funds are much smaller than half of the size of mandatory funds. According to the latest figures, 125 voluntary funds have 1.1 million members against the 2.1 million members of 25 mandatory funds (PSZÁF 2001).

16. As mentioned above, voluntary funds have substitutes, in particular endowment life insurance, mandatory funds do not. The EHPM study on the Hungarian voluntary pension market (EHPM 1998) found that insurance companies have not entered the market in the first years after it has been opened, rather they positioned themselves as main competitors. The first insurance company establishing its own voluntary fund was the 175th. That may require a more thorough analysis if we want to calculate the level of concentration in the market.

17. With a few exceptions, mandatory funds in Hungary tried to recruit members through four channels. They built on the clientele of savings banks or insurance companies, the members of trade unions and employees of a company. These latter occupational plans recruited just a fragment of all members (we will discuss it later in more detail). Insurance companies proved the most successful. More than 55 percent of fund members belong to a fund backed by an insurance company.

18. Concentration of fund members does not always coincide with the concentration of assets. smaller employers do not have the capacities to set their own pension fund and appoint their trustees. These companies buy insurance for their employees or join a larger open fund or set a joint pension fund with similar small companies. Employers that join large open funds are called employer members in Hungary. A survey in 1996 found an average of 25 employer members in a voluntary pension fund (TÁRKI 1996). In a year, the total number of voluntary fund members more than doubled. The repeated survey already found an average of 48 employer members in a fund (Gál 1999). About 80 percent of fund members entered the pension fund with an employer member. On the average, employers tripled individual contributions to voluntary funds (ÁPF 1999, PSZÁF 2001).

19. Concentration of asset management is further increased by bigger closed occupational funds that do not manage assets but contract it out to professional asset managers (Szabó 2001). In the United Kingdom, about 80 percent of such assets are managed by just 5 large financial groups (Blake, Lehmann and Timmermann 1999).

Mandate and restrictions on membership

20. The OECD taxonomy distinguishes between two main types of pension funds, closed versus open funds (OECD 2000a). Closed funds restrict the membership to specific participants on the ground of employer, profession, trade union membership or residence. Open funds to not impose such restrictions.

21. Market concentration is strongly associated with this typology. Occupational funds are typically closed, whereas funds set up by insurance companies, banks or other financial institutions are usually open. Therefore, the characteristic form of pension funds in a given society is strongly linked to the mandate if it is loaded on employers or employees. If the mandate of pre-funding for old age is imposed on employers, closed funds will be more frequent. If it is the employee who is mandated, the typical pension fund will not restrict on membership.

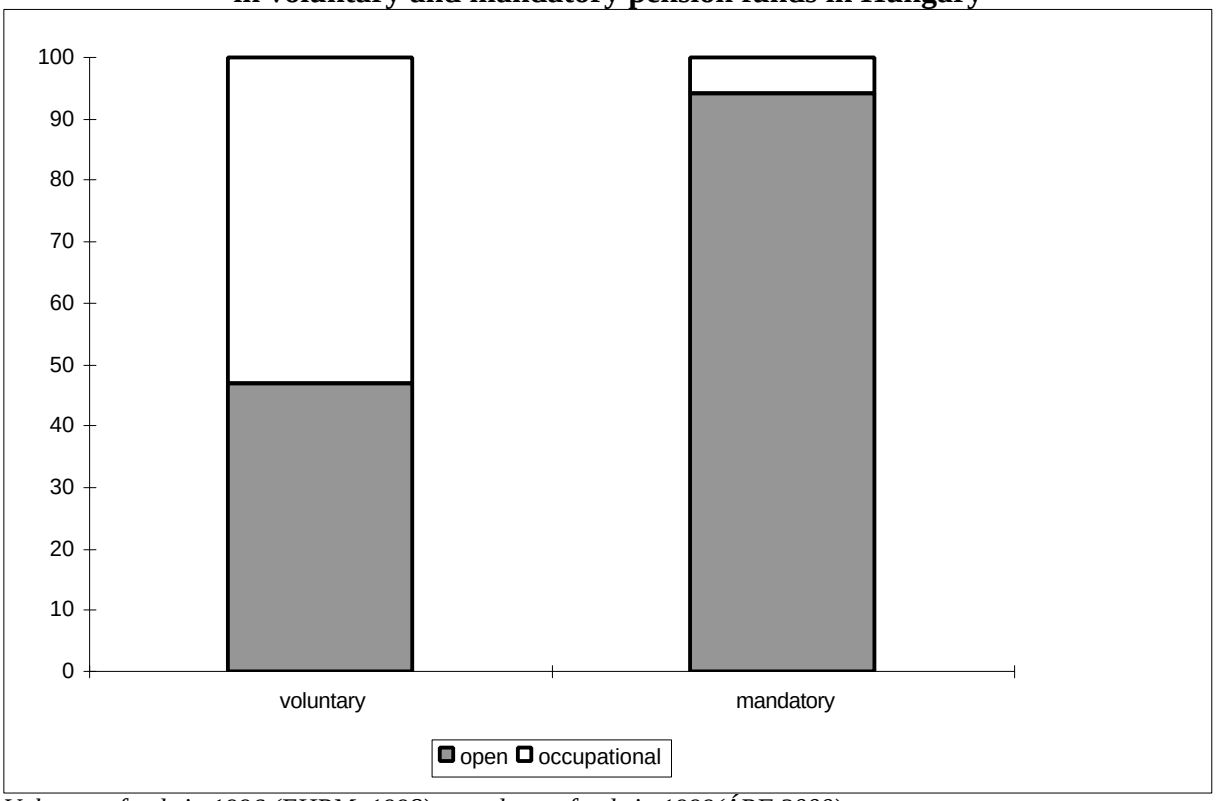
22. Closed funds appear more frequently in countries where company based occupational funds have emerged spontaneously, prior to a general regulation (Switzerland, and some Anglo-Saxon countries including Hong Kong; see Vittas, 1998). It reflects a special aspect of the mandate to pre-fund for old age: it can be moral or it can emanate from shop-floor politics rather than legislation. By contrast, open funds distinguish pension systems that have introduced the pre-funded sector recently, notably, Latin American and East European countries as well as Italy (OECD 2000a).

23. The Hungarian voluntary and mandatory funds display the same dissimilarity (see Figure 2). As mentioned before, the former are more often established by the employer in order to exploit possible tax exemptions. With respect to the latter, however, employers are neutral for lack of tax reduction. The mandate is imposed on the employee. Consequently, occupational funds cover a larger share of the voluntary funds whereas open funds are almost exclusive in the mandatory sector.

24. Some clarification has to be added here. Due to a special legal background of the sector in Hungary, there is no difference in the legal regulation of closed and open funds. This is why we distinguished between occupational and open rather than closed and open funds. We will return to this later. In addition, closed mandatory funds have turned opened with no exception. Yet, there are some funds that behave like occupational funds despite their legal status. Without this modification, the comparison between voluntary and mandatory funds would be even more contrasting.

Figure 2

Distribution of members between open and occupational funds in voluntary and mandatory pension funds in Hungary



Voluntary funds in 1996 (EHPM, 1998), mandatory funds in 1999(ÁPF 2000).

Property rights

25. Pension fund governance is a complex of two separate fields of potential conflict of interest: between the owner of the fund and the beneficiaries on one hand, and between the fund management and the beneficiaries, on the other hand. The first requires a thorough definition and separation of property rights, the second impels proper control mechanisms over the fund management.

26. Property rights of the employer and the beneficiaries can be blurred in two ways in a closed trust fund. First, if the fund invests in the assets of the employer, the ownership of the company might get vague. Who owns a firm, if more than half of the assets are in the hand of the company pension fund? What kind of investment and wage policy is to be expected of a firm that is owned by the occupational pension fund and workers have an influence appointing the fund administrators? How can the mandate of saving for old age be protected if self-

investment by a pension fund makes the company in question a labor managed firm, and the workers decide to pay back contributions as wages. In brief, self-investment of an occupational scheme in the assets of the establishing company can leave future beneficiaries unprotected against the employer and their own short-mindedness.

27. Ownership problems can be mitigated by limiting self-investment and regulating the independence and appointment of trustees or composition of the board of directors.

28. A comparative study of nine OECD countries (OECD 2000b) show that, in general, self-investment is permitted but limited to a ceiling between 5 percent (United Kingdom) and 30 percent (Finland, Italy). The study in hand finds the latter proportion threateningly high.

29. Independence and appointment of trustees or members of the board of directors are regulated in different ways. Since the infamous Maxwell-scandal, the United Kingdom has introduced the most comprehensive rules. The 1995 Pension Act, for instance, allowed members to appoint trustees (OECD 2000b).

30. The other way of blurred property rights in an occupational fund has to do with solvency risk. Company specific skills have the capacity to make the employee captive of the company. This has the potential of undermining willingness to invest in company specific skills and, as a reaction, may induce the emergence of specific labor contracts. An occupational pension fund raises the same risk by chaining the distant future of the employee to the solvency of the company. On the extreme, the mandate of compulsory long term saving for old age imposed on the employer can be turned by the employer a deposit given by the employee. In other words, property rights get dim over the risks of the future health of the company. The mandate can be used to create a forced asset specific investment.

31. Regulation usually tries to protect employees against this kind of capture by special solvency rules (OECD 2000b). Occupational schemes must be at least partially funded. The sponsor of the scheme is frequently required to insure against solvency risk. In addition, company pension schemes are often assured to have priority rights in case of bankruptcy of the sponsor.

32. As noted before, Hungarian pension funds have a special property rights structure. They take the form of mutual savings associations, so members are not clients but co-owners of the fund. Property rights of this kind have the capacity to leave the fund management without

proper control. We discuss the potential risks and methods to protect against them below. Here we reflect to another hazard of the mutual association form. They closely resemble to a labor managed firm that runs the risk of underinvestment and show the tendency to overvalue the present to the future. So far this has created the most serious problem for the Hungarian supervisory authority in the so called Premier case. Premier, a voluntary pension fund that grew the largest, made its success by using multilevel marketing techniques. However, these techniques drove the costs of rewarding flourishing recruit-chains alarmingly high. The authorities had to intervene and eventually withdraw the license of Premier.

33. As mentioned above, in Hungary, the same set of regulation applies to open as well as closed funds. Property rights are delegated to the board of directors in both cases. There is no systematic information on the appointment procedure and composition of boards of directors. Due to this special property rights structure, however, the fund management has the room for maneuvering to manipulate the assembly unless other control mechanisms hinder that. In this way, the management in some cases can even be able to informally appoint the members of the board of directors who should in principle control them (Rocha, Gutierrez and Hinz 1999).

Control over the management

34. Property rights issues emerge between the owner of the fund and its beneficiaries. Control problems surface in the relation of the management and the beneficiaries. These problems can be mismanagement, outright theft and fraud or reckless competition between funds.

35. Above, we have traced back market concentration and the presence or lack of restrictions on membership to the mandate of savings for old age: if it was imposed on the employer or the employee. Here we derive a taxonomy of pension funds from the previous points with respect to governance issues:

- occupational funds attached to a single employer (frequent in Switzerland, and Anglo-Saxon countries)
- occupational funds that contract out asset management, administration, or do not have influence on the appointment of trustees
- open funds (recently reformed Latin American and East European systems, US, UK).

These types are frequently associated with different kind of control problems and raise different risks for beneficiaries and tasks for supervisors.

36. Control over the fund management is meant to alleviate three potential risks: mismanagement, outright fraud, and reckless competition. Methods of handling these risks are various and sometimes reverse. For instance, a fast feedback of mismanagement requires a healthy competition among pension funds and portability of savings between funds. Some forms of competition, however, drive up costs without any sensible effect or increase risks to a level dispreferred by beneficiaries.

37. Competition of funds is influenced by two factors. First, results of competition, a higher rate of return and consequently higher annuity in old age, are realized only in the long run. Second, rates of return are easy to measure whereas risks involved are less visible. Individual fund members can be attracted by high returns, but a mere return-competition may force fund managers to take risks carelessly. In order to protect incompletely informed individual fund members and prudent managers, investment policies of the funds are frequently regulated. The Hungarian regulation sets risk classes and prescribe threshold values of these classes to be held in the portfolio. In addition, like in many countries, proportion of funds invested in abroad is limited.

The other aspect of competition, results realized only on the long run, also induces regulatory intervention. Since individuals tend to discount future results, new clients can be attracted only by outstanding returns or direct marketing methods. These means of competition, however, are either risky, as we saw, or raise costs without improving returns or reducing risks, even though they may add to consumer satisfaction. Nevertheless, regulation frequently tries to slow the switching process by assigning costs to jumping from one fund to the other.

Reckless competition is a typical risk of pension markets that are based on worker's mandate to save for old age.

38. In contrast, slow feedback of mismanagement may threaten small, employer-owned, closed funds. In these cases remedy is just the opposite, competition lashed up. Regulators can induce competition by hindering managerial efforts to conceal their output by releasing incomparable figures, difficult-to-understand reports and the like. Clear standards set and enforced by the supervisory agency can make the field transparent.

Competition can also be encouraged by opening up closed funds in a form of hybrid mandates (Vittas 1998). If the employer is responsible for managing compulsory savings for old age but accumulated savings are portable, a threat of losing clients may improve the results of the fund. Clients can be protected in yet another way, if their "voice" option is amplified rather than their "exit" option. In line with Hirschman's famous taxonomy, portability is "exit" and special information channels, such as the office of the Pension Ombudsman in the Netherlands and the United Kingdom, are the "voice".

An exclusive asset management between a fund and the asset manager can amplify the effects of mismanagement. In some cases, it may be advisable to rule out such exclusivity and force funds to contract with several asset managers.

Other methods could be designing and devising managerial contracts that tie wages of the management to the success of the fund. At the moment, there is very little information available of typical managerial contracts in the pension industry.

39. The risk of outright theft and fraud can be best reduced by transparency. Regulation frequently enforces the fund management to give a view on in-house affairs to external actors. The balance has to be confirmed by outside auditors, the business plan has to get checked by an actuary. Assets are supervised by a custodian. A detailed regulation, however, should assure that the external actors are truly external. In Hungary, for instance, some of the largest pension funds have custodians from the same financial group or do cross-custody for each other. External actors can be the members of the boards of directors. Since in cases the selection of board members can be manipulated by the fund management, rules can describe the selection procedure. Such rules require the presence of the representatives of workers in the board in a number of countries.

Supervisory agencies can also try to participate in reputation building for the fund management. Reputation, the superiority of long term calculation over short-termism can be measured. In the Hungarian case there seems to be a clear difference in asset management fees between asset managers. Since frequently it is them who established the fund, such fees can serve as a hint of the time horizon of the fund management. This measure and potential other indicators can serve as a base for rating pension funds.

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