

## THE ROMANIAN SYSTEM OF PRIVATE PENSIONS IN AN EUROPEAN CONTEXT

### Abstract

*The concept of “private pension” appeared as a financial planning measure, necessary for maintaining a decent way of living at the age when we prepare to become “consumers” again, due to the detrimental economical, social and demographic perspectives. Only a few years after its release, the private pensions in Romania, especially the optional ones, become one of the most favorable and secure ways of saving on a medium and long term, thanks to some fiscal measures and the existence of the Guarantee Fund.*

**Key Words:** sustainability of public pensions, reform of the pension system, privately administrated pension funds, *fonduri de pensii, administrate privat, security-risk profile, complete deductibility, performance, efficiency.*

### 1. Introduction

International studies show that most of the world has to deal with serious demographic problems, regarding birth rate and the aging rate of the population. The most recent demographic study, published by Eurostat, shows that around 2060, the East European countries will face the most detrimental situations. Among these, Romania has a special place, having an accelerated rate of population aging, which means that in the next 20, 30 years this indicator will reach a critical level, with a share of population over 60 years of 25% and a dependency rate of about 41%. The latter represents the ratio between the number of pensioners and the number of employees and it is essential for the sustainability of public pensions. In conclusion, this tendency of population reduction seems irreversible and this phenomenon covers the aging one and the increased life expectancy, which, without deep reforms, will immediately lead to the explosion of the “demographic bomb”.

All these aspects mean very high pressure on the shoulders of the public pensions budget that has to sustain, with fewer and fewer contributors, a higher number of beneficiaries, which, in the perspective of the next decades, will lead to collapse, if measures of deep reformation of the system will not be taken in time.

In Romania, the number of those who work and pay public contributions has decreased in the last 17 years from 8,2 million in 1990 to 4,9 million in 2008, the dependency report being modified from almost 3,3 employees sustaining a pensioner to an almost equal ratio (according to INS<sup>1</sup>).

According to Eurostat<sup>2</sup> assessments, between 2008 - 2060, Romania's population will record the fourth percentage decrease in EU in this area, with a rate of 21% after Bulgaria with 28%, Latvia with 26% and Lithuania with 24% and the dependency rate will triple during this period, reaching, in 2060, 1,5 employees/1 pensioner, Romania being among the states with the highest demographic pressure in Europe.

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<sup>2</sup> Eurostat study (statistic department of European Union), [www.pensiileprivate.ro/Nr-136-22-iunie-2011-xprimm-newsletter-articol-135](http://www.pensiileprivate.ro/Nr-136-22-iunie-2011-xprimm-newsletter-articol-135)

## 2. The European context of the pension system reform

On a global scale, more and more countries use the private solution of reforming their public pension system.

In Western Europe, the base model is the one of occupational private pensions, offered by the employer.

Central and Eastern Europe have adopted models of multipillar private pensions, the reform in this area beginning in 1994 first with the optional private pension (3<sup>rd</sup> pillar) and then with the mandatory private one (2<sup>nd</sup> pillar).

In many aspects, the countries of New Europe accomplished a greater progress than the Western economies in implementing the reform of the pensions system. The demographic problems that all the European countries have to confront are similar: significant increase of life expectancy and a decrease of birth rate. They have created an imbalance with the effects becoming more visible in the functioning of the pension system. However, for the CEE countries, the reconstruction of the social security system is slightly different.

“The potential benefits of the reform are greater, while its costs are smaller”, said Michael Rutkowski, World Bank expert<sup>3</sup>, in November 2000. „That’s why, it’s not at all surprising that, compared to EU15 states, the Central and East-European countries began a more drastic reform of the 1<sup>st</sup> pillar pensions (PAYG) and started implementing the multipillar pensions with greater enthusiasm”, concluded Rutkowski. Therefore, five years later, in 2005, pension experts from the World Bank concluded<sup>4</sup>: the reforms implemented in Central and Eastern Europe already led to the structuring of some pension systems that are more adequate, accessible, sustainable and robust than their predecessors.

Hence, the CEE countries succeeded the transition from the old systems, unsuccessful from the actuarial point of view and needing subsidiary budgets every year, to financially healthy long term and short term systems. The new pension systems are much more consistent, being diversified (through the coexistence of different formulas included in the three pillars) and sort of immune to political shock.

Nowdays, over 30 states in the entire world adopted the multipillar private pension systems, În prezent, peste 30 de state din întreaga lume au adoptat sisteme de pensii of them being in the Central and Eastern Europe, including Romania. All of these countries felt the impact of the “demographic bomb” in their public pension system, this being the reason why, in the middle of the global financial and economical storm, maybe the most severe one of the last 75 years, they launched the private pension system, following the tested and recommended example of the World Bank.

Under these circumstances, the new pension system structured on the three pillars, has common characteristics in Central and East European countries:

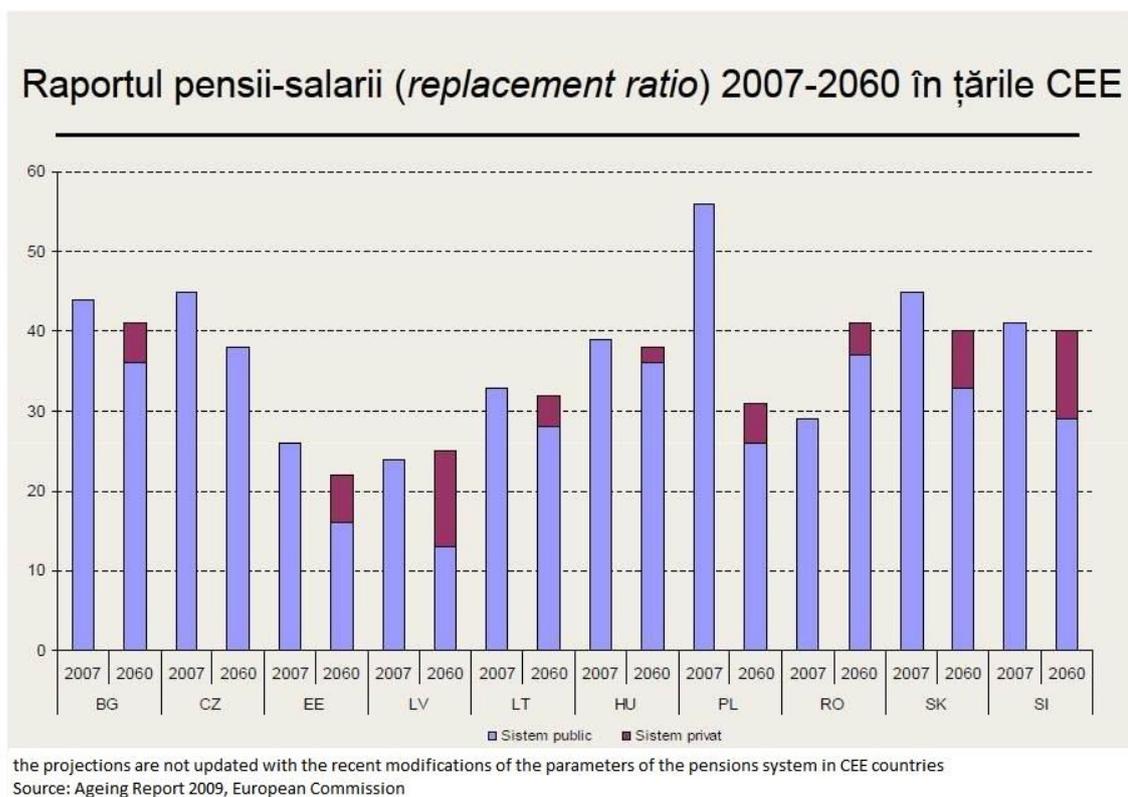
1<sup>st</sup> Pillar – the public pension system works based on the distributive principle (PAYG=pay as you go, through which the state collects social contributions to the pensions from the employees and pays it immediately), a system that proved to be fiscally unsustainable and needed some amendments regarding the tendency of increasing the retirement age and some less beneficent indexing algorithms.

<sup>3</sup> Social Security: Is It a Different Issue for Accession Countries?, Michal Rutkowski, World Bank - Conference on Economic and Social Dimensions of EU Enlargement, Brussels/Belgium, 16 November 2000.

<sup>4</sup> Old-Age Income Support in the Twenty-first Century: An International Perspective on Pension Systems and Reform by Robert Holzmann and Richard Hinz together with Hermann von Gersdorff, Indermit Gill, Gregorio Impavido, Alberto R. Musalem, Michal Rutkowski, Robert Palacios, Yvonne Sin, Kalandhi Subbarao, Anita Schwarz (February, 18, 2005).

2<sup>nd</sup> Pillar – the mandatory private pension system is a fined contribution type (through which each participant can save for his own future).

3<sup>rd</sup> Pillar – the optional pension system is a private pension system, fined contribution type with voluntary participation.



In terms of adequacy, ie **the replacement rate** these countries wanted to achieve, it's being maintained at high enough levels, mostly over 50% (or more for people with smaller income), while, as the voluntary participation schemes of the 3<sup>rd</sup> Pillar extend, it could easily reach a quota of 60 – 70%. (chart 1)

The private pensions system has a few essential **advantages** opposed to the public one:

- the participant's money are invested on a long term instead of being spent immediately;
- the participants have a right of property over their personal account, in which their contributions and the growths obtained from investing them are accumulated;
- gives the participants the chance of a decent pension upon their retirement from the active live;
- the competition between the private pensions administrators ensures the efficiency of the system and greater efficiency regarding the investments of the participant's money.

Also, the changes in the retirement age and the decrease of privileges for certain categories of pensioners have improved the situation of accessibility and sustainability.

However, the basis of the income after retirement it is still provided by the 1<sup>st</sup> Pillar and it's more and more obvious that we cannot talk about a satisfactory quality of life at the retirement age if we don't complete those incomes with a complementary source representing the participation in the private pensions system.

Joining the 2<sup>nd</sup> Pillar, which is the most accessible for the majority of the employees that have small and medium income, it is possible only for those people that still have about 25-30 years of active life. For the older generations, which, at the beginning of the reform were in their 50's, pension transformation offers only a partial solution, participating in the 3<sup>rd</sup> Pillar which is the optional private pensions. Under these circumstances, it becomes more and more important the optimization and the security of the investment in this form of accumulation. Even for the younger generations, an investment that spans over approximately 30-40 years and which is largely responsible for the quality of life after retirement brings forward the problem of guarantees regarding the safety of the investment.

### **3 . The functioning methodology of the Romanian private pension system**

In order to ensure the best safety conditions, especially for the 2<sup>nd</sup> Pillar, every country's legislation adopted strict prudential provisions and the activity of those more than 300 private pension funds in the countries that adhered to this system that administrates over 35 million clients it is strictly supervised by specialized people.

In this context, in order to protect the savings of those who join the private pension funds, the Romanian system has many safety elements. These are the main mechanisms that protect the participant's money: a) control, supervision and regulation of CSPPS (The Commission for Supervising the Private Pension System); b) separation of assets between the administrator and the private pension fund; c) by the law, the private pension fund cannot collapse; d) strict procedures of supervising and special administration; e) the existence and involvement of the depositary banks in the private pension system; f) financial auditors for the pension funds and for the administrators; g) reporting and transparency responsibility for the administrators and the depositary banks; h) the guarantee of the net contribution (the absolute capital guarantee); i) the guarantee of the minimum rentability rate (the relative guarantee of the market); j) the pension funds are not allowed to invest in wrong or dangerous assets; k) prudent actuarial calculations; l) technical provisions constituted by the administrator; m) the Guarantee Fund of the private pension fund; n) private funds that already started to pay the clients; o) minimum capital requirement for being active on the market; p) long term commitment of the administration companies; r) the private pension system has been designed by the World Bank; s) international financial organizations support the development of the private pensions.

Also in respect to this matter, the Chamber of Deputies adopted in December, 2011, the law on the establishment, organization and operation of the Guarantee Fund in the system of private pension, as a mechanism for the ultimate safety of the market. This law will be enforced after its publication in the Official Gazette, and will start operating in the first part of this year. The main purpose of the Guarantee Fund is to guarantee the rights of the participants (accumulation phase) and the beneficiaries (payment phase) to the private pension funds and to compensate any loss of the participants derived from any situation of impossibility of payment of the administrators and providers of private pensions.

Also, on September 28, 2011, the European Parliament adopted budgetary concessions for countries that develop 2<sup>nd</sup> Pillar mandatory private pensions, including Romania. This measure provides preferential treatment of the costs associated with the implementation of such a system of private pension, by excluding the contributions paid to the pension funds from the calculation of the budget deficit and public debt. The Parliament also voted a clause that strongly discourages the member states to affect their 2<sup>nd</sup> Pillar systems, since any reversal of these reforms will be seen as a negative measure, which does not enhance long-term sustainability of public finances, thus not being taken into account during the procedures of budget deficit analysis and public debt.

Specifically, these measures are a clear signal of support from the European Union, helping to reduce the influence of the political environment on the future of private pension systems and showing that the 2<sup>nd</sup> Pillar represents a medium and long term beneficial reform, desirable, solid and supported by the European community. The new provisions were introduced by modifying two regulations: 1) Regulation no. 1466/97 regarding the strengthening of fiscal positions supervision, observation economic policy coordination and 2) Regulation no. 1467/97 on speeding up and clarifying the implementation of the procedure for excessive deficit and will take effect from 2012, as it is shown in the official bulletin of the European Parliament.

The privately administrated pension system, 2<sup>nd</sup> Pillar in Romania, it's a "hybrid defined contributions" type of system. According to the classification made by the Organization for Economic Cooperation and Development (OECD) and the World Bank, the "defined contribution" system type is characterized by the fact that, when it acceded, voluntary or by obligation prescribed by law, only the value of the contribution in the system was known, without any other promises or guaranteed results on benefits, meaning the guaranteed value of the final amount used to obtain a private pension. In Romania, the system is a "hybrid" one due to the fact that it stipulates an absolute guarantee, namely the paid contributions diminished by the transfer penalties and legal fees.

#### 4. The characteristics of the private pension system in the EU countries

Countries like the Baltic States and Hungary have no guarantees regarding the efficiency of the 2<sup>nd</sup> Pillar funds, whereas Romania, Slovakia and the Czech Republic, for the 3<sup>rd</sup> Pillar, are the only countries in which the legislation regarding the private pension system has an absolute guarantee of the amount of the net contributions. Also, Romania is one of the few countries in which private pension administrators are required to establish actuarial reserves.

In consequence, we can say that our country has one of the most solid and yet restrictive guarantee systems regarding private pensions, as we can see in a CSSPP comparative study<sup>5</sup> containing updated information about the 12 states that have a private pension system made after the World Bank's model. The study presents guarantees, the relative to performance type and the absolute ones, applicable to the 2<sup>nd</sup> Pillar private pensions in Central and Eastern European countries, through the similarities and differences with the privately administrated pension funds system, 2<sup>nd</sup> Pillar, implemented in Romania.

##### **Bulgaria:**

1<sup>st</sup> Pillar - mandatory, Pay as You Go type (PAYG), reformed since 1995 (stability fund)

2<sup>nd</sup> Pillar – mandatory with 5% defined contributions (of 8,05%) of the gross salary, individual accounts, initiated in 2002: occupational, for high risk jobs; universal – mandatory for those born in or after 1960.

3<sup>rd</sup> Pillar – optional defined contributions type, individual accounts, initiated in the mid 90's.

4<sup>th</sup> Pillar – optional, voluntary occupational pensions, initiated in 2007, similar to the Western one.

The retirement age is 63 for men and 60 for women. The guarantee is the minimum relative of performance one. The minimum rate of rentability (mandatory for the 2<sup>nd</sup> Pillar)

<sup>5</sup> The official site of the Commission for Supervision of the Private Pensions Sysytem, [www.csspp.ro](http://www.csspp.ro), "Comparisons of private defined-contribution systems", study by Dan Zăvoianu, Department of Communication Private Pensions, July 2010.

equals with the smaller value between the average market yield minus 4 pp (procentual points) and 60% of the annualized average rentability rate of all the funds.

**In Poland**, the pension system reform was initialized in 1999.

1<sup>st</sup> Pillar: mandatory, PAYG system based on the "national defined contribution" principle, and the current level of the contributions is 9,76% of the gross salary (10.5% in Romania) for the employee and 9,76% of the gross salary (20.8% in Romania) for the employer.

2<sup>nd</sup> Pillar: (since 1999) "fully funded defined contribution" system (FFDC). Mandatory for people under 30 year's old, optional for those between 31 and 50 year's old. The first contribution was 7,3% of the gross income (transferred from the employee's contribution). Assets were 19,4% of GDP at the end of 2010. Regarding the 2<sup>nd</sup> Pillar, the mandatory contributions have been chosen as a way to reduce the consolidated budgetary deficit. Since 2011 the contributions to the 2<sup>nd</sup> Pillar were reduced to 2,3% and will gradually return to the 5pp difference transferred in sub-accounts of the 1<sup>st</sup> Pillar, having an annual yield equal with the growth of real GDP and average annual inflation.

3<sup>rd</sup> Pillar: FFDC private schemes with voluntary enrollment (existing since 1994).

Defined contributions, optional occupational diagrams introduced in 1999; personal optional diagrams introduced in 2004; reserve fund, on demographic basis.

The retirement age is 65 years for men and 60 years for women. The warranty is the minimum relative to performance. The minimum rate of return equals the lowest value between the average market value for the last 3 years minus 4pp and 50% of the average rate of profitability ponderată anualizată a tuturor fondurilor pe ultimii 3 ani.

**In Romania**, this system began in May 2007 with the 3<sup>rd</sup> Pillar (optional private pension) governed by rule no. 204/2006 and continued a year later, the 2<sup>nd</sup> Pillar (mandatory pension), governed by rule no. 411 / 2004 and rule 23/2007.

1<sup>st</sup> Pillar: PAYG type

2<sup>nd</sup> Pillar: when it was initiated (2008), the contribution rate was 2% of total 10.5% of contributions to social security, planning to grow to 6% until 2016. It is mandatory for persons under 35 years and an option for people aged between 35 and 45.

Freezing the rate of contribution to 2% in 2009 and resume scheduled growth with 0.5% per year, with a lag of one year behind the original schedule, the "cost" for the participants in mandatory private pension 2<sup>nd</sup> Pillar was 654, 88 million lei, contributions that were not collected in 2009 and 2010, as it is shown in the CSPPS report for 2010, published on the authority's website.

Taking into account the financial gains that would have been obtained by investing the money, the "check" that the participants in 2<sup>nd</sup> Pillar had to pay for budgetary savings in 2009 and 2010 rears to a smaller value of net assets with 732.77 million than would have been if they had respected the original schedule, foreseen by Law 411, to increase contributions, perpetuating the situation if the percentage is not recuperated by 2016.

3<sup>rd</sup> Pillar: optional pensions system, individual accounts, maximum contributions of 15% of the income, a minimum of 8 years.

The retirement age is nowadays 65 years for men and 60 years for women. Regarding the guarantee, this is a relative to performance one. If the annualized rate of return of a fund will fall below the minimum of the respective risk category for 4 consecutive quarters, the management authorization will be withdrawn and the procedure for special administration will be applied (after an interim measure of special monitoring will be applied).

The absolute guarantee, represent the correct total amount for the private pension and cannot be smaller than the value of the paid contributions, reduced by transfer penalties and legal fees.

Other safely elements: we have the widest range of risk controls instruments: separating assets, actuarial reserves, verification by the depositary, guarantee fund, audit and a minimum rate of return.

In **Slovakia** there is a Western like private pension system.

1<sup>st</sup> Pillar: mandatory Pay as You Go type, reformed since 2005.

2<sup>nd</sup> Pillar: initiated in 2005, mandatory defined contributions type, individual accounts, with 9% (out of 18%) of the gross salary. Optional for those who are just starting their working life and mandatory for the same category, between 1<sup>st</sup> of July 2006 – 31<sup>st</sup> of December 2007. The administrators have to provide three funds with different risk categories and to have at least 50.000 members in 18 months.

3<sup>rd</sup> Pillar: optional, defined contributions, individual accounts, initiated in 1996, reformed in 2004.

The retirement age is 62 years for men and 62 years for women. Regarding the relative minimum guarantee, it depends on the interest rate and the average return rate of a fund cannot be smaller than 40% of the annual average interest rate on government securities with a maturity exceeding one year. In case of failure, the deficit must be covered from own resources.

Pension reform in **Hungary**, pioneer of pension reform among the CEE countries (1997-1998):

1<sup>st</sup> Pillar: PAYG system reformed in the mid 90's. The current level of the contributions is 10% of the gross salary for the employee and 24% of the gross salary for the employer.

2<sup>nd</sup> Pillar: mandatory for those under 35 years and to in the working field and optional for the others. It is a fully funded defined contribution type system (FFDC) and, in the beginning, the contribution was 6% of the gross salary (transferred from the employee's contribution). It was subsequently increased to 8% (an optional additional contribution of 2%). Since 2009 the participants are assigned to three risk categories, according to their age.

The assets represented 10% of the GDP at the end of 2010 and the guaranteed flow was 85 % of the average flow of the last three years.

3<sup>rd</sup> Pillar: private FFDC systems with voluntary enrollment, initiated in mid 1994.

At the end of 2010 we see a "de facto" nationalization of the assets accumulated in the 2<sup>nd</sup> Pillar, with the motivation to reduce the stock of public debt (budgetary surplus in 2011) and temporary coverage of some tax cuts. Under these circumstances, the implicit public debt increases with the updated value of the future pensions that were to be paid to the contributors of the 2<sup>nd</sup> Pillar, resulting in an aggravation of the long-term sustainability of the public finances.

4<sup>th</sup> Pillar: optional private pension system, initiated in 2007.

Retirement age is 62 years for men and 62 years for women.

No performance guarantees, only the direct ones.

The main consequences of the financial constraints generated by the financial crisis have been partial inversions on a limited or unlimited term of the contributions transferred to the 2<sup>nd</sup> Pillar also in other CEE countries such as: Principalele consecințe ale constrângerilor fiscale generate de criza financiară au fost inversări parțiale pe termen limitat ori nelimitat ale fluxurilor de contribuții transferate pilonului II și în alte țări CEE cum ar fi:

- Latvia: where we see a decrease of contributions from 8% to 2%.

- Lithuania: a decrease of contributions from 5,5% to 2%.

## 5. The specificity of private pensions funds in Romania

The degree of risk exposure of the investments related to the private pensions it is smaller and strictly controlled, the legal provisions imposing strict limits regarding the maximum balance of each type of investment, and the issuers on each class of permissible financial instruments. Also, investments in instruments that are considered to be highly volatile or with low liquidity are not allowed.

Though, the risks of the private funds investments are those related to the capital market, the interest rates, the exchange rates and the credit risks.

**The market risk** is a general risk that affects any type of investment. Price fluctuation of the transferable securities it is generally determined by the financial markets trends and by the economical situation of the issuers, who are affected by the general situation. This risk cannot be reduced by variation. In emerginc countries such as Romania, the market risk is relatively high.

**The specific risk** represents the risk related to the instruments of a certain issuer. Variation can reduce the specific risk, but not even a very prudent selection of the investments can totally eliminate it.

**The interest risk** is the risk of potential downfall of the market value of the securities and bonds with a fixed income because of the increase of the interest rates.

**The credit risk** means that there is a possibility that for a security or a bond to not pay fixed term interest rate, according to the contractual terms. Reflecting an increased credit risk, the lower quality assets provide higher benefits than the high quality assets.

**The exchange risk** affects the assets that are in other currencies. Even if the value of those assets grows when it's in the main currency, their value in lei can drop if the respective currency recedes in comparison to the domestic currency.

In Romania, the administrators approach an investment style compatible with the risk objectives of each fund and apply rules of prudent diversification of the portfolio. Moreover, the diversification of the fund leads, in general, to a decrease of its volatility by reducing the specific risk.

Regarding the investment risk of the pension funds, in a recent study<sup>6</sup> conducted by a known British consultancy company, Oxera, it has been stated that "running" of the capital market during a crisis it is not the best option for long-term investments, a recent example showing that the those pension funds with higher exposure recovered their losses from the top period of the crisis (2008) faster that the ones with more conservative investments. Moreover, British analysts have made a simulation to highlight, starting with real financial data regarding the evolution of bonds and stock indices spanning over 30 years, the differences between the benefits obtained from a participant whose assets are exclusively invested in stocks and a participant whose assets are 100% invested in bonds. The result showed that, with equal contributions and accumulatin duration, a participant who chose a portfolio with investments mainly in stocks can have a significantly better investment result compared to the scenario in which he would have opted for conservative investments.

Therefore, due to the long period of financial accumulation, the risk of having a very low income when retiring during a crisis increases insignificantly.

It is also true that the participants will have smaller benefits if the fund has a lower investment productivness, investing only in low risk financial instruments that have a poorer

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<sup>6</sup> Oxera Agenda, Advancing economics in business,"Weathering the storm:should pension funds switch to low risk assets", [www.pensiile private.ro](http://www.pensiile.private.ro), bulletin of private pensions no. 136, June 22, 2011

performance. In other words, conservative investments will reduce the differences generated by different moments of retirement, but this advantage will come with the price of modest results for everyone, no matter the moment of retirement.

In Romania, although they suffered from a very bad stock year, the privately administrated mandatory pension funds (2<sup>nd</sup> Pillar) ended their fourth year with an average annual **performance** above the inflation rate.

The nine mandatory private pensions funds (2<sup>nd</sup> Pillar) recorded in 2011 a positive average annual return, of 3,64%, but almost 4 times lower than in 2010 (14,36%), according to the Commission for Supervision of the Private Pensions System (CSPPS), and to data released by the fund administrators on their sites.

Individually, the funds had last year an efficiency between 1,94% and 4,96%, while a year ago, the efficiency had been from 11,20% to 16,10%. Also, the level of the rentability rate over the last two years, an indicator closely monitored by the CSPPS, reduced significantly in comparison to the previous year. Therefore, in the last two years, the average rentability rate of the mandatory private funds diminished from 15,09% in December 2010 to 8,56% at the end of the last year. All these considered, the average annualized efficiency since its initiation and until the end of 2011 was +11,7% for 2<sup>nd</sup> Pillar (opposed to a medium annual inflation of 5,3%) and +7,3% for 3<sup>rd</sup> Pillar (opposed to a medium annual inflation of 6,0%). (source APAPR<sup>7</sup>)

According to the Commission for Supervision of the Private Pensions System (CSPPS)<sup>8</sup>, the assets of the mandatory and optional private funds have increased with 47% in 2011, approximately 1,6 billion Euros and reached a share of 1,25% of the Gross Domestic Product (GDP).

In December 2011, on the 2<sup>nd</sup> Pillar, the number of participants was over 5,5 million people and there were 9 fund administrators for each of the two pillars. The assets of the nine mandatory private funds have increased with 48,1% during last year, to 6,42 billion lei, while the advance on the 3<sup>rd</sup> Pillar was of 32,8%, to 435,65 billion lei.

The change in the Tax Code established on January 1<sup>st</sup> 2012 **total fiscal deductibility** for the contributions paid by the companies for their employees's optional private pension funds (3<sup>rd</sup> Pillar). Thus, the deductibility targets the tax on profit and the tax on income, as all the mandatory social contributions, within a limit of 400 Euros/year (approximately 144 RON/month). For the individual contributions, made by each natural person from its own income, into his own account, partial fiscal deductibility, only for the tax on income, it is still valid.

According to the Association for Privately Administrated Pensions in Romania, compared to offering a bonus in cash or a salary increase, a contribution paid by a company to an optional pension fund, for an employee, it's 6,4% more efficient in terms of additional payment obligations of the company.

Specifically, providing a benefit as an optional pension, compared to offering a bonus or a salary increase, reduces by 1,4% total personnel costs and can increase the company's profit by 7-8%, according to APAPR's<sup>9</sup> calculations. At the same time, the employee earns in addition to his net income another 2,7% (net salary plus benefit) if he accepts an optional pension rather than a bonus in cash.

<sup>7</sup> Association for Privately Administrated Pensions in Romania, [www.aparp.ro](http://www.aparp.ro), The European Forum for Private Pensions, Bucharest, October 25, 2011.

<sup>8</sup> Commission for Supervision of the Private Pensions System, [www.csspp.ro](http://www.csspp.ro), January 30, 2012;

<sup>9</sup> Association for Privately Administrated Pensions in Romania - [www.apapr.ro](http://www.apapr.ro), Simulation model of corporate deduction, "Optional Private Pensions: total fiscal deductibility for employers", January 2012.

## 6. Conclusions and proposals

2011 was marked<sup>10</sup>, like the previous year, by the volatility of the financial markets. The slowdown in global demand and the significant deterioration of the trust level of the corporate sector and of the consumers, in a context marked by uncertainty, caused more tension on the financial markets, given that the stock prices have dropped sharply and financing conditions have tightened in more countries in the Euro area.

The tendency among the administrators of private funds regarding investments it's to maintain, as much as possible, the performances obtained in the past, considering that the administrators will manage more money for the participants as a consequence of the growth contribution scheme, from 3% to 3,5% starting March 2012. Investments in securities still hold a share of 65% of the assets of the pension funds, those in deposits have increased in total active and those in shares have dropped.

The results of the private funds, since its initiation, are really positive. Still, in 2011, there is a diminuation of their profits from previous years (2008-2010), amid the turmoil in financial markets. In this context, it should be noted the fact that when the caoital markets and the price of securities held by the pension funds drop, their results are also affected in a negative way, which may lead to register losses. Although in an economic cycle there are also such times, we shouldn't forget that the pension funds are long-term investors, prudent, with a decreased appetite towards risk, one of their objectives being optimizing the replacement income of the participants when they retire.

Considering all these, participants with simillar investment pattern, can have different values of their individual assets, according to the moment they've chosen to transform those assets in pension. Therefore, a participant who retires during a financial boom will get more money comparative to one who retires during a crisis.

Forecasts for 2012 show that on the segment of mandatory private pensions (2<sup>nd</sup> Pillar), the number of participant will be greater than it was at the end of 2011, as a result of defence, public safety and national security employees coming into the system. Following a contribution growth by 3,5%, foreseen for 2012, the amounts transferred to the 2<sup>nd</sup> Pillar will cumulate 2,5 billion lei and will be over 9,5 billion lei (approximately 2,2 billion Euro) in December 2012. As a consequence, according to CSPPS, the assets of the optional and mandatory private funds will grow this year by more than 40%.

Following the deductibility, optional pensions, next to practical benefits, offer to the employer and the employee a fiscal advantage greater than a salary increase; being an instrument for employee loyalty and, more important, giving the employees extra income when they retire. Also, the state will directly benefit from taxing the pensions (a larger basis will be charged) and indirectly from consumption growth. Additionally, the collected amounts will be utilized in the real economy by investing them continuously.

Compared with other forms of savings, the tax regime applied to the optional pensions it's better than the traditional ways of saving (deposits, certificates of deposit etc.) and than other means of investment (stocks, bonds, etc.). For the optional pensions, the result of the investments it is not taxed, the savings are long-term and the sum's destination at retirement it's the participant's choice.

Therefore, it can be **concluded** that optional pensions represent not only the way of ensuring a better living standard in retirement but also the most beneficial form saving existing now on the market.

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<sup>10</sup> Liviu Ionescu, financial analyst, csspp.ro, "An economic retrospective of 2011 and the investment evolution of the private funds", January 23, 2012l.

Still, the low level of “financial literacy” limits public support for the private pensions and competition between pension funds. That’s why financial education it’s the key condition for people to correctly appreciate their needs, risks and opportunities and to understand the concepts and private pension products. Unfortunately, studies and surveys conducted by famous institutions in the world show, repeatedly, a worrying level of financial “illiteracy”, a critical deficiency considering that the modern world it’s increasingly forced to pass to the individuals the respnsability of their financial future at the age of retirement. Future retirees cannot afford financial “illiteracy”, a direct consequence of this situation being that most of the citizens are being exposed to a high risk of being taken completely by surprise by financing the last years of their lives.

Not understanding the pension system, they won’t be able to understand to save for their retirement. And even if they do, most of them are not qualified to chose correctly the means of saving and adjust their economies.

In these circumstances, the first and most important step to secure financial balance of future generations of retirees is to educate people financially. Otherwise, no matter how well developed all the components of the pension system will be, legislatively and operational, their social efficiency will remain limited at the very least.

"A forewarned, is forearmed", popular wisdom says. Regarding private pensions we can say that “a man warned has the most chances to become a happy retiree”, while ignorance may come with an austere old age.

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