

# IS THE ROMANIAN FINANCIAL MARKET PREPARED TO SUPPORT PENSION SYSTEM REFORM?

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## **Abstract:**

*The paper outlines the challenges that a multi-pillar functional pension system may bring, considering the current state of development of the Romanian financial system, considering the macroeconomic stability, the current financial infrastructure and the existence of a regulatory and supervisory framework. After realizing an overview over the Romanian pension market, issues like the capacity of the domestic financial market of generating long-term returns and adequate financial instruments are also addressed from an analytical point of view.*

**Key words:** *pension, system, financial market, reform*

**JEL classification:** *G12, G02, H55*

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## **1. Introduction**

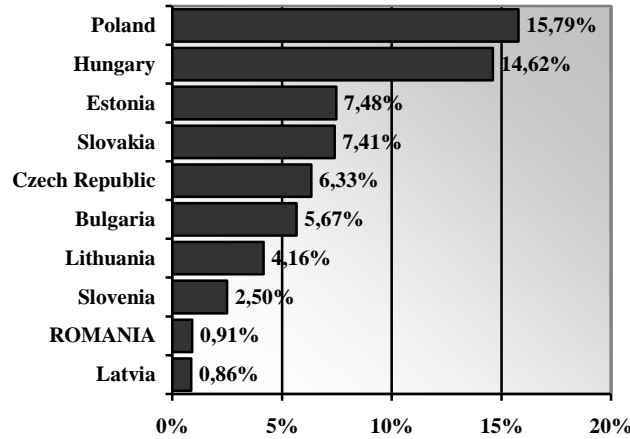
Due to the recent demographic evolution and the pressure put on the sustainability of the traditional pay-as-you-go pension systems, after the transition to the free market democracy, Romania has begun the multipillar reform, in close connection with the ones realized in the other Central and Eastern European countries, members of the European Union. But the implementation of a functional multipillar system, capable of generating funded pension benefits is challenging in the context of the current stage of development of the financial markets and of the difficult international economic context. The paper is organized as follows: section 2 describes the current stage of pension reform in Romania, analysing some recent statistics and positioning the Romanian pension market in the regional context, section 3 presents the requirements that a functional financial market must meet in order to welcome the growing pool of retirement savings, as the pension reform evolves, analyzing if these can be validated in the case of the Romanian financial market, section 4 concludes.

## **2. An overview over the Romanian pension market**

As in the other CEE countries, Romania has implemented the multi-pillar pension reform, the current pension system being composed from: a first redistributive PAYG component (1<sup>st</sup> Pillar), publicly managed, based on the intra-generational solidarity, which still provides the main part of the future pension and a private component: the privately managed mandatory defined-contribution pension system (2<sup>nd</sup> Pillar) respectively the voluntary defined-contribution pension system (3<sup>rd</sup> Pillar). As in other countries, the implementation of the 3<sup>rd</sup> Pillar began earlier than in the case of the 2<sup>nd</sup> Pillar (in may 2007, in comparison with may 2008). Though, both markets are at their beginning, when we are considering the accumulated total assets and the contribution rates, still low when comparing them with the ones from the other CEE countries.

As far as concerns the 2<sup>nd</sup> Pillar market, we have begun with a contribution rate of 2 % in 2008, that remained stable in 2009, due to the financial crisis (although it should have experienced an increase of 0.5 %), then it rose up gradually to 2,5 % in 2010, to 3 % in 2011 and since march 2012, to 3,5 %. Till 2016, the government intends to increase the 2<sup>nd</sup> Pillar contribution rate to 6 %. If we look at the total cumulated assets indicator, we can notice that Romania lags behind the majority of CEE countries, that have begun earlier their pension system reform.

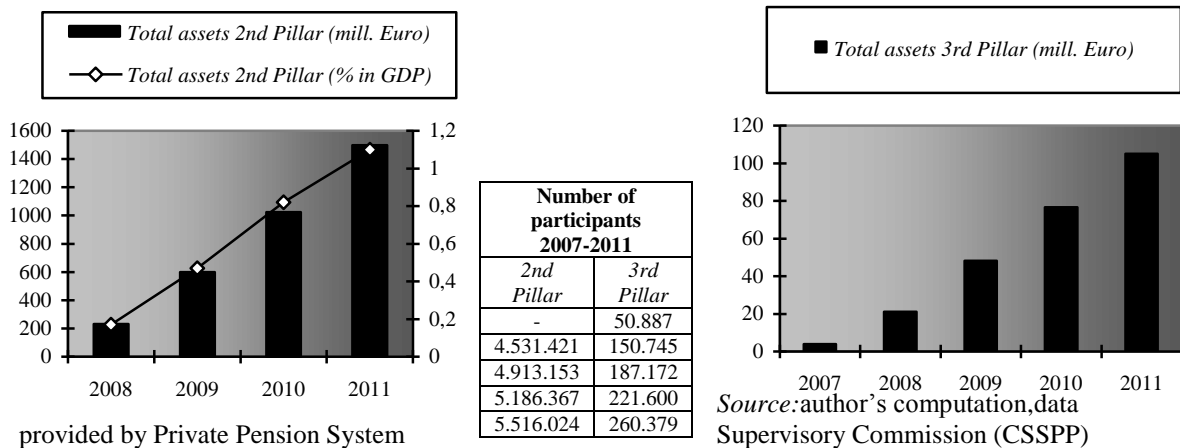
**Figure 1.** Pension funds' assets in CEE countries, 2010 (% of GDP)



Source: author's computation, with data provided by OECD and web pages of national commissions of surveillance of the private pension systems

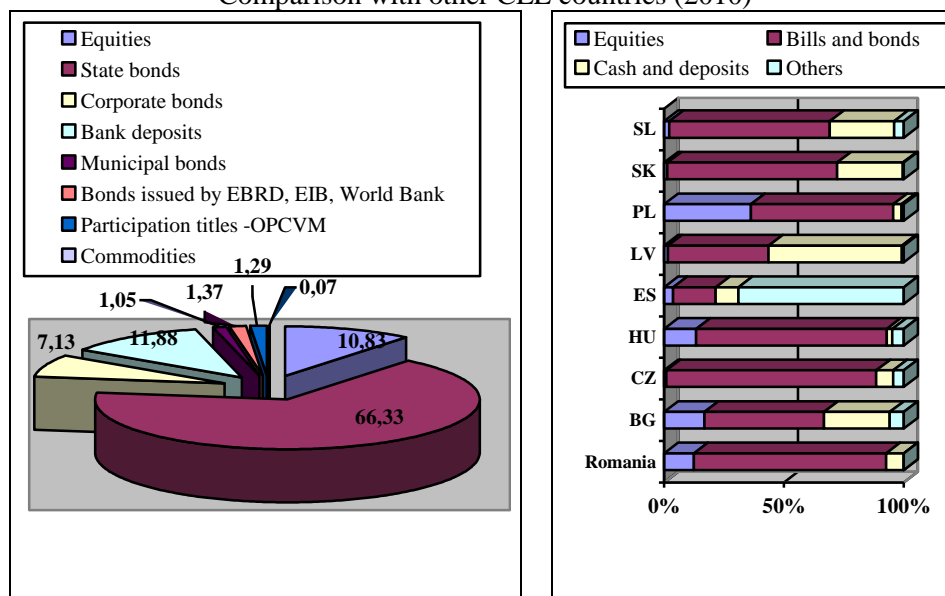
Still, when looking at the dynamics of this indicator over the last four years we can see the continuous growth pace and the growing potential of the pension funds as players on the domestic financial markets (Figure 2).

**Figure 2.** The size of the pension market in Romania



As far as concerns the investment policy practiced by pension funds, we can observe a policy of investing in low-risk financial instruments (state bonds-66 % of the total), rather than in more risky financial instruments, like equities, where the allocated percentage is quite low (a little bit over of 10 %). This fact proves once again that the pension reform is in its first operation years, maintaining a rather conservative policy which creates a shield against the financial crisis (Figure 3).

**Figure 3.** Pension funds' asset allocation for investment in Romania (2011). Comparison with other CEE countries (2010)



Source: realized by authors, data provided by CSSPP and OECD Global pension statistics

The same situation can be observed in other CEE countries, which maintain a similar investment policy, the majority of their investments being directed towards bills and bonds and less towards equities (Figure 3).

### 3. Is the Romanian financial market ready to face the growing demand of assets?

In the literature there are suggested three main requirements that can prove the readiness of a financial market: macroeconomic stability, a proper financial infrastructure, and adequate regulatory and supervisory framework (Holzmann (1997); Holzmann et al. (2009); Glaessner and Valdes (1998); Vittas (1998, 1999); Impavido, Musalem, and Vittas (2002); Holzmann and Hinz (2005)). As far as concerns the first condition, the macroeconomic stability, the literature mainly recommends low rates of inflation, in order for pension funds to make long-term suitable investments. Secondly, the financial infrastructure means sound banks and insurance companies, in the early stages of reform, these being necessarily accompanied later by a sound capital market and financial innovation. Finally, the regulatory and supervisory framework makes sure that an effective regulation applies, with focus on the key aspects of the early stages of reform, like licensing of participants (Holzmann et al., 2009). Rudolph and Rocha (2007), on the other hand, mention nine key areas, from which three non-related with the financial market, that can warn about the readiness of the financial system (which means just that the introduction of the funded pension scheme will not fail, and not that it will succeed):

- a prudent fiscal approach, quantified in the quality of the models used to monitor the fiscal trajectory, since the introduction of the private component of the pension system implies both current and future fiscal costs;
- effective mechanisms for tax administration and collection, since their effectiveness guarantee the pension reform;
- a historical context that is capable of supplying credibility in the financial markets;
- a legal and institutional infrastructure, that can ensure that the collection of contributions, the investments of pension assets and the purchase of annuities are to be developed in a regulated environment

- the availability and quality of financial information, regarding all the economic actors that are connected with the pension reform;
- transaction security;
- availability and quality of critical financial services;
- an adequate supply of financial instruments, that can allow pension funds to obtain sustainable returns;
- the quality of governance.

Holzmann et al. (2009) adds a tenth relevant key area, the financial education, that analyses the existence of some financial education programs or campaigns in order to increase the level of financial literacy. They placed Romania, among other CEE countries, before the pension reform implementation, according to all these criteria, on not such a comfortable position, with many requirements still missing or necessary to be improved.

If we look at the tenth dimensions of Holzmann et al. (2009), we can notice that their observations are still applying nowadays in the Romanian case, not many of them being solved since their moment of analysis. From them I outline here just a few of the most important ones: there should be used more analytical tools and projections in order to have a prudent fiscal approach, tax collection could be improved, securities law should be in line with the best practices, the availability of the financial instruments is still lagging in comparison with other developed financial markets, a more deep and liquid stock market (especially the corporate bond market, but also the other categories) is required, derivatives should become more available and permitted to pension schemes, the governance could be improved by ensuring the protection of minority shareholders, campaigns and programs for enhancing the level of financial education should be further promoted. Not at least, people's confidence in 2<sup>nd</sup> and 3<sup>rd</sup> pillar pension schemes should be restored, because once with the financial crisis, many people began to question about the real benefits of the pension system reform.

One latter remark is that, even though pension fund assets in emerging countries are growing in relation to the size of their financial markets, when measured against stock market capitalization and the volume of bank deposits they remain small vis-à-vis developed countries with big pension fund industries (Holzmann et al., 2009). This is also the case of Romania. If we look at the pension fund assets, as a share of the sum of market capitalization (just the stock market) and bank deposits, they amounted to merely 1 % in almost entirely period of analysis (Table 1). This suggests that pension fund assets in Romania, like in other CEE countries, have not yet overwhelmed the financial market, but whether that could happen in the future remains an open question.

**Table 1.** Pension assets and financial market size in Romania

	<i>Pension assets (2<sup>nd</sup> and 3<sup>rd</sup> Pillar) (mill.Euro)</i>	<i>% of sum of the market capitalization (stock market) + bank deposits</i>	<i>% of market capitalization</i>
<b>2008</b>	229,9	0,9 %	2 %
<b>2009</b>	612,2	1,4 %	3,2 %
<b>2010</b>	1087,5	2,2 %	4,5 %
<b>2011</b>	1590,4	1,2 %	9,7 %

Source: own computation, data provided by BSE, CSSPP, NBR

#### **4. Conclusions**

The private pension market is growing in importance, the assets owned by the pension funds experienced a high growing pace from the year of the implementation. Although, there are a number of risks that may affect pension funds and that are likely

to appear in some developing financial markets, like the Romanian one. First of all, the *contagion risk*, given the situation on the monetary and financial markets. The high volatility of exchange rates and the potential increase in the level of interest rates could lead to the capital markets volatility. *Inflation* represents also a threat because it triggers lower real rate returns for portfolios holders. Then, the *risk of decrease in the value of the portfolio*. The portfolios are affected by the high volatility experienced by assets' prices in the stock markets. The share of the equities traded on Bucharest Stock Exchange, in total assets owned by pension funds was 8,26 % at the end of 2011, the dynamics of the main indexes plays therefore an important role for the rates of returns obtained by pension funds. Moreover, the *unemployment risk*, that reduces the volume of contributions to the pension funds; cutting the levels of salaries, affects also the volume of contributions to the pension funds.

Although 2011 was announcing itself like a year of economic recovery worldwide, the end of the year has forced the rating agencies to reduce their forecasts concerning the economic growth registered for the whole year. Moreover, the attention of many investors and rating agencies has focused primarily on the CEE countries area, including Romania. There are still efforts necessary to be made in order to ensure a functional financial market for the growing pension industry, especially in a turbulent international environment.

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