How the Polish pension fund reform will affect the fund’s investments

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In December 2013, the Polish parliament passed a governmental bill to reform the private pension fund sector in Poland despite receiving strong criticism from many economists and experts and ignoring warnings that that the bill could breach the Polish constitution. Even though the constitutionality of the bill will be examined by the Polish Constitutional Tribunal, this will not prevent the bill from entering into force at the beginning of February, and some of its provisions from doing so as early as mid-January 2014. The effects of the bill will be seen immediately with the outflow of more than half of the assets held by open pension funds to the Polish state, a move which some commentators openly call “nationalisation”. It is expected that the asset transfer, along with other changes that the bill will introduce, will reshape the landscape of the Polish capital market, making open pension funds a significantly different player than they used to be.

How open pension funds’ assets will be affected

The bill will require open pension funds (OFEs), which have so far collectively been the largest private investor on the Warsaw Stock Exchange, to transfer 51.5% of their assets, primarily in treasury bonds and treasury bills (worth around PLN 127 billion), to the state’s Social Security Institution (ZUS). It is estimated that the transfer will lead to a decrease of public debt in Poland from around 55% GDP to 47% GDP and this is the main short-term purpose of the reform, rather than providing improved financial security for retirees.

Further outflow of funds from OFEs or lack of inflow will, for example, result from the following factors:

- gradual transfer of each person’s retirement funds managed by OFE to ZUS, which will start ten years before reaching retirement age;
- automatic transfer of retirement contributions to ZUS, instead of OFE, unless an individual OFE member files a declaration (first time-slot will be between 1 April and 31 July 2014) requesting his/her contributions be transferred to OFE;
- decrease of the maximum fee OFE can charge from contributions (oplata dystrybucyjna) from 3.5% to 1.75%;
- value of certain categories of assets in OFEs portfolio (ie investment certificates issued by closed-end funds, units of open-ended funds or specialised open-ended funds, or units issued by foreign collective investment undertakings of the closed or open-ended type) will not be included in the overall value of total net assets managed by OFE, which means that OFEs may not charge a management fee (oplata za zarządzanie) from these assets.

51.5% of the net asset value as of 31 January 2014

this part of OFEs’ assets will be transferred to ZUS in February 2014.
How open pension funds will be able to invest their funds

The reform will also lead to a change in the composition of assets’ portfolios managed by OFEs (see the structure chart as of November 2013 below) not only due to the forced transfer of assets to ZUS but also due to new rules applicable to OFE investment activities.

Structure of OFEs portfolio as of November 2013.
NAV of OFEs as of November 2013 was over PLN 305 bln
Source: KNF website
The key investment rules applicable to OFEs will include:

**Prohibition of investment in government’s debt**
- OFEs will not be allowed to invest in government bonds, treasury bills and other debt instruments issued or guaranteed by the State Treasury, National Bank of Poland, governments or central banks nor in bonds, mortgage bonds and bank securities issued by Bank Gospodarstwa Krajowego (BGK), which are guaranteed by the State Treasury.

**Minimum level of investment in stocks**
- OFEs will be able to invest in shares of companies listed on regulated markets in Poland or abroad and bonds convertible into such shares, listed pre-emptive rights and listed rights to shares as well as shares, pre-emptive rights and rights to shares offered in a public offering in Poland or in EU, OECD or EEA member states. These investments will need to be kept above or at the level of 75% of total assets managed by a given OFE in 2014, 55% in 2015, 35% in 2016 and 15% in 2017. OFEs will not be able to invest in shares listed on alternative markets (eg NewConnect market in Warsaw).

**Investments in non-PLN denominated assets**
- Maximum level of OFEs’ investments in assets not denominated in PLN will be gradually increased: 10% until the end of 2014, 20% in 2015 and 30% from 2016. This legislative change aims to implement the judgment of the European Court of Justice in case C-277/09: European Commission v Republic of Poland where the Court found Polish law concerning limiting and discouraging pension funds investments outside Poland to be in breach of the EU’s free movement of capital principle.

**Investment diversification**
- Not more than 10% of total assets can be invested in the securities of one issuer or issuers which are related entities. Other investment limits also apply to particular categories of assets of one issuer or issuers which are related entities (see below).

Moreover, the following investment limits will apply to particular categories of OFEs’ investments:

- Municipal bonds and other municipal debt securities (including those issued by the city of Warsaw), offered in a public offering.
- Municipal bonds and other debt securities issued by regional and local authorities of EU, OECD or EEA member states, offered in a public offering.
- Corporate bonds with their nominal value and potential interest secured, offered in a public offering in Poland.
- Corporate bonds and other corporate debt securities with their nominal value and potential interest secured, offered in a public offering in EU, OECD or EEA member states
- Mortgage bonds
- Debt securities issued by one credit institution with its seat in EU, OECD or EEA member states, which is subject to a special public supervision aimed at protecting the holders of securities, provided that the amounts collected from the issue of these securities are invested in assets which, until their redemption, ensure repayment of money to which their holders are entitled under the securities and in the event of an issuer’s insolvency – ensure the priority of repayment.

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1 The Polish Council of Ministers shall issue an ordinance setting out the maximum limits of assets which OFEs will be able to invest in particular categories of investments. The maximum limits shall not however exceed the levels indicated in this document.
- Bank deposits in PLN held in licensed banks or credit institutions which are seated and pursue business activity in member states of the EU, OECD or EEA*

- Bank deposits in currencies of EU, OECD or EEA member states held in licensed banks or credit institutions which are seated and pursue business activity in member states of the EU, OECD or EEA. The currency purchase is only permitted to settle the fund’s current obligations arising from the acquisition or sale of assets according to the fund’s investment policy*

* However, for bank deposits in PLN and other currencies as indicated above - not more than 5% of total assets can be located in one bank or credit institution or credit institutions which are related entities, although the limit cannot exceed 7.5% for a single chosen bank or credit institution or a group of banks or credit institutions which are related entities

- Municipal bonds and other municipal debt securities not offered in a public offering

- Municipal bonds and other debt securities issued by the regional and local authorities of EU, OECD or EEA member states not offered in a public offering.

- Revenue bonds referred to in the Polish Act on Bonds of 29 June 1995

- Debt securities under which the issuer’s liability may be limited to the amount of income or value of an undertaking, from which bondholders may satisfy their claims with priority against other creditors of the issuer, provided that the debt securities are issued by certain categories of issuers having their seat in EU, OECD or EEA member states

- Units sold by open-ended funds and specialised open-ended funds**

- Units issued by collective investment undertakings of the open-ended type with a seat in member states of the EU, OECD or EEA, which meet certain specific criteria**

** However, not more than 5% of total assets can be invested in units sold by a single open-ended fund or a single specialised open-ended fund or units issued by a single collective investment undertakings of the open-ended type, provided that not more than 15% of total assets can be invested in open-ended funds and specialised open-ended funds managed by a single management company or collective investment undertakings of the open-ended type managed by a single management company.
- Investment certificates issued by closed-end funds
- Units issued by collective investment undertakings of the closed-end type with a seat in member states of the EU, OECD or EEA, which meet certain specific criteria

*** However, not more than 2% of total assets can be invested in investment certificates issued by one closed-end investment fund or units issued by one collective investment undertaking of the closed-end type

- Corporate bonds or other corporate debt securities with their nominal value and potential interest secured, which are not offered in a public offering in Poland
- Corporate bonds and other corporate debt securities with their nominal value and potential interest secured, which are offered in EU, OECD, or EEA member states not in a public offering
- Bonds and other debt securities under which companies listed on the Polish regulated market are liable (other than the corporate bonds subject to the 40% investment limit referred to above)
- Bonds and other debt securities under which companies listed on foreign regulated markets are liable (other than the corporate bonds subject to the 10% investment limit referred to above)
- Depository receipts admitted to trading on the Polish regulated market
- Depository receipts admitted to trading on the foreign regulated market

- Bonds and other debt securities which are the subject of a public offering in Poland (other than municipal bonds and corporate bonds which are subject to the 40% investment limit referred to above)
- Bonds and other debt securities which are the subject of a public offering in EU, OECD or EEA member states (other than municipal bonds and corporate bonds which are subject to the 40% investment limit referred to above)
- Investment certificates or bonds issued by one securitisation fund and units or bonds issued by one collective investment undertaking of the closed-end type with a seat in member states of the EU, OECD or EEA, for the purpose of collecting money to acquire claims or rights to certain claims
What is the open pension funds’ future?

The reform of open pension funds will change the landscape of the Polish capital market. Certainly, with the outflow of more than half of the assets under OFE management at the beginning of February 2014, the funds’ investment potential will significantly decrease, making them a much smaller player on the Polish capital market. OFE’s with less money to spend mean that issuers looking for capital on the market may face more difficulties selling their securities at a satisfactory price or selling them at all, which may in turn shift their attention to foreign investors with potentially much deeper pockets. OFE’s role as the liquidity provider on the Warsaw Stock Exchange will definitely not be that prominent.

The pension fund reform has already triggered some changes in the structure of OFE portfolios. In anticipation of the forthcoming legislative changes, OFEs have started to remodel their portfolios by selling part of their stocks. Knowing that they will not be allowed to invest in government bonds, which have so far been the main component in the total value of their assets, they have also turned their attention to corporate bonds. Certainly, OFEs will need to look at the new rules of investing future pensioners’ contributions, ensuring the security of the assets under their management by diversifying their portfolios, no matter how small these assets are compared to the “old times”. They have been given until the beginning of July 2014 to adjust their statutes to the new investment rules.

The scale of OFE reform will be seen more clearly at the end of July 2014, ie with the expiry of the first deadline for filing individual declarations by OFE members who want to keep their retirement contributions with the OFEs and prevent their automatic transfer to ZUS. It will not be easy to convince OFE members to “stay with the OFE”, especially given the new law’s prohibition on advertising open pension funds, which will last (not by coincidence) until the end of July 2014. Of course, the more declarations filed means more pensioners’ money under the OFE’s management, which is something the market will definitely welcome. However, whether this will lessen the reform’s impact on OFEs remains to be seen.

The last thing to note is that immediately after the Polish President signed the governmental bill reforming the pension fund system, he filed an application to the Polish Constitutional Tribunal to examine the bill’s constitutionality. The Tribunal has surely been assigned a difficult task, especially given the context in which the reform has been introduced, i.e. the security of the public financial system. Bearing this in mind, one is almost certain that once the OFE’s assets are transferred to the Polish state, they are gone for good.

If you have any questions or queries regarding the above publication, please do not hesitate to contact us.