# Long-Term and Pension Savings

## The Real Return

2020 Edition


BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

# Pension Savings: The Real Return

## 2020 Edition

**A Research Report by BETTER FINANCE**


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# Acronyms

| | |
|---|---|
| AIF | Alternative Investment Fund |
| AMC | Annual Management Charges |
| AuM | Assets under Management |
| BE | Belgium |
| BG | Bulgaria |
| Bln | Billion |
| BPETR | ‘Barclay’s Pan-European High Yield Total Return’ Index |
| CAC 40 | ‘Cotation Assistée en Continu 40’ Index |
| CMU | Capital Markets Union |
| DAX 30 | ‘Deutsche Aktieindex 30’ Index |
| DB | Defined Benefit plan |
| DC | Defined Contribution plan |
| DE | Germany |
| DG | Directorate General of the Commission of the European Union |
| DK | Denmark |
| DWP | United Kingdom’s Governmental Agency Department for Work and Pensions |
| EBA | European Banking Authority |
| EE | Estonia |
| EEE | Exempt-Exempt-Exempt Regime |
| EET | Exempt-Exempt-Tax Regime |
| ETF | Exchange-Traded Fund |
| EIOPA | European Insurance and Occupational Pensions Authority |
| ES | Spain |
| ESAs | European Supervisory Authorities |
| ESMA | European Securities and Markets Authority |
| EU | European Union |
| EURIBOR | Euro InterBank Offered Rate |
| EX | Executive Summary |
| FR | France |
| FSMA | Financial Services and Market Authority (Belgium) |
| FSUG | Financial Services Users Group - European Commission’s Expert Group |
| FTSE 100 | The Financial Times Stock Exchange 100 Index |
| FW | Foreword |
| GDP | Gross Domestic Product |
| HICP | Harmonised Indices of Consumer Prices |
| IBEX 35 | Índice Bursátil Español 35 Index |
| IKZE | ‘Indywidualne konto zabezpieczenia emerytalnego’ – Polish specific Individual pension savings account |
| IRA | United States specific Individual Retirement Account |

| | |
|---|---|
| IT | Italy |
| JPM | J&P Morgan Indices |
| KIID | Key Investor Information Document |
| LV | Latvia |
| NAV | Net Asset Value |
| Mln | Million |
| MSCI | Morgan Stanley Capital International Indices |
| NL | Netherlands |
| OECD | The Organisation for Economic Co-Operation and Development |
| OFT | United Kingdom's Office for Fair Trading |
| PAYG | Pay-As-You-Go Principle |
| PIP | Italian specific 'Individual Investment Plan' |
| PL | Poland |
| PRIIP(s) | Packaged Retail and Insurance-Based Investment Products |
| RO | Romania |
| S&P | Standard & Poor Indexes |
| SE | Sweden |
| SK | Slovakia |
| SME | Small and Medium-sized Enterprise |
| SPIVA Scorecard | Standard & Poor Dow Jones' Indices Research Report on Active Management performances |
| TEE | Tax-Exempt-Exempt Regime |
| TCR/TER | Total Cost Ratio/ Total Expense Ratio |
| UCITS | Undertakings for the Collective Investment of Transferable Securities |
| UK | United Kingdom |

# Country Case: Latvia

## Summary

Funded pension schemes have experienced negative returns even the portfolio of pension funds in mandatary pension pillar is conservatively oriented. Pillar II pension funds recorded on average solid annual nominal return of 12.59%, while Pillar III funds delivered also on average positive nominal return of 10.80%. A positive development could have been seen on the Pillar II market, where the introduction of passively managed funds contributed to further decrease of fees in 2019. The fees have decreased also in the Pillar III, however, complex fee structure and still higher fees of Pillar III pension funds play a significant role on the expected accumulated benefits.

## Introduction

Latvia is currently operating a multi-pillar pension system based on three pension pillars. The reform followed World Bank recommendations on creating a pension system with unfunded PAYG and funded pension pillars. Since 2001, the Latvian multi-pillar pension system includes:

- Pillar I (state compulsory PAYG pension scheme);
- Pillar II (mandatory state funded pension scheme) which is financed by a part of the social insurance contributions diverted from Pillar I;
- Pillar III (voluntary private pension scheme).

The introduction of the multi-pillar pension system has aimed its overall functionality on a different approach to each pension pillar operation, but with the overall objective of ensuring an adequate pension for individuals under the demographic risks of an aging society, as well as the pension system's overall future financial stability.

The reform of the Latvian pensions system started in 1995, when it was decided to implement the three-pillar pension system. Firstly, the shift from the old Soviet-styled PAYG pension system to the notional defined contribution pension scheme (NDC PAYG Pillar I) was carried out. The new law on state pensions was adopted by the Parliament in November 1995 and came into force on 1 January 1996. The state mandatory-funded pension scheme (Pillar II) started operating in July 2001. The private pension funds (Pillar III) have been operating since 1998.[227]

[227] Groduma, M. 2002. Social insurance in Latvia: Seeking balance between financial stability and equity. In: European regional meeting "New and revised approaches to social protection in Europe". Budapest, 13 - 15 November 2002. [Online] Available: http://www.issa.int/html/pdf/budapest02/2groduma.pdf

From the point of view of individual savers, the Latvian pension system combines two aspects: personal interest in building wealth (based on a level of contributions and the length of the saving period) and intergenerational solidarity.

The Latvian NDC PAYG-based pension Pillar I has been effectively introduced by a partial reform in January 1996 and represents a mandatory scheme for all economically active persons who make social insurance contributions calculated from a monthly gross salary (income). Paid contributions are used for the payment of old age pensions to the existing generation of pensioners. Pillar I is organized as a NDC scheme, where the notional value of career contributions is recorded on each contributor`s personal account. Prior to claiming pension benefits, the pension capital recorded on individual NDC account is recalculated in accordance with the laws and regulations at the time when the individual accesses his/her pension.

Pension Pillar II is in fact a state-organized 1bis pillar, meaning that part of the individually paid social contributions are channeled to Pillar II and recorded on individual pension accounts. Monthly contributions are invested into individually chosen investment plans (pension funds) managed by private pension fund management companies. Pillar II was launched in July 2001 and completed the multi-pillar-based pension reform in Latvia.

Pillar III was launched in July 1998 and is organized as a private voluntary pension scheme. It accumulates individual contributions, as well as employer contributions made on the behalf of individual employees, to the selected voluntary pension fund.

Table LV1. Multi-pillar pension system in Latvia

| Pillar I | Pillar II | Pillar III |
|---|---|---|
| **State Pensions** | **State Funded pensions** | **Voluntary private pensions** |
| Mandatory | Mandatory | Voluntary |
| NDC PAYG | Funded | Funded |
| Financed by social insurance contributions | DC | DC |
| Benefits paid via State Social Insurance Agency | Financed by social insurance contributions | Privately managed two types of pension plans: |
| Publicly managed | Individual pension accounts | 1. open (individual), |
| | Privately (and publicly) managed pension funds | 2. closed (quasi occupational) |
| Coverage: generally all population | Coverage: generally entire working population | Coverage: 23% of working population (in 2019) |

*Source: BETTER FINANCE own composition*

| Summary Return Table | | |
|---|---|---|
| Latvian Pillar II | | |
| Holding Period | Net Nominal Annualized Performance | Real Net Annualized Performance |
| 1-year | 10.57% | 8.43% |
| 3-years | 3.06% | 0.77% |
| 5-years | 2.63% | 0.75% |
| 7-year | 2.95% | 1.62% |
| 10-years | 3.57% | 1.83% |
| Since inception | 3.79% | -0.20% |
| Latvian Pillar III | | |
| Holding Period | Net Nominal Annualized Performance | Real Net Annualized Performance |
| 1-year | 10.80% | 8.66% |
| 3-years | 2.89% | 0.59% |
| 5-years | 2.86% | 0.98% |
| 7-year | 3.27% | 1.94% |
| 10-years | - | - |
| Since inception | 3.18% | 1.52% |

Source: *Tables LV8 and LV9*

## Pillar I – State Pension Insurance

State old-age pension (Pillar I) should guarantee the minimum income necessary for subsistence. It is based on an NDC PAYG principle of redistribution, i.e. the social tax paid by today's employees covers the pensions of today's pensioners. However, the amount of paid contributions for each saver are recorded on individual accounts.

The state old-age pension is paid out of the social insurance contributions. Total level of social insurance contributions is 34.09% of gross salary for employees (employers contributes 23.59% and employees 10.5%; self-employed persons pay 27.52%). Of the total contribution in 2019, 14% funded the Pillar I NDC pension and 6% was redirected to the individual's account under Pillar II. The remaining portion of contributions financed social security elements such as disability pension, sickness and maternity benefits, work injury benefits, parent's benefits, and unemployment benefits.

The **statutory retirement age** in Latvia in 2019 is 63 years and 6 months for both men and women. However, the law stipulates a gradual increase of the retirement age by three months every year until the general retirement age of 65 years is reached in 2025. Early pension is possible in Latvia if two conditions are met: 1) an individual in 2019 reaches the age of at least 61 years and 6 months (gradually rising by three months a year until 2025) and 2) an individual contributed for a period of at least 30 years.

**Old-age pension** is based on the insured's contributions, annual capital growth adjusted according to changes in the earnings index, and average life expectancy. Old age pension is calculated by considering two parameters:

1. K - accumulated life-time notional pension capital, which is an accrued amount of paid contributions since the introduction of NDC system (1 January 1996) until the pension granting

month. However, during the transition period to a full the NDC system, these two aspects are also taken into account:

   a. average insurance contribution wage from 1996 until 1999 (inclusive);
   b. insurance period until 1 January 1996;

2. G – cohort unisex life-expectancy at the time of retirement.

Annual old-age pension (P) is calculated as follows:

$$P = \frac{K}{G}$$

It can be said that the Latvian NDC PAYG Pillar I has shifted in a direction where the average gross replacement ratio is lower than 35%. The average income replacement ratios for old-age pension in Latvia are shown in the table below.

| Table LV2. Latvian NDC PAYG pillar statistics | | | | | |
|---|---|---|---|---|---|
| | Average Old-age pensions | Average Gross Monthly Wages and Salaries | Gross Replacement Ratio | Average Net Monthly Wages and Salaries | Net Replacement Ratio |
| 2003 | 92 | 274 | 34% | 196 | 47% |
| 2004 | 101 | 300 | 34% | 214 | 47% |
| 2005 | 115 | 350 | 33% | 250 | 46% |
| 2006 | 137 | 430 | 32% | 308 | 44% |
| 2007 | 158 | 566 | 28% | 407 | 39% |
| 2008 | 200 | 682 | 29% | 498 | 40% |
| 2009 | 233 | 655 | 36% | 486 | 48% |
| 2010 | 250 | 633 | 39% | 450 | 56% |
| 2011 | 254 | 660 | 38% | 470 | 54% |
| 2012 | 257 | 685 | 38% | 488 | 53% |
| 2013 | 259 | 716 | 36% | 516 | 50% |
| 2014 | 266 | 765 | 35% | 560 | 48% |
| 2015 | 273 | 818 | 33% | 603 | 45% |
| 2016 | 280 | 859 | 33% | 631 | 44% |
| 2017 | 289 | 926 | 31% | 676 | 43% |
| 2018 | 314 | 1004 | 31% | 742 | 42% |
| 2019 | 340 | 1076 | 32% | 793 | 43% |

*Source: Own calculations based on Central Statistical Bureau of Latvia 2019*

A **Minimum old-age pension** mechanism is effective in Latvia. The minimum amount of the monthly old-age pension cannot be less than the state social security benefits (€80 monthly since January 2020) with an applied coefficient tied to the years of service (insurance period):

1. persons with insurance period up to 20 years - 1.1;
2. persons with insurance period from 21 to 30 years - 1.3;
3. persons with insurance period from 31 to 40 years - 1.5;
4. persons with insurance period starting from 41 years - 1.7.

The minimum old-age pension is calculated using the basic state social security benefit multiplied by the respective coefficient that is tied to the number of service (working) years (see table below).

| Table LV3. Minimum Old-age Pension in Latvia | | |
|---|---|---|
| Years of service (Insurance period) | Minimum old-age pension until December 2019 (in €) | Minimum old-age pension since January 2020 (in €) |
| Insurance length up to 20 years | 70.43 | 88.00 |
| Insurance length from 21 to 30 years | 83.24 | 104.00 |
| Insurance length starting from 31 to 40 years | 96.05 | 120.00 |
| Insurance length starting from 41 years | 108.85 | 136.00 |

*Source: Own elaboration based on Ministry of Welfare data, 2020*

## Pillar II –State Funded Pensions

Pillar II of the pension scheme was launched on 1 July 2001. As of that date, a portion of every individual's social contributions are invested into the financial market and accumulated on their Pillar II personal account. Everyone who is socially insured is entitled to be a participant of the Pillar II scheme as long as the person was not older than 50 years of age on 1 July 2001. Participation in the 2$^{nd}$ tier is compulsory for those who had not reached the age of 30 on 1 July 2001 (born after 1 July 1971).

Gradually all employees will participate in Pillar II. Persons who were between the ages of 30 and 49 (born between 2 July 1951 and 1 July 1971) at the time when the scheme was launched could and still can join the system voluntarily. Administration of Pillar II contributions are made by the State Social Insurance Agency, which collects and redirects 20% old-age pension insurance contributions between the NDC and FDC pillar pension scheme individual accounts. According to the Law on State Funded Pension, the State Social Insurance Agency also performs additional tasks connected to the Pillar II administration.

The Ministry of Welfare, according to the Law on State Funded Pension, performs the supervision of the funded pension scheme and has the right to request and receive an annual account from the State Social Insurance Agency regarding the operation of the funded pension scheme.

Total redistribution of old-age pension contributions between Pillar I and Pillar II of the pension scheme are shown in the table below.

| Table LV4. Redistribution of the old-age pension contributions between pillar I and pillar II | | |
|---|---|---|
| Years | Pillar I (NDC) | Pillar II (FDC) |
| 2001-2006 | 18% | 2% |
| 2007 | 16% | 4% |
| 2008 | 12% | 8% |
| 2009-2012 | 18% | 2% |
| 2013-2014 | 16% | 4% |
| 2015 | 15% | 5% |
| 2016 and ongoing | 14% | 6% |

*Source: State Social Insurance Agency*

Contributions into Pillar II were raised continuously with the adopted reforms. However, during the financial crisis, the contributions into Pillar II were reduced to 2% with gradual growth since 2012. It should be mentioned that the largest part of contributions (8% of salary) had flown into the pension fund in 2008, right at the top and before the crash of financial markets. This has significantly influenced the performance of funds, which is analyzed in the sub-section dedicated to Pension Returns. Investing is performed by a third party: licensed fund managers.

Upon retiring, Pillar II participants will be able to make a choice: either add the accumulated pension capital to Pillar I and receive both pensions together or to entrust the capital accumulated in Pillar II to the insurance company of their choice and buy a single annuity.

Several changes have been made in the management of accumulated savings on personal accounts of Pillar II participants. Until 1 January 2003, there was only one public fund manager for the funds of Pillar II, the State Treasury. They invested the funds exclusively into the Latvian state bonds and into the deposits of the largest and safest Latvian banks. As of 1 January 2003, the private fund managers were involved, but today participants of Pillar II are in the position to choose their fund manager themselves. The private fund managers offer to invest the pension capital and into corporate bonds, shares and foreign securities. Participants of the system are entitled to change their fund manager once a year and, in addition, investment plans within the frame of one fund manager can be changed twice a year. Operation of private fund managers is supervised by the Finance and Capital Market Commission.

In 2019, the Parliament has adopted changes in Pillar II, where since January 2020, a saver could define any person, to which the accumulated capital on personal account can be inherited directly.

## Pillar III – Voluntary private pensions

Voluntary private pension scheme, or pension Pillar III, was launched in July 1998, and it gives the opportunity to create additional voluntary savings in addition to the state organized Pillar I and II. Contributions that individuals and/or the employer regularly pay into the pension fund are invested in different securities, depending on the chosen investment strategy.

The Law on Private Pension Funds foresees that Latvian commercial banks, insurance companies and legal persons have the right to establish a private fund. Assets are invested by private pension funds with the aim not only to maintain the value of savings, but to increase it over a long-time period. There are generally two types of voluntary private pension funds in Latvia:

1. open pension funds (15 operational in Latvia in 2019)
2. closed pension funds (only one operating in Latvia in 2019).

Pension scheme participants can subscribe to a pension scheme by entering directly into a contract with an open pension fund or via their employer. Pension scheme participants can participate in a pension scheme through the intermediation of their employer if the employer has entered into a collective contract with an open or closed pension fund. A collective contract with a closed pension fund may be entered into only in such cases when the relevant employer is also one of the founders (stockholders) of the same closed pension fund. Acknowledging the fact that employers might enter into collective agreement with employees and establish the pension scheme, voluntary private pension funds might be recognized as a collective pension scheme.

According to the Law on Private Pension Funds, accumulated pension capital in private pension funds can be accessed by individuals when they reach the age of 55. In order to receive the Pillar III accrued pension, an individual must submit an application to the respective pension fund. The supervisory authority for all voluntary private pension funds in Latvia is the Financial and Capital Markets Commission.

# Pension Vehicles

## Pillar II – State Funded Pensions

Pension funds are the only pension vehicles allowed by the Law of State Funded Pensions for state-funded pension scheme. The law states that a funded pension scheme is a state-organized set of measures for making contributions, administration of funds contributed and payments of pensions which (without increasing the total amount of contributions for old age pensions) - provides an opportunity to acquire additional pension capital by investing part of the pensions' contributions in financial instruments and other assets in accordance with the procedures specified in the Law.

Currently (as of 31 December 2019), 31 state-funded pension schemes have been operational on the Pillar II market. Three new equity based funds emerged during 2019, most of them designed as target-date funds for savers at certain age. There is no specific legal recognition of types of pension funds based on their investment strategy, nor any legal requirement to provide a specific investment strategy for pension funds. It is up to a pension fund manager to provide an in-demand type of pension fund in order to succeed on the market. However, every fund manager is required to develop a systematic set of provisions, according to which funds are managed. They are presented in a prospectus of the relevant pension fund and in a key investor information document (KIID, specific for UCITS funds, but with particular features) for participants of the scheme. The prospectus of a pension fund and the key information document for participants are an integral part of the contract entered into between the Agency and the manager of pension funds. Pension fund prospectus must clearly define the risk-reward profile and indicate proposed investment strategy of the respective expected portfolio structure.

Although there is no legal recognition of types of pension funds, they can be divided into three types based on their risk/return profiles:

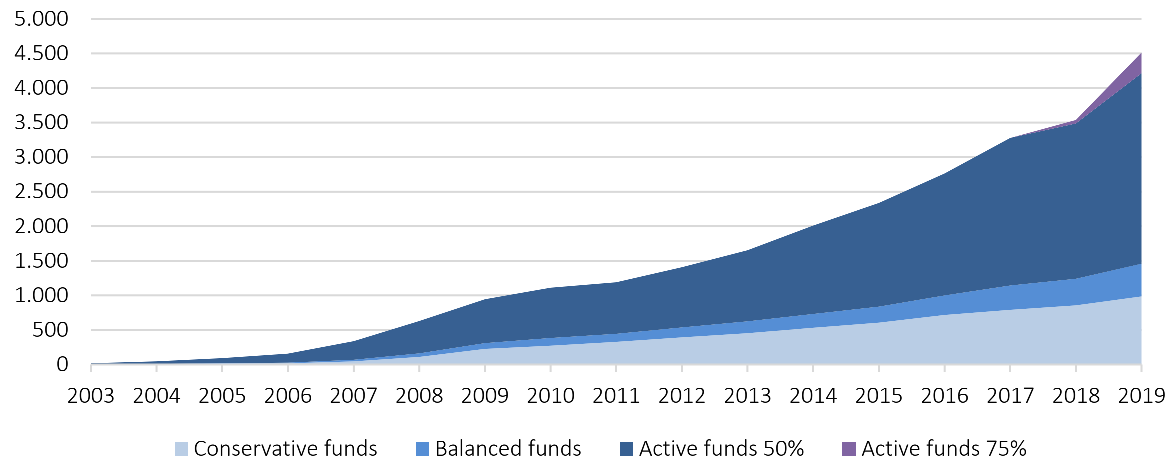
1. Conservative funds, with no equity exposure and a 100% share of bonds and money market instruments;
2. Balanced funds with bonds and money market instrument share of at least 50%; in addition, a maximum of 15% of the funds' balances can be invested in equities;
3. Active funds with an equity share (resp. investments in capital securities, alternative investment funds or such investment funds that may make investments in capital securities or other financial instruments of equivalent risk) of up to 75% (since 2018) and no limits on investments in bonds and money market instruments.

The legislation sets relatively strict quantitative investment limits for pension funds, trying to supplement the prudent principle.

Overall asset allocation in Latvia is fairly conservative despite the possibility of choosing a plan according to risk preference. The chart below presents the amount of Assets under Management for types of pension funds according to their investment strategy.

Contrary to many other CEE countries running mandatory pension systems, there is no requirement for pension funds to guarantee a certain minimum return. On the contrary, doing so is explicitly forbidden.

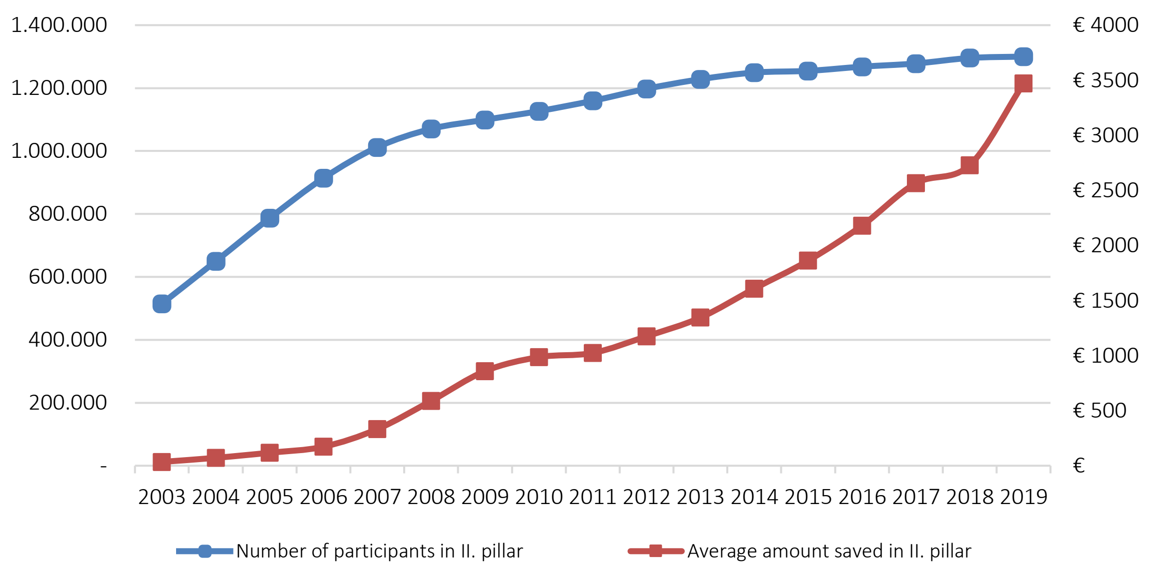
Graph LV5. Assets under Management in State Funded Pension Scheme pension vehicles (in mln. €)




*<u>Source</u>: Own calculations based on Manapensjia LV*

As the State Funded Pension scheme is mandatory for all economically active individuals in Latvia, the number of savers (as well as the average amount of accumulated assets on individual accounts) is rising. The chart below indicates that the Pillar II market is starting to be saturated in terms of the number of participants.

Graph LV6. Number of participants and average size of individual accounts in Latvian II pillar




*<u>Source</u>: Own calculations based on Manapensjia LV*

The number of Pillar II participants has almost encompassed the entire working population. Further growth of Pillar II savings will therefore be driven by the amount of contributions and pension funds´ performance.

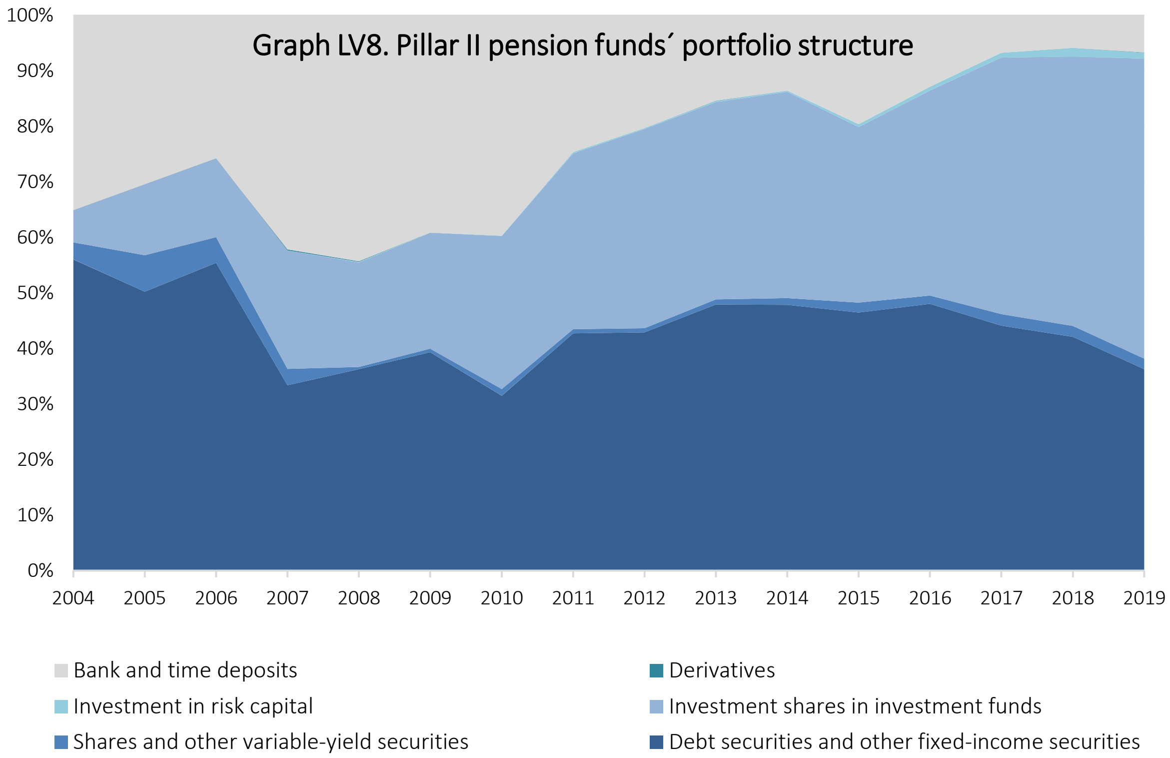
There are 31 pension funds operating by 9 providers (table below).

Table LV7. List of State Funded Pension Funds

| Pension Fund Name | Investment style of the pension plan | Inception day |
|---|---|---|
| CBL Aktīvais ieguldījumu plāns | Active 50 | 07/01/2003 |
| CBL Universālais ieguldījumu plāns | Conservative | 07/01/2003 |
| Luminor Sabalansētais ieguldījumu plāns | Balance | 21/02/2005 |
| Ieguldījumu plāns „INVL Ekstra 47+” | Active 50 | 08/08/2006 |
| Ieguldījumu plāns „INVL Komforts 53+” | Balance | 08/08/2006 |
| Ieguldījumu plāns „INVL Konservatīvais 58+” | Conservative | 07/01/2003 |
| Luminor aktīvais ieguldījumu plāns | Active 50 | 02/02/2009 |
| Luminor konservatīvais ieguldījumu plāns | Conservative | 02/02/2009 |
| PNB Konservatīvais ieguldījumu plāns "DAUGAVA" | Conservative | 07/01/2003 |
| PNB Aktīvais ieguldījumu plāns "GAUJA" | Active 50 | 14/10/2003 |
| PNB Sabalansētais ieguldījumu plāns "VENTA" | Balance | 14/10/2003 |
| SEB aktīvais plāns | Active 50 | 07/01/2003 |
| SEB Eiropas plāns | Active 50 | 07/01/2003 |
| SEB konservatīvais plāns | Conservative | 26/05/2003 |
| SEB Latvijas plāns | Conservative | 07/01/2003 |
| SEB sabalansētais plāns | Balance | 07/01/2003 |
| Swedbank pensiju ieguldījumu plāns "Dinamika" | Active 50 | 07/01/2003 |
| Swedbank pensiju ieguldījumu plāns "Stabilitāte" | Conservative | 07/01/2003 |
| Ieguldījumu plāns "INDEXO Izaugsme 47-57" | Active 50 | 21/06/2017 |
| ABLV ACTIVE INVESTMENT PLAN | Active 50 | 02/08/2017 |
| CBL dzīves cikla plāns Millennials | Active 75 | 24/04/2018 |
| Ieguldījumu plāns "INDEXO Jauda 16-50" | Active 75 | 18/01/2018 |
| Ieguldījumu plāns "INVL MAKSIMĀLAIS 16+” | Active 75 | 05/11/2018 |
| Luminor Progresīvais ieguldījumu plāns | Active 75 | 06/04/2018 |
| SEB dinamiskais plāns | Active 75 | 05/03/2018 |
| SEB indeksu plāns | Active 75 | 05/03/2018 |
| Swedbank ieguldījumu plāns 1990+ | Active 75 | 09/02/2018 |
| Ieguldījumu plāns "INDEXO Konservatīvais 55+" | Conservative | 04/04/2018 |
| Swedbank ieguldījumu plāns 1970+ | Active 75 | 08/01/2019 |
| Swedbank ieguldījumu plāns 1980+ | Active 75 | 08/01/2019 |
| CBL Ilgtspējīgu iespēju ieguldījumu plāns | Active 75 | 13/05/2019 |

*Source: Own composition based on Manapensjia LV*

The portfolio structure of Pillar II pension funds (figure below) shows that debt and other fixed income securities as well as investment funds (UCITS funds) remain the dominant investments. There is only limited direct investment into equities.




*Source: Own elaboration based on Financial and Capital Market Commission data, 2020*

## Pillar III – Voluntary private pensions

There are two types of private pension funds in the Latvian voluntary private pension pillar:

1. closed, for fund founders' (corporate) staff;
2. open, of which any individual may become a participant, either directly or through an employer.

This distinction between private pension funds is rather significant, as closed private pension funds (only one operating in Latvia in 2019) could be recognized as a typical occupational pension fund. However, open private pension funds are more personal ones.

The law on Private Pension Funds provides a wide range of possibilities to organize and manage private pension funds. The law prescribes the accumulation of pension benefits (both in the specified contribution scheme and in the specified pay-out scheme), the types of private pension funds, the basis for activities thereof, the types of pension schemes, the rights and duties of pension scheme participants, the management of funds, the competence of holders of funds, and state supervision of such activities.

Pension vehicles (pension funds) can be created only by limited types of entities in Latvia, namely:

1. employers entering into a collective agreement with a pension fund, technically become founders of a closed pension fund;
2. for an open pension fund, two types of institutions can establish a fund:
    1) bank (licensed credit institution);
    2) life insurance company.

These founders usually hire a management company, who creates a different pension plan managed under one pension fund and manages the investment activities. Pension scheme assets can be managed only by the following commercial companies:

- a credit institution, which is entitled to provide investment services and non-core investment services in Latvia;
- an insurance company, which is entitled to engage in life insurance in Latvia;
- an investment brokerage company, which is entitled to provide investment services in Latvia;
- an investment management company, which is entitled to provide management services in Latvia.

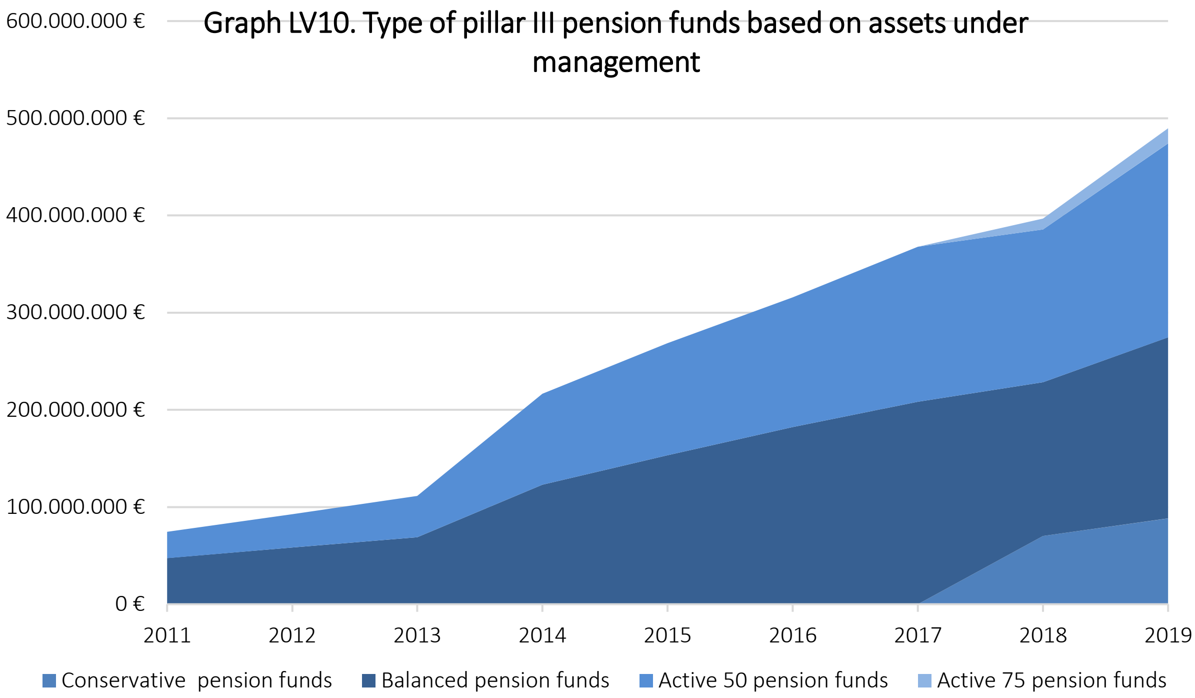
The level of transparency in providing publicly available data for private pension funds before the year 2011 is rather low. Therefore, the analysis of the market and main pension vehicles has been performed with publicly available data starting from 31 December 2011. Currently (as of 31 December 2019), 15 open private pension funds and one closed private pension fund exist on the market.

Table LV9. List of Pillar III Supplementary pension funds

| Pension Fund Name | Investment style of the pension plan | Inception day |
|---|---|---|
| Swedbank pensiju plāns Stabilitāte+25 | Conservative opened pension funds | 14/07/2003 |
| INVL KOMFORTS 53+ | Conservative opened pension funds | 23/10/1998 |
| CBL Sabalansētais | Balanced opened pension funds | 30/09/1999 |
| Luminor sabalansētais pensiju plāns | Balanced opened pension funds | 18/10/2011 |
| "SEB - Sabalansētais" pensiju plāns | Balanced opened pension funds | 31/07/2000 |
| INVL Klasika | Balanced opened pension funds | 07/03/2008 |
| INVL EKSTRA 47+ | Balanced opened pension funds | 08/10/2015 |
| CBL Aktīvais | Active opened pension funds | 21/03/2000 |
| INVL MAKSIMĀLAIS 16+ | Active opened pension funds | 08/10/2015 |
| "SEB Aktīvais" pensiju plāns | Active opened pension funds | 15/09/2004 |
| Swedbank pensiju plāns Dinamika+60 | Active pension funds | 01/08/2003 |
| Swedbank pensiju plāns Dinamika+100 | Active opened pension funds | 27/12/2006 |
| CBL Aktīvais USD | Active opened pension funds | 01/04/2006 |
| Swedbank pensiju plāns Dinamika+(USD) | Active opened pension funds | 14/07/2003 |
| Luminor progresīvais pensiju plāns | Active 75 opened pension funds | 18/10/2011 |
| "Pirmais Pensiju Plāns" | Closed pension fund | 01/12/1999 |

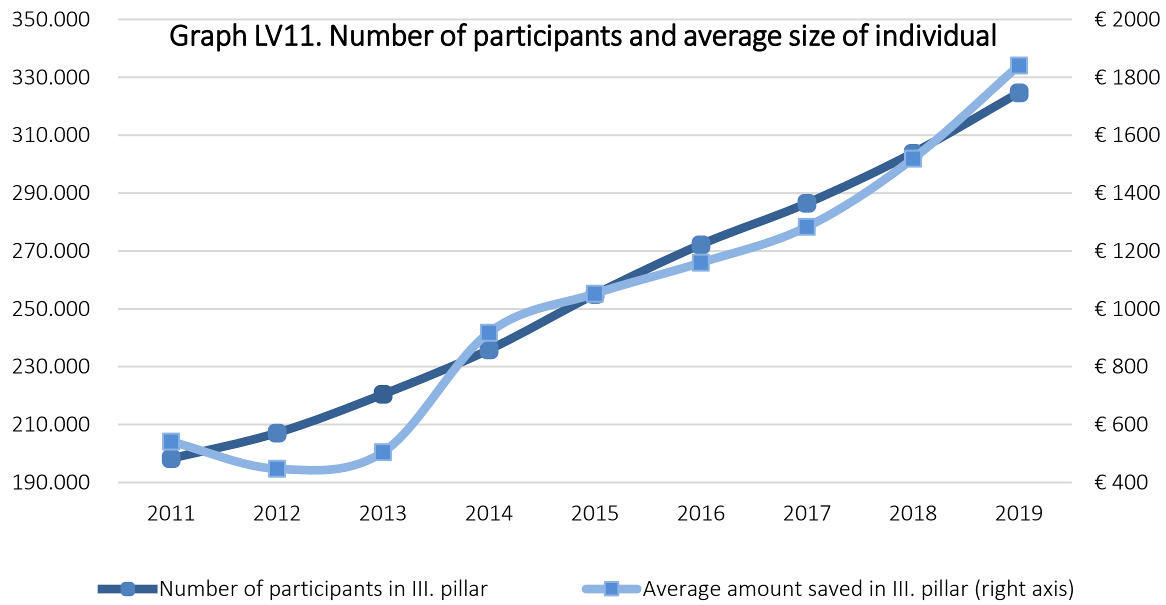
*Source: Own elaboration based on Financial and Capital Market Commission data, 2020*

The structure of the pension vehicles according to the type of the fund and investment strategy offered is presented in the figure below.




*Source: Own calculation based on Manapensija data*

The number of participants as well as the average amount saved in Pillar III saving accounts rises steadily. As of 31 December 2019, there has been 324,671 Pillar III saving accounts with an average amount of € 1,841 saved in them. The developments of these parameters are presented in the figure below.

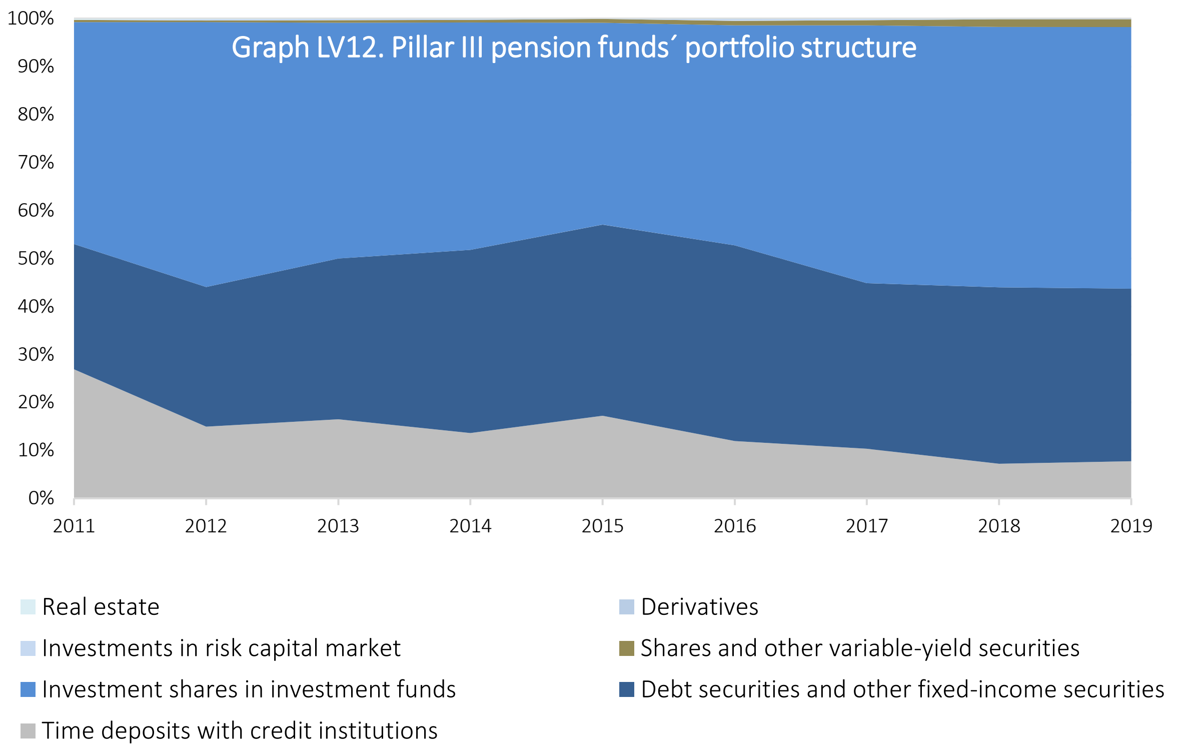



*Source: Own calculation based on Manapensija data*

It should be noted that balanced pension funds (5 funds) accounted for about 33% of market share based on AuM in 2019. Active funds – for which the investment strategy allows more equity investments - are gaining market share (from 25% in 2011 to 38.5% in 2019). Conservative funds due to the reclassification of one fund from balanced to conservative have market share of around 16% in 2019.

On the other hand, the only closed pension fund, (which has only 5% of market share based on the number of participants) accounts for almost 12.5% of market share based on assets under management (data as of 2019), meaning that the closed pension fund has the highest level of accumulated assets per participant. However, considering the decreasing trend in market share during the last years, the number of participants is not increasing, and the closed pension fund serves a relatively matured market.

The portfolio structure of Pillar III pension funds is presented in the figure below. Generally, Pillar III pension funds invest predominantly into debt securities, bank deposits and UCITS funds. Direct investment into equities, real estate or other long-term riskier investment constitute for less than 1% of total portfolio.




*Source: Own elaboration based on Financial and Capital Market Commission data, 2020*

## Charges

### Pillar II – State Funded Pensions

Latvia has adopted the cap on fees within Pillar II, which forces that the maximum amount of payment for the management of investment plan (including the fixed and variable parts of payment, calculating for the last 12-month period) to not exceed:

1) 1.50% of the average value of investment plan assets to the investment plans, where the investment plan prospectuses do not provide for any investments in the shares of commercial companies, other capital securities and other equivalent securities;

2) 2.00% of the average value of investment plan assets of all other investment plans.

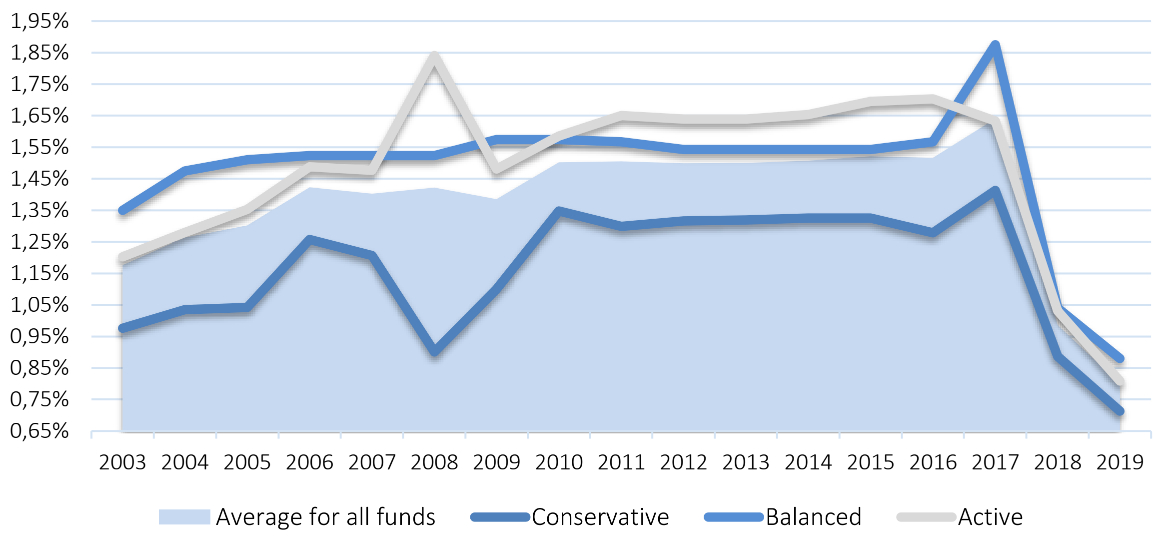
Fees that can be charged to pension funds by fund managers are recognized by law as having a fixed and variable part. The law stipulates that payment for the management of an investment plan shall include:

a) fixed component of payment, which is 1% of the average value of investment plan assets per year and includes payments to the manager of the funds, custodian, as well as payments to third persons, which are performed from the funds of the investment plans (except expenses which have arisen upon performing transactions by selling the assets of the investment plan with repurchase);

b) variable component of payment, which is remuneration to the manager of funds of the funded pension scheme for performance of investment plan, with its amount depends on the return of the pension plan.

Year 2019 brought further decrease in the fees. Introduction of low-cost passively managed pension funds has spurred price battle and the charges dropped further in 2019 to an average of 0.81% p.a.

Graph LV13. Pillar II Pension Funds' Charges




*Source: Own elaboration on Manapensjia LV*

## Pillar III – Voluntary private pensions

It cannot be said that such a positive trend seen in Pillar II charges is observed in Pillar III. Complex fee structure and high fees preserve in Latvian Pillar III even if slight decrease in custodian fees can be observed in Pillar III.

Voluntary private pension funds have typically lower level of transparency when it comes to fee policy. In most cases, only current fees and charges are disclosed. Historical data is almost impossible to track via publicly accessible sources. Charges of voluntary private pension funds for the last 5 years are presented in the table below. Administration cost, Fund Manager´s Commission, and Custodian bank´s commission are based on the assets under management. Funds managed by Nordea and Swedbank use mixed Administration costs, which are a combination of entry fees (fees on contributions paid) and ongoing charges (AuM based). CBL funds alos use a performance fee if the fund returns outperform the benchmark (12-month RIGIBID).

Table LV14. Voluntary Private Pension Funds´ Fees and Charges

| Voluntary Private Pension Funds | Type of the Charges | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| CBL Aktīvais | Administration Cost | 1.50% | 1.50% | 1.50% | 1.50% | 1.50% |
| | Fund Manager´s Commission | 0.9% | 0.9% | 0.9% | 0.9% | 0.8% |
| | Custodian bank´s commission | 0.2% | 0.2% | 0.2% | 0.2% | 0.15% |
| | Performance fee | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) |
| CBL Aktīvais USD | Administration Cost | 1.50% | 1.50% | 1.50% | 1.50% | 1.50% |
| | Fund Manager´s Commission | 0.9% | 0.9% | 0.9% | 0.9% | 0.8% |
| | Custodian bank´s commission | 0.2% | 0.2% | 0.2% | 0.2% | 0.15% |
| | Performance fee | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) |
| CBL Sabalansētais | Administration Cost | 1.50% | 1.50% | 1.50% | 1.50% | 1.50% |
| | Fund Manager´s commission | 0.75% | 0.75% | 0.75% | 0.75% | 0.7% |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.20% | 0.20% | - |
| | Performance fee | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) | 10% (RIGIBID) |

| | | | | | | |
|---|---|---|---|---|---|---|
| INVL KOMFORTS 53+ | Administration Cost | 2.00% | 2.00% | 2.00% | 0.50% | 0.50% |
| | Fund Manager´s commission | 0.70% | 0.70% | 0.70% | 0.99% | 0.99% |
| | Custodian bank´s commission | 0.50% | 0.50% | 0.1% | 0.1% | 0.1% |
| INVL Klasika | Administration Cost | 1.00% | 1.00% | 1.00% | 0.99% | 0.99% |
| | Fund Manager´s commission | 1.00% | 1.00% | 1.00% | 0.5% | 0.5% |
| | Custodian bank´s commission | 0.50% | 0.50% | 0.1% | 0.1% | 0.1% |
| INVL EKSTRA 47+ | Administration Cost | | 0.00% + 30% of contributions during the 1st year | 0 | 0.55% | 0.55% |
| | Fund Manager´s commission | | 0.00% | 0 | 0.5% | 0.50% |
| | Custodian bank´s commission | | 0.00% | 0 | 0.1% | 0.1% |
| | Fee from contributions during the first year of participation | | | 0.3 | 30.00% | 30.00% |
| INVL MAKSIMĀLAIS 16+ | Administration Cost | | 0.00% + 30% of contributions during the 1st year | 0 | 0.55% | 0.55% |
| | Fund Manager´s commission | | 0.00% | 0 | 0.5% | 0.5% |
| | Custodian bank´s commission | | 0.00% | 0 | 0.1% | 0.1% |
| | Fee from contributions during the first year of participation | | | 0.3 | 0.3 | 0.3 |
| Luminor progresīvais pensiju plāns | Administration Cost | 2% from each contribution + 0.75% per year from average assets | 2% from each contribution + 0.75% per year from average assets | 0.75% per year from average assets. | 0.75% per year from average assets. | 0.75% per year from average assets. |
| | Fund Manager´s commission | 1.60% | 1.60% | 0.016 | 1.6% | 1.6% |
| | Custodian bank´s commission | 0.15% | 0.15% | 0.15% | 0.07% | 0.07% |
| Luminor sabalansētais pensiju plāns | Administration Cost | 1% from each payment + 1% per year from average assets | 1% from each payment + 1% per year from average assets | 0,75% per year from average assets. | 0.75% per year from average assets. | 0.75% per year from average assets. |

| | | | | | | |
|---|---|---|---|---|---|---|
| | Fund Manager´s commission | 1.10% | 1.10% | 1.1% | 1.1% | 1.1% |
| | Custodian bank´s commission | 0.15% | 0.15% | 0.15% | 0.07% | 0.07% |
| "Pirmais Pensiju Plāns" | Administration Cost | 1.50% | 1.50% | 1.50% | 1.50% | 1.50% |
| | Fund Manager´s commission | 1.30% | 1.30% | 1.30% | 1.30% | 1.30% |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.20% | 0.20% | 0.20% |
| "SEB Aktīvais" pensiju plāns | Administration Cost | 1.50% | 1.50% | Pension fund`s administration costs 0.9-0.3%% (in accordance with the amount of savings at SEB pension fund) | Pension fund`s administration costs 0.9-0.3%% (in accordance with the amount of savings at SEB pension fund) | Pension fund`s administration costs 0.9-0.3% (in accordance with the amount of savings at SEB pension fund) |
| | Fund Manager´s commission | 0.90% | 0.90% | Fund manager`s commission 0.6% | Fund manager`s commission 0.6% | Fund manager`s commission 0.4-0.35% |

| | | | | | |
|---|---|---|---|---|---|
| | | | (The commission fee will be reduced by 25% if customer uses at least one other pension savings product offered by the SEB Group administrated by SEB Investment Management: life insurance with saving of funds for at least 10 years or Lifetime pension insurance. If the amount of customer's savings in SEB Pension Fund is 100 000 EUR or more, the commission rate for the asset manager is 0,35%). | (The commission fee will be reduced by 25% if customer uses at least one other pension savings product offered by the SEB Group administrated by SEB Investment Management: life insurance with saving of funds for at least 10 years or Lifetime pension insurance. If the amount of customer's savings in SEB Pension Fund is 100 000 EUR or more, the commission rate for the asset manager is 0,35%). | The commission fee will be reduced by 25% if customer uses at least one other pension savings product offered by the SEB Group administrated by SEB Investment Management: life insurance with saving of funds for at least 10 years or Lifetime pension insurance. |
| Custodian bank´s commission | 0.20% | 0.20% | 0.1% | 0.1% | 0.08% |
| Administration Cost | 1.50% | 1.50% | Pension fund`s administration costs 0.9-0.3% (in accordance with the amount of savings at SEB pension fund) | Pension fund`s administration costs 0.9-0.3% (in accordance with the amount of savings at SEB pension fund) | Pension fund`s administration costs 0.9-0.3% (in accordance with the amount of savings at SEB pension fund) |
| Fund Manager´s commission | 0.90% | 0.90% | Fund manager`s commission 0.6% | Fund manager`s commission 0.6% | Fund manager`s commission 0.4-0.35% |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | (The commission fee will be reduced by 25% if customer uses at least one other pension savings product offered by the SEB Group administrated by SEB Investment Management: life insurance with saving of funds for at least 10 years or Lifetime pension insurance. If the amount of customer's savings in SEB Pension Fund is 100 000 EUR or more, the commission rate for the asset manager is 0,35%. ) | (The commission fee will be reduced by 25% if customer uses at least one other pension savings product offered by the SEB Group administrated by SEB Investment Management: life insurance with saving of funds for at least 10 years or Lifetime pension insurance. If the amount of customer's savings in SEB Pension Fund is 100 000 EUR or more, the commission rate for the asset manager is 0,35%. ) | The commission fee will be reduced by 25% if customer uses at least one other pension savings product offered by the SEB Group administrated by SEB Investment Management: life insurance with saving of funds for at least 10 years or Lifetime pension insurance. |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.1% | 0.1% | 0.08% |
| Swedbank pensiju plāns Dinamika+(USD) | Administration Cost | 2% from payments + 0.6% from assets per year | 2% from payments + 0.6% from assets per year | 0.6% | 0.45% | 0.26% |
| | Fund Manager´s commission | 1.25% | 1.25% | 0.9% | 0.5% | 0.34% |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.18% | 0.1% | 0.09% |
| Swedbank pensiju plāns Dinamika+100 | Administration Cost | 2% from payments + 1% from assets per year | 2% from payments + 1% from assets per year | 0.6% | 0.45% | 0.26% |

| | | | | | | |
|---|---|---|---|---|---|---|
| | Fund Manager´s commission | 1.60% | 1.60% | 0.9% | 0.4% | 0.34% |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.1% | 0.1% | 0.09% |
| Swedbank pensiju plāns Dinamika+60 | Administration Cost | 2% from payments + 0.6% from assets per year | 2% from payments + 0.6% from assets per year | 0.6% | 0.45% | 0.26% |
| | Fund Manager´s commission | 1.25% | 1.25% | 0.009 | 0.4% | 0.34% |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.001 | 0.1% | 0.09% |
| Swedbank pensiju plāns Stabilitāte+25 | Administration Cost | 2% from payments + 0.6% from assets per year | 2% from payments + 0.6% from assets per year | 0.006 | 0.45% | 0.26% |
| | Fund Manager´s commission | 0.90% | 0.90% | 0.005 | 0.4% | 0.34% |
| | Custodian bank´s commission | 0.20% | 0.20% | 0.10% | 0.1% | 0.09% |

*Source: Own research based on Manapensjia LV*

When comparing the charges applied to the voluntary private pension funds and to state-funded pension funds, the level of charges in Pillar III pension funds are significantly higher and the structure of fees is more complex. This limits the overall understanding of the impact of fees on the pension savings for an average saver. The total cost ratio of Pillar III funds starts at 0.8% p.a. and can reach as high as 3% p.a on managed assets.

There are neither limitations nor caps on fees in the law. The legislative provisions only indicate that at least the following should be disclosed: general information on maximum fees and charges applied, procedures for covering the expenses of the scheme, information regarding maximum payments to the management of the pension scheme and to the manager of funds, and the amount of remuneration to be paid out to the holder of funds, as well as the procedures by which pension scheme participants shall be informed regarding such pay-outs of the scheme.

# Taxation

## Pillar II – State Funded Pensions

Latvia is applying an "EET" taxation regime for Pillar II with some specifications (deductions) to the payout regime taxation, where generally the "T" regime is applied for the pay-out phase in retirement.

Taxation of contributions

Contributions paid to the state funded pension scheme are made via social insurance contributions redirection. As such, these contributions are personal income tax deductible items, so the contributions are not subject to additional personal taxation.

Taxation of the Fund

The Corporate Income tax rate in Latvia is 15%. However, income or profits of the fund (investment fund as a legal entity) are not subject to Latvian corporate income tax at the fund level. Latvia applies a general principle for all investment and savings-based schemes to levy the income taxation on the final beneficiaries and not on the investment vehicles.

Taxation of pension benefits

Latvia has one of the lowest levels of income redistribution among EU countries. Personal income tax rate is 23% and the pension benefits paid from the NDC PAYG scheme (Pillar I) and state-funded pension scheme (Pillar II) are considered taxable income. As such, pension benefits are subject to personal income tax. Latvia applies a non-taxable minimum, which is recalculated and announced every year by Cabinet regulation.

### Pillar III – Voluntary private pensions

Latvian tax legislation stipulates the use of the "EET" regime (like Pillar II) for voluntary private pension schemes as well, where the contribution by individuals is treated in a slightly different way. Payments made to private pension funds established in accordance with the Republic of Latvia Law on Private Pension Funds or to pension funds registered in another Member State of the European Union or the European Economic Area State shall be deducted from the amount of annual taxable income, provided that such payments do not exceed 10 % of the person's annual taxable income. However, there is a limit on total income tax base deductible payments. The total of donations and gifts, payments into private pension funds, insurance premium payments and purchase costs of investment certificates of investment funds may not exceed 20% of the amount of the payer's taxable income.

## Pension Returns

### Pillar II – State Funded Pensions

Pension funds´ performance is closely tied to the portfolio structure defined by an investment strategy (as well as investment restrictions and regulations) applied by a fund manager. Investment regulations differ, depending on whether pension plans are managed by the State Treasury or by private companies. The State Treasury is only allowed to invest in Latvian government securities, bank deposits, mortgage bonds and deposit certificates. Moreover, it can only invest in financial instruments denominated in the national currency. In contrast, private managers are allowed to invest in a much broader range of financial instruments. The main investment limits include the following:

- 35% for securities guaranteed by a state or international financial institution;
- 5% for securities issued or guaranteed by a local government;

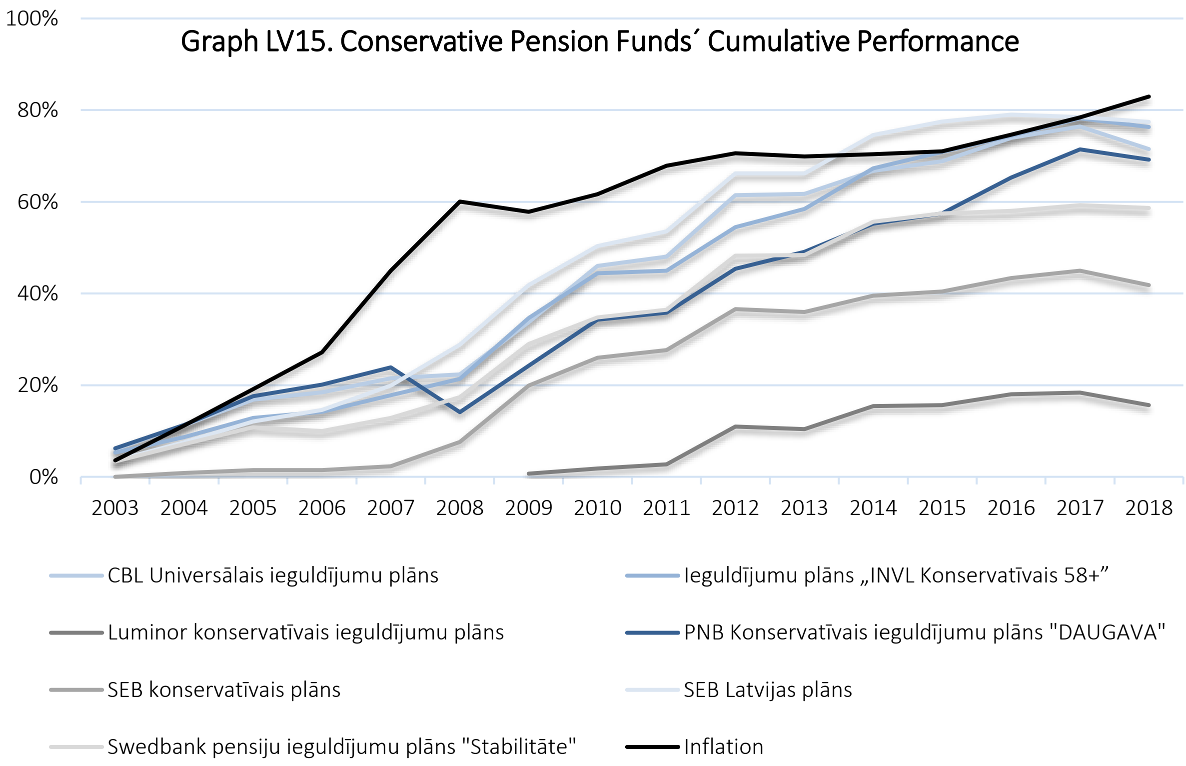
- 10% for securities of a single issuer, except government securities; for deposits at one credit institution (investments in debt and capital securities of the same credit institution and derivative financial instruments may not exceed 15%); and for securities issued by one commercial company (or group of commercial companies);
- 20% for investments in non-listed securities;
- 5% for investments in a single fund (10% of the net assets of the investment fund).

There is no maximum limit for international investments so long as pension funds invest in securities listed on stock exchanges in the Baltics, other EU member states, or the European Free Trade Area. However, the law stipulates a 70% currency matching rule. There is also a 10% limit for each non-matching currency. Investments in real estate, loans, and self-investment are not permitted.

All data presented on the pension funds' returns are presented in net values, i.e. after all fees charged to the fund portfolio. The graphs contain also inflation on an annual as well as cumulative basis.

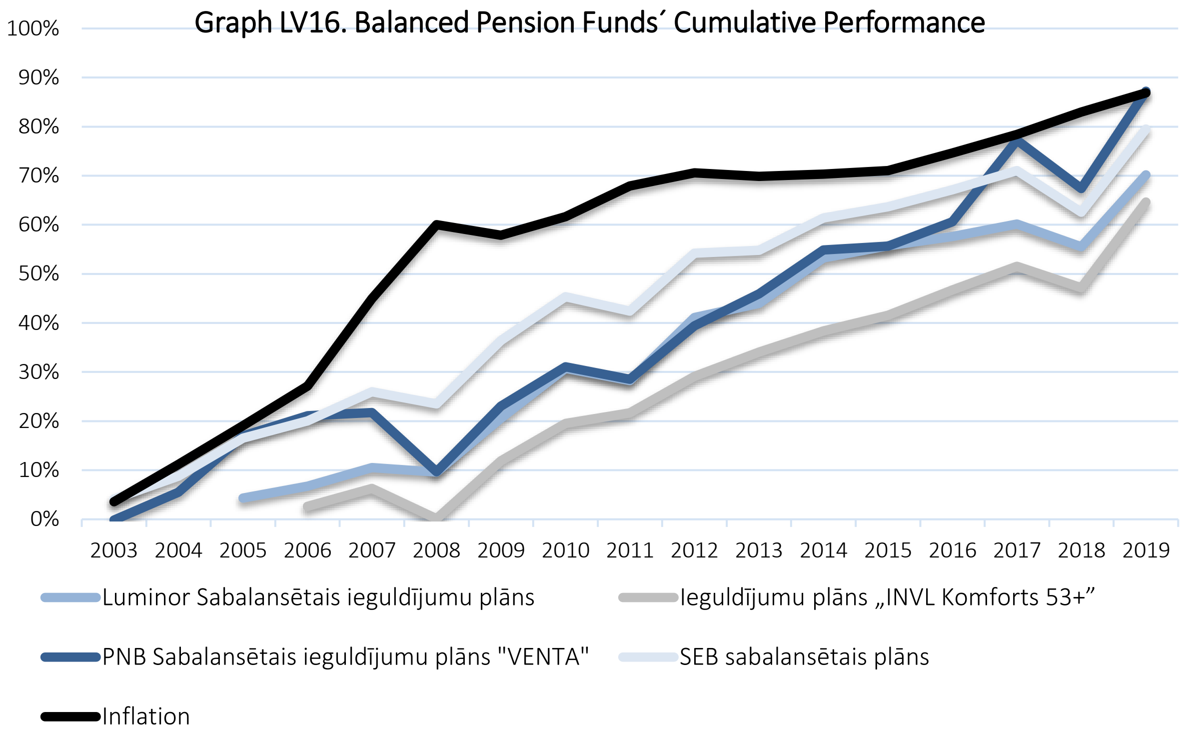
Pension reform introduced Pillar II in July 2001. However, pension funds started their effective operation from January 2003, so only data for the period from 2003 to 2019 is presented.

Conservative mandatory pension funds' performance on a cumulative basis compared to the inflation is presented below.

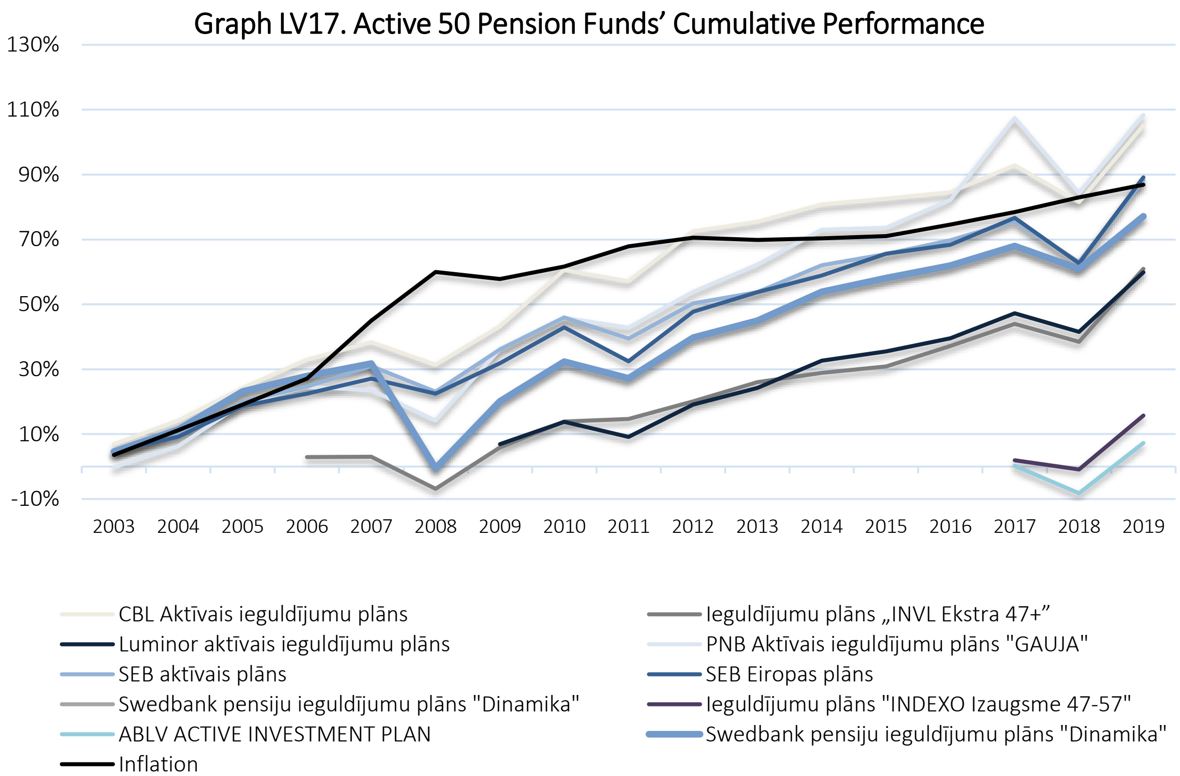



*Source: Own calculation based on Manapensjia LV*

Balanced mandatory pension funds' performance on a cumulative basis compared to the inflation is presented below.




Active pension funds' performance on a cumulative basis compared to the inflation is presented in the graphs below.




*Source: Own calculation based on Manapensjia LV pension funds´ Prospectuses and Terms, 2020*

It should be noted that only few of the actively managed pensions were able to “beat” the inflation, and thus able to deliver the positive real returns to the savers. In 2018, the Active 75 pension funds started operating on the market that invests major proportion of assets into the equities. Their cumulative performance is presented below.

Nominal as well as real returns of state funded pension funds in Latvia weighted by AuM are presented in a summary table below.

| Table LV18. Nominal and Real Returns of State Funded Pension Funds in Latvia | | | | | | |
|---|---|---|---|---|---|---|
| 2003 | Nominal return after charges, before inflation and taxes | 4.86% | 3.79% | Real return after charges and inflation and before taxes | 1.28% | -0.20% |
| 2004 | | 5.69% | | | -1.65% | |
| 2005 | | 8.93% | | | 1.80% | |
| 2006 | | 3.91% | | | -2.83% | |
| 2007 | | 3.51% | | | -10.52% | |
| 2008 | | -10.04% | | | -20.44% | |
| 2009 | | 13.51% | | | 14.88% | |
| 2010 | | 8.45% | | | 6.05% | |
| 2011 | | -2.10% | | | -5.98% | |
| 2012 | | 9.06% | | | 7.47% | |
| 2013 | | 2.32% | | | 2.72% | |
| 2014 | | 5.25% | | | 4.97% | |
| 2015 | | 1.93% | | | 1.53% | |
| 2016 | | 2.02% | | | -0.08% | |
| 2017 | | 3.23% | | | 1.07% | |
| 2018 | | -4.09% | | | -6.64% | |
| 2019 | | 10.57% | | | 8.43% | |

*Source: Own calculations based on Manapensjia LV data*

Another view on the performance of the Pillar II pension funds allowing the comparison across EU pension schemes is using the holding period approach.

| Table LV19. Annualized returns of State Funded Pension Funds | | |
|---|---|---|
| Holding Period | Net Nominal Annualized Performance | Real Net Annualized Performance |
| 1-year | 10.57% | 8.43% |
| 3-years | 3.06% | 0.77% |
| 5-years | 2.63% | 0.75% |
| 7-year | 2.95% | 1.62% |
| 10-years | 3.57% | 1.83% |
| Since inception | **3.79%** | **-0.20%** |

*Source: Table LV18*

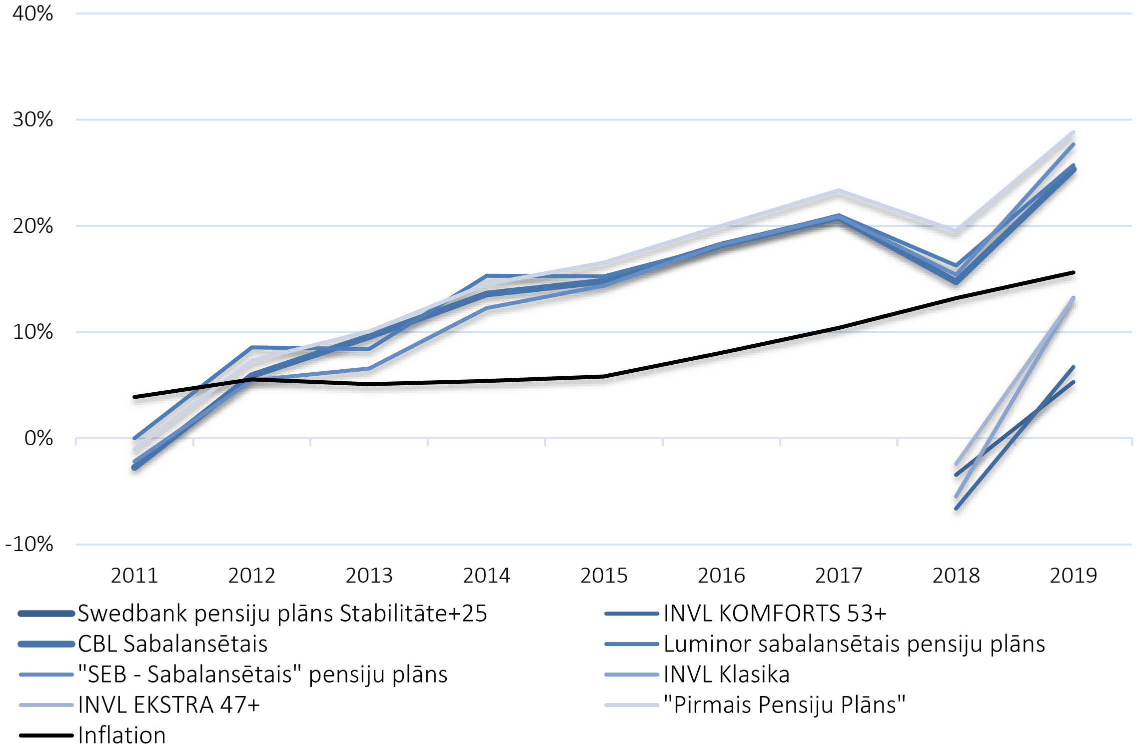
## Pillar III – Voluntary private pensions

The analysis of voluntary pension funds’ performance uses annual approaches as well as cumulative approaches, peer comparison and inflation.

Investment rules for private pension funds are similar to those for state-funded schemes but are more flexible. For example, investment in real estate is permitted (with a limit of 15%), the currency matching rule is only 30%, and limits for some asset classes are higher. Considering the structure of voluntary pension funds' portfolios in Latvia, a larger proportion is invested in structured financial products (mainly equity based UCITs funds) and direct investment in equities and bonds is decreasing.

Due to the lack of publicly available data before 2011, the performance of voluntary pension funds on an annual and cumulative basis starting from the year 2011 is presented in the charts below.

Graph LV20. Balanced and conservative voluntary open and closed pension funds´ cumulative performance

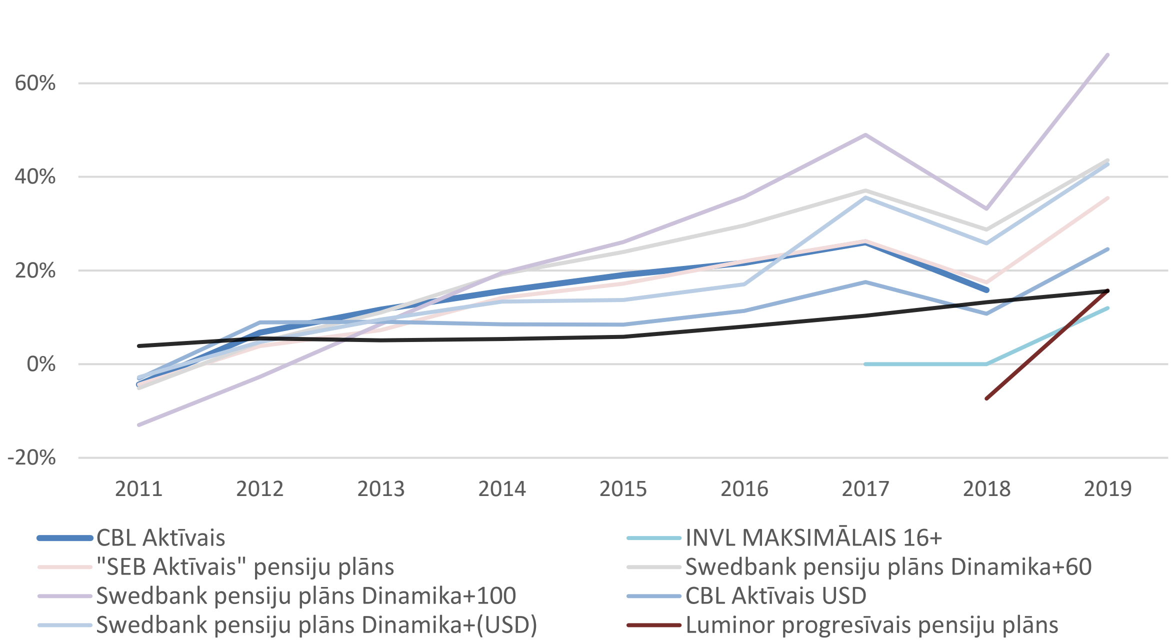



*Source: Own elaboration based on Manapensjia data*

Contrary to balanced Pillar II funds, balanced Pillar III funds all provide positive real returns (outperform inflation). Balanced Pillar III funds have a more aggressive portfolio structure. However, short historical data does not allow for a comprehensive conclusion to be drawn. There is a backward pressure of charges which might reverse the trend in future.

The performance of Latvian active voluntary private pension funds differs significantly, and the dispersion of annual returns and cumulative returns is higher. Performance of analyzed voluntary private pension funds on a cumulative basis is presented on the chart below.

Graph LV21. Active 50 & Active 75 voluntary pension funds´ cumulative performance




*Source: Own composition based on Manapensjia LV data*

Nominal as well as real returns of voluntary pension funds in Latvia weighted by AuM are presented in a summary table below.

| Table LV22. Nominal and Real Returns of Voluntary pension funds in Latvia | | | | | | |
|---|---|---|---|---|---|---|
| 2011 | | -2.70% | | | -6.58% | |
| 2012 | | 8.77% | | | 7.18% | |
| 2013 | | 3.08% | | | 3.48% | |
| 2014 | | 5.56% | | | 5.29% | |
| 2015 | Nominal return after charges, before inflation and taxes | 2.28% | 3.18% | Real return after charges and inflation and before taxes | 1.87% | 1.52% |
| 2016 | | 3.35% | | | 1.24% | |
| 2017 | | 3.62% | | | 1.46% | |
| 2018 | | -5.12% | | | -7.67% | |
| 2019 | | 10.80% | | | 8.66% | |

*Source: Own calculations based on Manapensjia LV data*

Additionally, we provide data on Pillar III (Voluntary) pension funds´ performance according to various holding periods.

| Table LV23. Annualized returns of voluntary pension funds in Latvia | | |
|---|---|---|
| Holding Period | Net Nominal Annualized Performance | Real Net Annualized Performance |
| 1-year | 10.80% | 8.66% |
| 3-years | 2.89% | 0.59% |
| 5-years | 2.86% | 0.98% |
| 7-year | 3.27% | 1.94% |
| 10-years | - | - |
| Since inception | 3.18% | 1.52% |

*Source: Table LV22*

# Conclusions

Latvia has managed to build a sustainable pension system over the last decade with impressive growth in Pillar II funds. Acceptance of voluntary pension savings in Pillar III is still weak, but this trend has changed after the financial crisis. Pillar III pension funds have enjoyed high inflow of new contributions despite rather weak performance and high fees.

Latvian Pillar II experienced further drop in charges in 2019 driven by a competition from low-cost passively managed funds. Pillar III funds managers enjoy smaller decrease in charges, but Pillar III charges remain relatively high. Delivered real returns on the other hand are negative. Most of the Pillar II pension funds were not able to beat the inflation. One of the reasons is also the relatively conservative risk/return profile of most funds. Pillar III vehicles in Latvia suffer not only from significantly high fees charged by fund managers, but also from low transparency.

Pension fund managers of both pillars have started to prefer packaged investment products (investment funds) and limit their engagement in direct investments. Thus, the question of potential future returns (when using financial intermediaries multiplied by high fee policy) in both schemes should be raised.

# Policy Recommendations

Latvia has improved significantly its mandatory part of funded pension system. Together with its NDC scheme for pay-as-you-go pillar, mandatory funded part as well as NDC part form a well-designed pension system that motivates individuals to contribute as there is a clear connection between paid contributions and expected pension benefits. However, voluntary part of the pension system still suffers from very complicated fee structure, high fees and low transparency.

These limits, despite a generous fiscal stimulus, larger participation in voluntary pension scheme. Regulators should seek for modern fee policies that would on one hand decrease the fee structure and on the other hand introduce success fee tied to the market benchmark. Applying high-water mark principle could limit the risk appetite of asset managers as they will start to prefer low-risk investments where constant fee revenue could be expected. If the benchmarking principle is applied, where the asset manager is rewarded by higher fee when the market benchmark has been outperformed and penalized by lower fees if the fund performance is lower than the market benchmark, savers could benefit more and start trusting the voluntary pension providers on a larger scale.

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