PENSION SAVINGS
THE REAL RETURN
2018 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
2018 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

Glossary of terms

Accrued benefits* – is the amount of accumulated pension benefits of a pension plan member on the basis of years of service.

Accumulated assets* – is the total value of assets accumulated in a pension fund.

Active member* – is a pension plan member who is making contributions (and/or on behalf of whom contributions are being made) and is accumulating assets.

AIF(s) – or Alternative Investment Funds are a form of collective investment funds under E.U. law that do not require authorization as a UCITS fund.[1]

Annuity* – is a form of financial contract mostly sold by life insurance companies that guarantees a fixed or variable payment of income benefit (monthly, quarterly, half-yearly, or yearly) for the life of a person(s) (the annuitant) or for a specified period of time. It is different than a life insurance contract which provides income to the beneficiary after the death of the insured. An annuity may be bought through instalments or as a single lump sum. Benefits may start immediately or at a pre-defined time in the future or at a specific age.

Annuity rate* – is the present value of a series of payments of unit value per period payable to an individual that is calculated based on factors such as the mortality of the annuitant and the possible investment returns.

Asset allocation* – is the act of investing the pension fund's assets following its investment strategy.

Asset management* – is the act of investing the pension fund's assets following its investment strategy.

Asset manager* – is(are) the individual(s) or entity(ies) endowed with the responsibility to physically invest the pension fund assets. Asset managers may also set out the investment strategy for a pension fund.

Average earnings scheme* – is a scheme where the pension benefits earned for a year depend on how much the member's earnings were for the given year.

Basic state pension* – is a non-earning related pension paid by the State to individuals with a minimum number of service years.

Basis points (bps) – represent the 100th division of 1%.

Benchmark (financial) – is a referential index for a type of security. Its aim is to show, customized for a level and geographic or sectorial focus, the general price or performance of the market for a financial instrument.

Beneficiary* – is an individual who is entitled to a benefit (including the plan member and dependants).

Benefit* – is a payment made to a pension fund member (or dependants) after retirement.

[1] See Article 4(1) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, p. 1–73.

Bonds – are instruments that recognize a debt. Although they deliver the same utility as bank loans, i.e. enabling the temporary transfer of capital from one person to another, with or without a price (interest) attached, bonds can be also be issued by non-financial institutions (States, companies) and by financial non-banking institutions (asset management companies). In essence, bonds are considered more stable (the risk of default is lower) and in theory deliver a lower, but fixed, rate of profit. Nevertheless, Table EX2 of the Executive Summary shows that the aggregated European Bond Index highly overperformed the equity one.

Closed pension funds* – are the funds that support only pension plans that are limited to certain employees. (e.g. those of an employer or group of employers).

Collective investment schemes – are financial products characterised by the pooling of funds (money or asset contributions) of investors and investing the total into different assets (securities) and managed by a common asset manager. Under E.U. law collective investment schemes are regulated under 6 different legal forms: UCITS (see below), the most common for individual investors; AIFs (see above), European Venture Capital funds (EuVECA), European Long-Term Investment Funds (ELTIFs), European Social Entrepreneurship Funds (ESEF) or Money Market Funds.[2]

Contribution* – is a payment made to a pension plan by a plan sponsor or a plan member.

Contribution base* – is the reference salary used to calculate the contribution.

Contribution rate* – is the amount (typically expressed as a percentage of the contribution base) that is needed to be paid into the pension fund.

Contributory pension scheme* – is a pension scheme where both the employer and the members have to pay into the scheme.

Custodian* – is the entity responsible, as a minimum, for holding the pension fund assets and for ensuring their safekeeping.

Defered member* – is a pension plan member that no longer contributes to or accrues benefits from the plan but has not yet begun to receive retirement benefits from that plan.

Deferred pension* – is a pension arrangement in which a portion of an employee's income is paid out at a date after which that income is actually earned.

Defined benefit (DB) occupational pension plans* – are occupational plans other than defined contributions plans. DB plans generally can be classified into one of three main types, "traditional", "mixed" and "hybrid" plans. These are schemes where "the pension payment is defined as a percentage of income and employment career. The employee receives a thus pre-defined pension and does not bear the risk of longevity and the risk of investment. Defined Benefits schemes may be part of an individual employment contract or collective agreement. Pension contributions are usually paid by the employee and the employer".[3]

"Traditional" DB plan* – is a DB plan where benefits are linked through a formula to the members' wages or salaries, length of employment, or other factors.

[2] See European Commission, 'Investment Funds' (28 August 2018) https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en.

[3] Werner Eichhorst, Maarten Gerard, Michael J. Kendzia, Christine Mayrhruber, Connie Nielsen, Gerhard Runstler, Thomas Url, 'Pension Systems in the EU: Contingent Liabilities and Assets in the Public and Private Sector' EP Directorate General for Internal Policies IP/A/ECON/ST/2010-26.

"Hybrid" DB plan* – is a DB plan where benefits depend on a rate of return credited to contributions, where this rate of return is either specified in the plan rules, independently of the actual return on any supporting assets (e.g. fixed, indexed to a market benchmark, tied to salary or profit growth, etc.), or is calculated with reference to the actual return of any supporting assets and a minimum return guarantee specified in the plan rules.

"Mixed" DB plan* – is a DB plans that has two separate DB and DC components, but which are treated as part of the same plan.

Defined contribution (DC) occupational pension plans* – are occupational pension plans under which the plan sponsor pays fixed contributions and has no legal or constructive obligation to pay further contributions to an ongoing plan in the event of unfavorable plan experience. These are schemes where "the pension payment depends on the level of defined pension contributions, the career and the returns on investments. The employee has to bear the risk of longevity and the risk of investment. Pension contributions can be paid by the employee and/or the employer and/or the state".[4]

Dependency ratio* – are occupational pension plans under which the plan sponsor pays fixed contributions and has no legal or constructive obligation to pay further contributions to an ongoing plan in the event of unfavourable plan experience.

Early retirement* – is a situation when an individual decides to retire earlier later and draw the pension benefits earlier than their normal retirement age.

Economic dependency ratio* – is the division between the number of inactive (dependent) population and the number of active (independent or contributing) population. It ranges from 0% to 100% and it indicates how much of the inactive population's (dependent) consumption is financed from the active population's (independent) contributions.[5] In general, the inactive (dependent) population is represented by children, retired persons and persons living on social benefits.

EET system* – is a form of taxation of pension plans, whereby contributions are exempt, investment income and capital gains of the pension fund are also exempt, and benefits are taxed from personal income taxation.

Equity (or stocks/shares) – are titles of participation to a publicly listed company's economic activity. With regards to other categorizations, an equity is also a security, a financial asset or, under E.U. law, a transferable security.[6]

ETE system* – is a form of taxation whereby contributions are exempt, investment income and capital gains of the pension fund are taxed, and benefits are also exempt from personal income taxation.

ETF(s) – or Exchange-Traded Funds are investment funds that are sold and bought on the market as an individual security (such as shares, bonds). ETFs are structured financial products, containing a

[4] Ibid.
[5] For more detail on the concept, see Elke Loichinger, Bernhard Hammer, Alexia Prskawetz, Michael Freiberger, Joze Sambt, 'Economic Dependency Ratios: Present Situation and Future Scenarios' MS13 Policy Paper on Implications of Population Ageing for Transfer Systems, Working Paper no. 74, 18th December 2014, 3.
[6] Article 4(44) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, p. 349–496 (MiFID II).

basket of underlying assets, and are increasingly more used due to the very low management fees that they entail.

Fund member* – is an individual who is either an active (working or contributing, and hence actively accumulating assets) or passive (retired, and hence receiving benefits), or deferred (holding deferred benefits) participant in a pension plan.

Funded pension plans* – are occupational or personal pension plans that accumulate dedicated assets to cover the plan's liabilities.

Funding ratio (funding level) * – is the relative value of a scheme's assets and liabilities, usually expressed as a percentage figure.

Gross rate of return* – is the rate of return of an asset or portfolio over a specified time period, prior to discounting any fees of commissions.

Gross/net replacement rate – is the ratio between the pre-retirement gross or net income and the amount of pension received by a person after retirement. The calculation methodology may differ from source to source as the average working life monthly gross or net income can used to calculate it (divided by the amount of pension) or the past 5 year's average gross income etc. (see below **OECD net replacement rate**).

Group pension funds* – are multi-employer pension funds that pool the assets of pension plans established for related employers.

Hedging and hedge funds – while hedging is a complex financial technique (most often using derivatives) to protect or reduce exposure to risky financial positions or to financial risks (for instance, currency hedging means reducing exposure to the volatility of a certain currency), a hedge fund is an investment pool that uses complex and varying investment techniques to generate profit.

Indexation* – is the method with which pension benefits are adjusted to take into account changes in the cost of living (e.g. prices and/or earnings).

Individual pension plans* – is a pension fund that comprises the assets of a single member and his/her beneficiaries, usually in the form of an individual account.

Industry pension funds* – are funds that pool the assets of pension plans established for unrelated employers who are involved in the same trade or businesses.

Mandatory contribution* – is the level of contribution the member (or an entity on behalf of the member) is required to pay according to scheme rules.

Mandatory occupational plans* – Participation in these plans is mandatory for employers. Employers are obliged by law to participate in a pension plan. Employers must set up (and make contributions to) occupational pension plans which employees will normally be required to join. Where employers are obliged to offer an occupational pension plan, but the employees' membership is on a voluntary basis, these plans are also considered mandatory.

Mandatory personal pension plans* - are personal plans that individuals must join or which are eligible to receive mandatory pension contributions. Individuals may be required to make pension contributions to a pension plan of their choice normally within a certain range of choices or to a specific pension plan.

Mathematical provisions (insurances) – or *mathematical reserves* or *reserves*, are the value of liquid assets set aside by an insurance company that would be needed to cover all current liabilities (payment obligations), determined using actuarial principles.

Minimum pension* – is the minimum level of pension benefits the plan pays out in all circumstances.

Mixed indexation* – is the method with which pension benefits are adjusted taking into account changes in both wages and prices.

Money market instruments – are short-term financial products or positions (contracts) that are characterized by the very high liquidity rate, such as deposits, shor-term loans, repo-agreements and so on.

MTF – multilateral trading facility, is the term used by the revised Markets in Financial Instruments Directive (MiFID II) to designate securities exchanges that are not a regulated market (such as the London Stock Exchange, for example).

Multi-employer pension funds* – are funds that pool the assets of pension plans established by various plan sponsors. There are three types of multi-employer pension funds:

a) for related employers i.e. companies that are financially connected or owned by a single holding group (group pension funds);

b) for unrelated employers who are involved in the same trade or business (industry pension funds);

c) for unrelated employers that may be in different trades or businesses (collective pension funds).

NAV – Net Asset Value, or the amount to which the market capitalisation of a financial product (for this report, pension funds' or insurance funds' holdings) or a share/unit of it arises at a given point. In general, the Net Asset Value is calculated per unit or share of a collective investment scheme using the daily closing market prices for each type of security in the portfolio.

Net rate of return* – is the rate of return of an asset or portfolio over a specified time period, after discounting any fees of commissions.

Normal retirement age* – is the age from which the individual is eligible for pension benefits.

Non-contributory pension scheme* – is a pension scheme where the members do not have to pay into scheme.

Occupational pension plans* – access to such plans is linked to an employment or professional relationship between the plan member and the entity that establishes the plan (the plan sponsor). Occupational plans may be established by employers or groups of thereof (e.g. industry associations) and labour or professional associations, jointly or separately. The plan may be administrated directly by the plan sponsor or by an independent entity (a pension fund or a financial institution acting as pension provider). In the latter case, the plan sponsor may still have oversight responsibilities over the operation of the plan.

OECD gross replacement rate - is defined as gross pension entitlement divided by gross pre-retirement earnings. It measures how effectively a pension system provides a retirement income to replace earnings, the main source of income before retirement. This indicator is measured in percentage of pre-retirement earnings by gender.

OECD net replacement rate - is defined as the individual net pension entitlement divided by net pre-retirement earnings, taking into account personal income taxes and social security contributions paid by workers and pensioners. It measures how effectively a pension system provides a retirement income to replace earnings, the main source of income before retirement. This indicator is measured in percentage of pre-retirement earnings by gender.

Old-age dependency ratio - defined as the ratio between the total number of elderly persons when they are generally economically inactive (aged 65 and above) and the number of persons of working age.[7] It is a sub-indicator of the economic dependency ratio and focuses on a country's public (state) pension system's reliance on the economically active population's pensions (or social security) contributions. It is a useful indicator to show whether a public (Pillar I) pension scheme is under pressure (when the ratio is high, or the number of retirees and the number of workers tend to be proportionate) or relaxed (when the ratio is low, or the number of retirees and the number of workers tend to be disproportionate). For example, a low old-age dependency ratio is 20%, meaning that 5 working people contribute for one retiree's pension.

Open pension funds* – are funds that support at least one plan with no restriction on membership.

Pension assets* – are all forms of investment with a value associated to a pension plan.

Pension fund administrator* – is(are) the individual(s) ultimately responsible for the operation and oversight of the pension fud.

Pension fund governance* – is the operation and oversight of a pension fund. The governing body is responsible for administration, but may employ other specialists, such as actuaries, custodians, consultants, asset managers and advisers to carry out specific operational tasks or to advise the plan administration or governing body.

Pension fund managing company* – is a type of administrator in the form of a company whose exclusive activity is the administration of pension funds.

Pension funds* – the pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the pension fund. Pension funds take the form of either a special purpose entity with legal personality (such as a trust, foundation, or corporate entity) or a legally separated fund without legal personality managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.

Pension insurance contracts* – are insurance contracts that specify pension plans contributions to an insurance undertaking in exchange for which the pension plan benefits will be paid when the members reach a specified retirement age or on earlier exit of members from the plan. Most countries limit the integration of pension plans only into pension funds, as the financial vehicle of the pension plan. Other countries also consider the pension insurance contract as the financial vehicle for pension plans.

Pension plan* – is a legally binding contract having an explicit retirement objective (or – in order to satisfy tax-related conditions or contract provisions – the benefits can not be paid at all or without a significant penalty unless the beneficiary is older than a legally defined retirement age). This contract

[7] See Eurostat definition: http://ec.europa.eu/eurostat/web/products-datasets/product?code=tsdde511.

may be part of a broader employment contract, it may be set forth in the plan rules or documents, or it may be required by law. In addition to having an explicit retirement objective, pension plans may offer additional benefits, such as disability, sickness, and survivors' benefits.

Pension plan sponsor* – is an institution (e.g. company, industry/employment association) that designs, negotiates, and normally helps to administer an occupational pension plan for its employees or members.

Pension regulator* – is a governmental authority with competence over the regulation of pension systems.

Pension supervisor* – is a governmental authority with competence over the supervision of pension systems.

Personal pension plans* - Access to these plans does not have to be linked to an employment relationship. The plans are established and administered directly by a pension fund or a financial institution acting as pension provider without any intervention of employers. Individuals independently purchase and select material aspects of the arrangements. The employer may nonetheless make contributions to personal pension plans. Some personal plans may have restricted membership.

Private pension funds* – is a pension fund that is regulated under private sector law.

Private pension plans* – is a pension plan administered by an institution other than general government. Private pension plans may be administered directly by a private sector employer acting as the plan sponsor, a private pension fund or a private sector provider. Private pension plans may complement or substitute for public pension plans. In some countries, these may include plans for public sector workers.

Public pension plans* – are pensions funds that are regulated under public sector law.

Public pension plans* – are the social security and similar statutory programmes administered by the general government (that is central, state, and local governments, as well as other public sector bodies such as social security institutions). Public pension plans have been traditionally PAYG financed, but some OECD countries have partial funding of public pension liabilities or have replaced these plans by private pension plans.

Rate of return* – is the income earned by holding an asset over a specified period.

REIT(s) or Real Estate Investment Trust(s) is the most common acronym and terminology used to designate special purpose investment vehicles (in short, companies) set up to invest and commercialise immovable goods (real estate) or derived assets. Although the term comes from the U.S. legislation, in the E.U. there are many forms of REITs, depending on the country since the REIT regime is not harmonised at E.U. level.

Replacement ratio* – is the ratio of an individual's (or a given population's) (average) pension in a given time period and the (average) income in a given time period.

Service period* – is the length of time an individual has earned rights to a pension benefits.

Single employer pension funds* – are funds that pool the assets of pension plans established by a single sponsor.

Supervisory board* – is(are) the individual(s) responsible for monitoring the governing body of a pension entity.

System dependency ratio* – typically defined as the ratio of those receiving pension benefits to those accruing pension rights.

TEE system* – is a form of taxation of pension plans whereby contributions are taxed, investment income and capital gains of the pension fund are exempt, and benefits are also exempt from personal income taxation.

Trust* – is a legal scheme, whereby named people (termed trustees) hold property on behalf of other people (termed beneficiaries).

Trustee* – is a legal scheme, whereby named people (termed trustees) hold property on behalf of other people (termed beneficiaries).

UCITS – or Undertakings for Collective Investment in Transferable Securities, is the legal form under E.U. law for mutual investment funds that are open to pool and invest funds from any individual or institutional investor, and are subject to specific authorisation criteria, investment limits and rules. The advantage of UCITS is the general principle of home-state authorisation and mutual recognition that applies to this kind of financial products, meaning that a UCITS fund established and authorised in one E.U. Member State can be freely distributed in any other Member State without any further formalities (also called *E.U. fund passporting*).

Unfunded pension plans* – are plans that are financed directly from contributions from the plan sponsor or provider and/or the plan participant. Unfunded pension plans are said to be paid on a current disbursement method (also known as the pay as you go, PAYG, method). Unfunded plans may still have associated reserves to cover immediate expenses or smooth contributions within given time periods. Most OECD countries do not allow unfunded private pension plans.

Unprotected pension plan* – is a plan (personal pension plan or occupational defined contribution pension plan) where the pension plan/fund itself or the pension provider does not offer any investment return or benefit guarantees or promises covering the whole plan/fund.

Voluntary contribution – is an extra contribution paid in addition to the mandatory contribution a member can pay to the pension fund in order to increase the future pension benefits.

Voluntary occupational pension plans - The establishment of these plans is voluntary for employers (including those in which there is automatic enrolment as part of an employment contract or where the law requires employees to join plans set up on a voluntary basis by their employers). In some countries, employers can on a voluntary basis establish occupational plans that provide benefits that replace at least partly those of the social security system. These plans are classified as voluntary, even though employers must continue sponsoring these plans in order to be exempted (at least partly) from social security contributions.

Voluntary personal pension plans* – Participation in these plans is voluntary for individuals. By law individuals are not obliged to participate in a pension plan. They are not required to make pension contributions to a pension plan. Voluntary personal plans include those plans that individuals must join if they choose to replace part of their social security benefits with those from personal pension plans.

Wage indexation* – is the method with which pension benefits are adjusted taking into account changes in wages.

Waiting period* – is the length of time an individual must be employed by a particular employer before joining the employer's pension scheme.

Winding-up* – is the termination of a pension scheme by either providing (deferred) annuities for all members or by moving all its assets and liabilities into another scheme.

World Bank multi-pillar model – is the recommended design, developed by the World Bank in 1994, for States that had pension systems inadequately equipped to (currently and forthcoming) sustain a post-retirement income stream for future pensioners and alleviate the old-age poverty risk. Simpler, it is a set of guidelines for States to either enact, reform or gather legislation regulating the state pension and other forms of retirement provisions in a form that would allow an increased workers' participation, enhance efficiency for pension savings products and a better allocation of resources under the principle of solidarity between generations.

The standard design of a robust pension system would rely on five pillars:

a) the non-contributory scheme (pillar 0), through which persons who do not have an income or do not earn enough would have insured a minimum pension when reaching the standard retirement age;

b) the public mandatory, Pay-As-You-Go (PAYG) scheme (**Pillar I**), gathering and redistributing pension contributions from the working population to the retirees, while accumulating pension rights (entitlements) for the future retirees;

c) the mandatory funded and (recommended) privately managed scheme (**Pillar II**), where workers' contributions are directed to their own accumulation accounts in privately managed investment products;

d) the voluntary privately managed retirement products (**Pillar III**), composed of pension savings products to which subscription is universal, contributions and investments are deregulated and tax-incentivised;

e) the non-financial alternative aid scheme (pillar IV), through which the state can offer different forms of retirement support – such as housing or family support. Albeit the abovementioned, the report focuses on the "*main pillars*", i.e. Pillar I, II and III, since they are the most significant (and present everywhere) in the countries that have adopted the multi-pillar model.

Definitions with "*" are taken from OECD's Pensions Glossary - http://www.oecd.org/daf/fin/private-pensions/38356329.pdf.

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Country Case: Latvia

Latvija

2017.gadā 2.pensiju līmeni (vidējā gada nominālā peļņa 3.31%) un 3.pensiju līmeni (vidējā gada nominālā peļņa 4.70%) raksturo stabile izaugsme. Šo tendenci pavadīja arī pieaugums 3.pensiju līmeņa dalībnieku skaitā. Mazāk pozitīvs fakts ir izmaksu pieaugums un pastāvošā sarežģīta maksu struktūra 3.pensiju līmeņa fondos, kas nesniedz skaidru priekšstatu par to cik lielu daļa no pensiju fondu peļņas aiziet komisijas maksās.

Summary

2017 can be viewed as a year of solid returns for Pillar II (average annual nominal return of 3.31%) and Pillar III funds (average annual nominal return of 4.70%). This trend has been accompanied by a continuous growth of savers in Pillar III. The less positive feature is the increase of charges and remaining complex fee structure of Pillar III pension funds, which limits the possibility of seeing the overall impact of fees on accumulated savings.

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 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.

Pension Savings: The Real Return | 2018 Edition

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.[232]

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.

Pension 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.

[232] 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

Introductory table LV - 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 entire population	Coverage: generally entire working population	Coverage: 23.5% of working population (in 2017)

Gross replacement ratio: 31%
Source: own calculations based on Central Statistical Bureau of Latvia data, 2018
Remark: working population is defined according to the working and retirement ages established by the legislation of the respective year (methodology of Central Statistical Bureau of Latvia)

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 2017, 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.

Statutory retirement age in Latvia in 2017 is 63 years 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) the saver is at least 61 years old (gradually rising by three months a year until 2025) and 2) the saver has at least 30 years of contribution.

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 20% of all retirees receive a pension lower than €213 (equal to 40% of the average net salary of the working population). However, considering the level of contributions for pension insurance (16% of salary), the average income replacement ratio of old-age pensions is rather low. The average income replacement ratios for old-age pension in Latvia are shown in the table below.

Table LV1. Latvian NDC PAYG pillar statistics						
Indicator / Year	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%

Source: Own calculations based on Central Statistical Bureau of Latvia (http://data.csb.gov.lv), 2018 http://data.csb.gov.lv/pxweb/en/Sociala/Sociala__ikgad__ienemumi/II0010_euro.px/?rxid=16744538-cfbc-4791-959d-41ac400179ee

A **Minimum old-age pension** mechanism has been introduced in Latvia. The minimum amount of the monthly old-age pension cannot be less than the state social security benefits (€60.43 monthly in 2017) 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 LV2. Minimum Old-age Pension in Latvia	
Years of service (Insurance period)	Minimum old-age pension (in €)
• insurance length up to 20 years	70.43
• insurance length from 21 to 30 years	83.24
• insurance length starting from 31 to 40 years	96.05
• insurance length starting from 41 years	108.85

Source: own elaboration based on Ministry of Welfare data, 2018 (http://www.lm.gov.lv/text/2112)

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 2nd 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 LV3. Redistribution of the old-age pension contributions between Pillar II and III		
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: https://www.vsaa.lv/en/services/for-employees/2-nd-tier-mandatory-state-funded-pension-scheme/, 2018

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.

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 (17 operational in Latvia in 2017)
2. closed pension funds (only one operating in Latvia in 2017).

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 2017), 23 state-funded pension schemes have been operational on the Pillar II market. Three new funds emerged during 2017, of which two funds present their investment strategy as “passive”. 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.

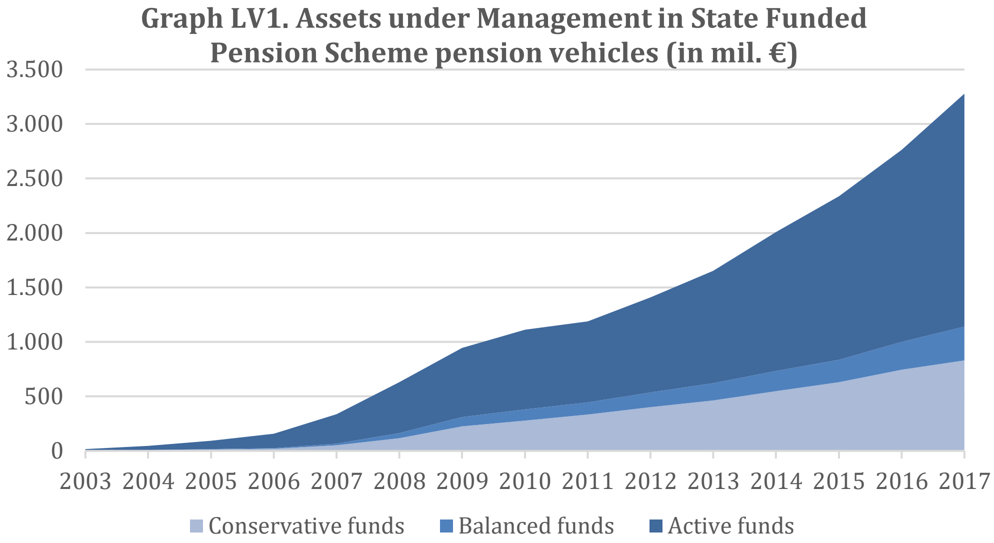
Although there is no legal recognition of types of pension funds, they can be divided into three types based on their risk/return profiles:

1. Conservative funds, with no equity exposure and a 100% share of bonds and money market instruments;
2. Balanced funds with an equity share of up to 15% and a 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 50% 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.

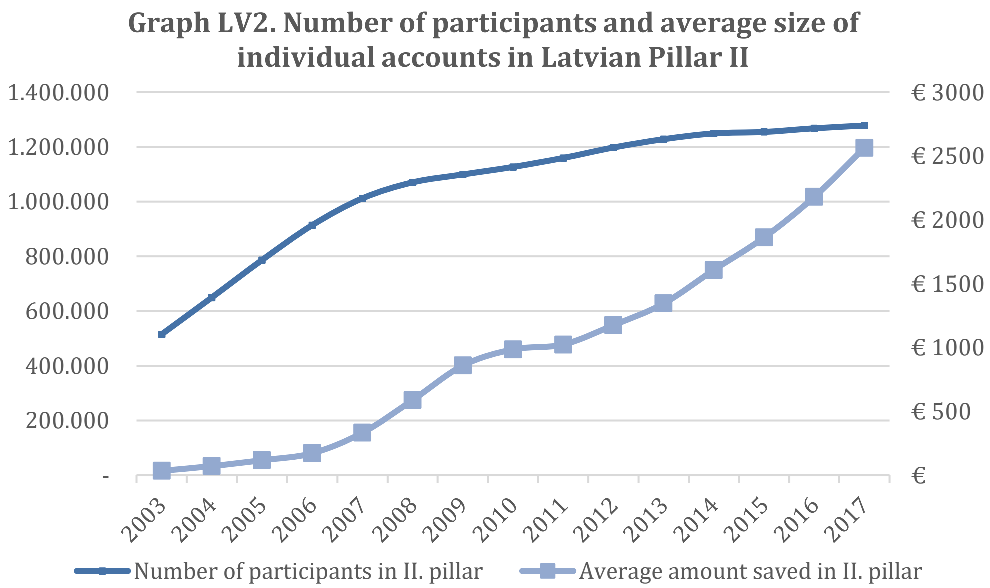
Overall asset allocation in Latvia is fairly conservative despite the possibility of choosing a plan according to risk preference. The chart below presents the amount of Assets under Management for types of pension funds according to their investment strategy.

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.



<u>Source</u>: Own calculations (http://www.manapensija.lv/en/2nd-pensionpillar/statistics/data), 2018

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.



<u>Source</u>: Own calculations (http://www.manapensija.lv/en/2nd-pension-pillar/statistics/data), 2018

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.

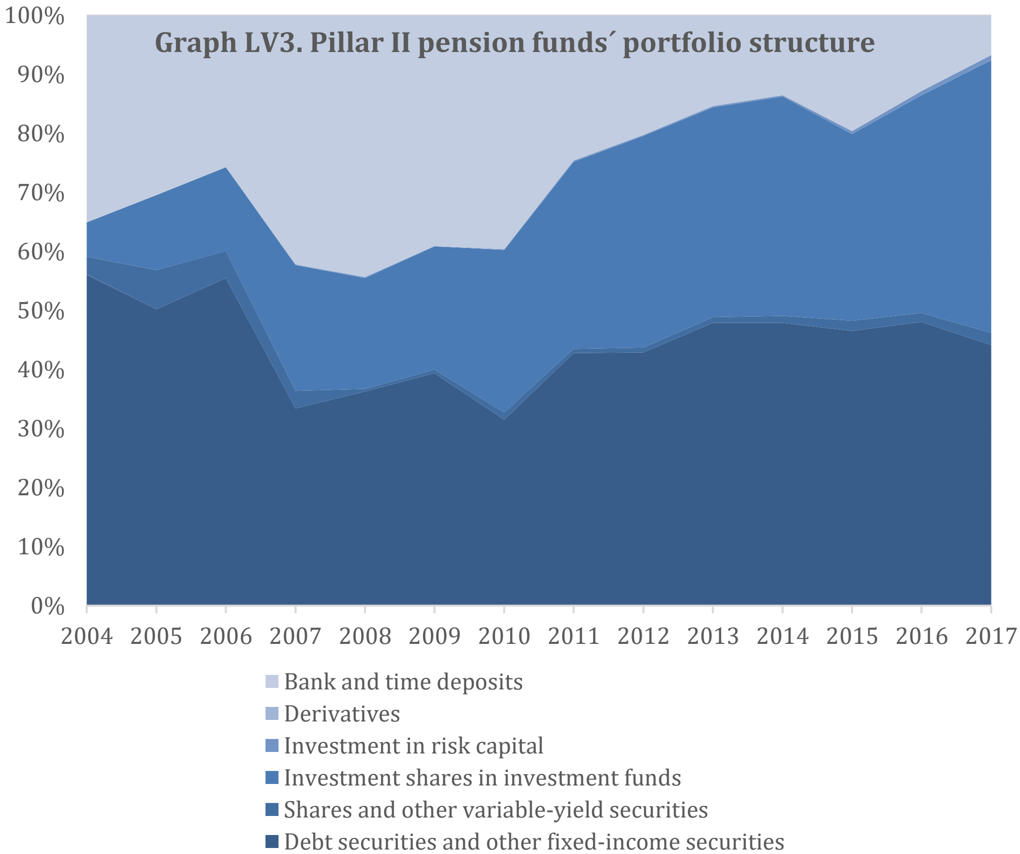
There are 23 pension funds operating on the market in 2016. There was no change in the number of pension funds offered in Pillar II. The list of Pillar II pension funds is presented in the table below.

Table LV5. List of State Funded Pension Funds

Pension Fund Name	Investment style of the pension plan	Inception day
ABLV ACTIVE INVESTMENT PLAN	Active	**02.08.2017**
CBL Aktīvais ieguldījumu plāns	Active	07.01.2003
CBL Universālais ieguldījumu plāns	Conservative	07.01.2003
Ieguldījumu plāns "INDEXO Izaugsme 47-57"	Passive	**21.06.2017**
Ieguldījumu plāns „INVL Ekstra 16+”	Active	08.08.2006
Ieguldījumu plāns „INVL INDEX DIRECT”	Passive	**14.08.2017**
Ieguldījumu plāns „INVL Komforts 47+”	Balanced	08.08.2006
Ieguldījumu plāns „INVL Konservatīvais 58+”	Conservative	07.01.2003
Luminor (D) Aktīvais ieguldījumu plāns	Active	21.02.2005
Luminor (D) Konservatīvais ieguldījumu plāns	Balanced	21.02.2005
Luminor (N) aktīvais ieguldījumu plāns	Active	02.02.2009
Luminor (N) konservatīvais ieguldījumu plāns	Conservative	02.02.2009
Luminor Sabalansētais ieguldījumu plāns	Conservative	21.02.2005
NORVIK Aktīvais ieguldījumu plāns "GAUJA"	Active	14.10.2003
NORVIK Konservatīvais ieguldījumu plāns "DAUGAVA"	Conservative	07.01.2003
NORVIK Sabalansētais ieguldījumu plāns "VENTA"	Balanced	14.10.2003
SEB aktīvais plāns	Active	07.01.2003
SEB Eiropas plāns	Active	07.01.2003
SEB konservatīvais plāns	Conservative	26.05.2003
SEB Latvijas plāns	Conservative	07.01.2003
SEB sabalansētais plāns	Balanced	07.01.2003
Swedbank pensiju ieguldījumu plāns "Dinamika"	Active	07.01.2003
Swedbank pensiju ieguldījumu plāns "Stabilitāte"	Conservative	07.01.2003

Source: http://www.manapensija.lv/en/2nd-pension-pillar/statistics/, 2018

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.



<u>Source</u>: Own elaboration based on Financial and Capital Market Commission data, 2018 (available at: http://www.fktk.lv/en/statistics/pension-funds/quarterly-reports.html).

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 2017) 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.

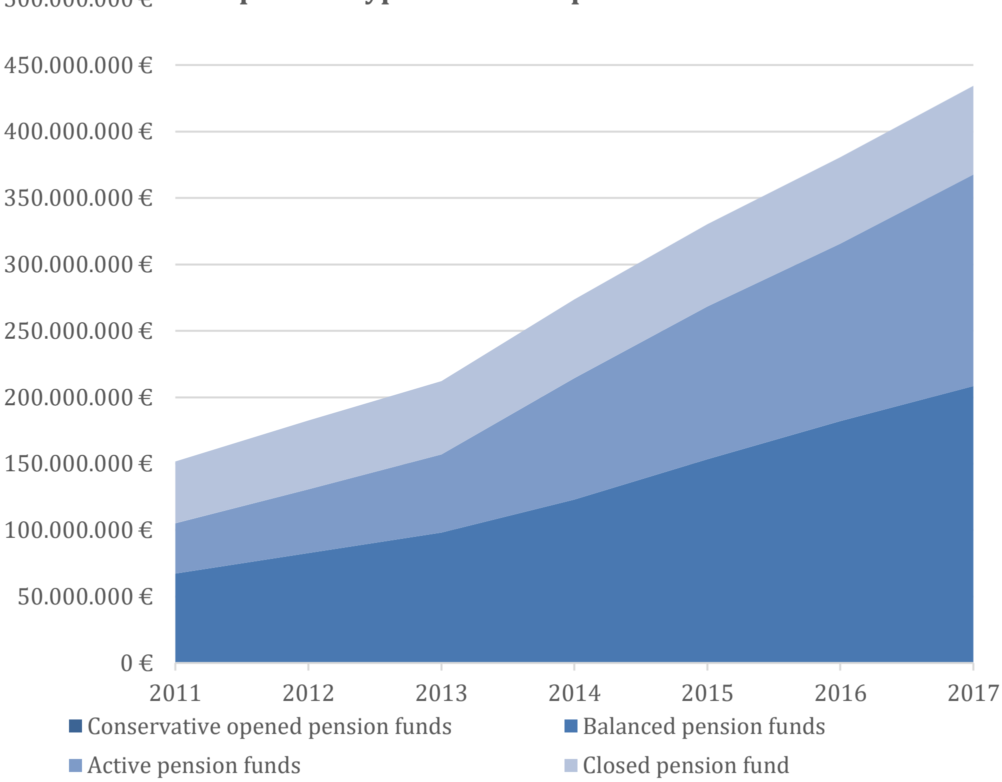
The level of transparency in providing publicly available data for private pension funds before the year 2011 is rather low. Therefore, the analysis of the market and main pension vehicles has been performed with publicly available data starting from 31 December 2011. Currently (as of 31 December 2017), 17 open private pension funds and one closed private pension fund exist on the market. A new company ("INVL") entered the market in 2015 and took over existing funds from the exiting company "Finasta". At the same time, in 2015 INVL started offering two new target date funds (conservative and balanced one).

Table LV6. List of Pillar III Supplementary pension funds		
Pension Fund Name	**Investment style of the pension plan**	**Inception day**
INVL Konservatīvais 58+	Conservative opened pension funds	08.10.2015
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
Swedbank pensiju plāns Stabilitāte+25	Balanced opened pension funds	14.07.2003
CBL Aktīvais	Active opened pension funds	21.03.2000
INVL plāns Aktīvais 16+	Active opened pension funds	08.10.2015
INVL "Dzintars - Konservatīvais"	Active opened pension funds	23.10.1998
INVL "Jūra - Aktīvais"	Active opened pension funds	07.03.2008
INVL "Saule - Sabalansētais"	Active opened pension funds	07.03.2008
INVL Sabalansētais 47+	Active opened pension funds	08.10.2015
Luminor progresīvais pensiju plāns	Active opened pension funds	18.10.2011
"SEB Aktīvais" pensiju plāns	Active opened pension funds	15.09.2004
Swedbank pensiju plāns Dinamika+60	Active opened 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
"Pirmais Pensiju Plāns"	Closed pension fund	01.12.1999

Source: Own elaboration based on Financial and Capital Market Commission data, 2018

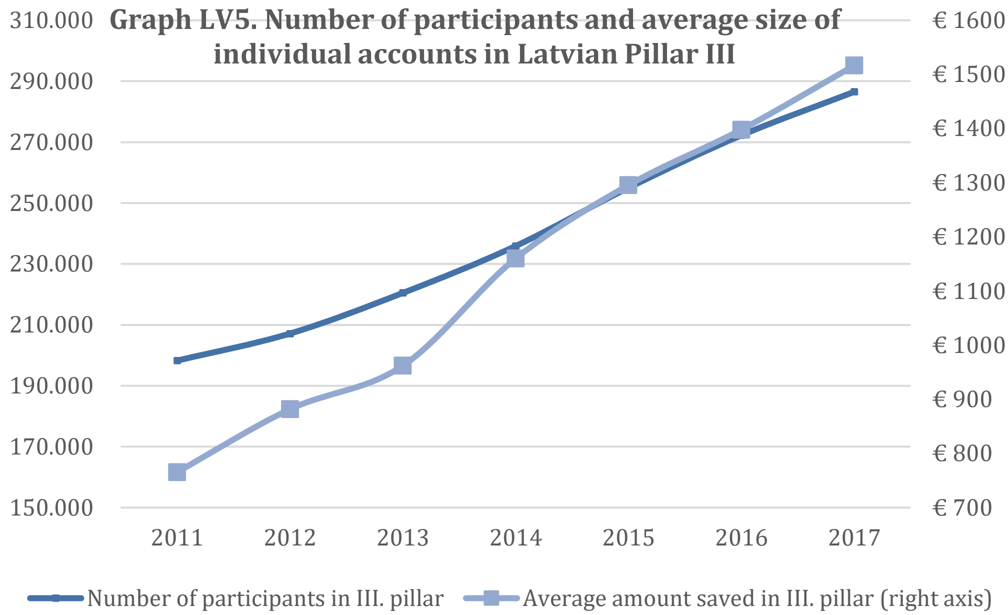
The structure of the pension vehicles according to the type of the fund and investment strategy offered is presented in the figure below.

Graph LV4. Type of Pillar III pension funds based on AuM



__Source__: Own calculation based on Manapensija data (http://www.manapensija.lv/en/3rd-pension-pillar/history-and-statistics/), 2018

The number of participants as well as the average amount saved in Pillar III saving accounts rises steadily. As of 31 December 2017, there has been almost 287,000 Pillar III saving accounts with an average amount of € 1,516 saved in them. The developments of these parameters are presented on the figure below.



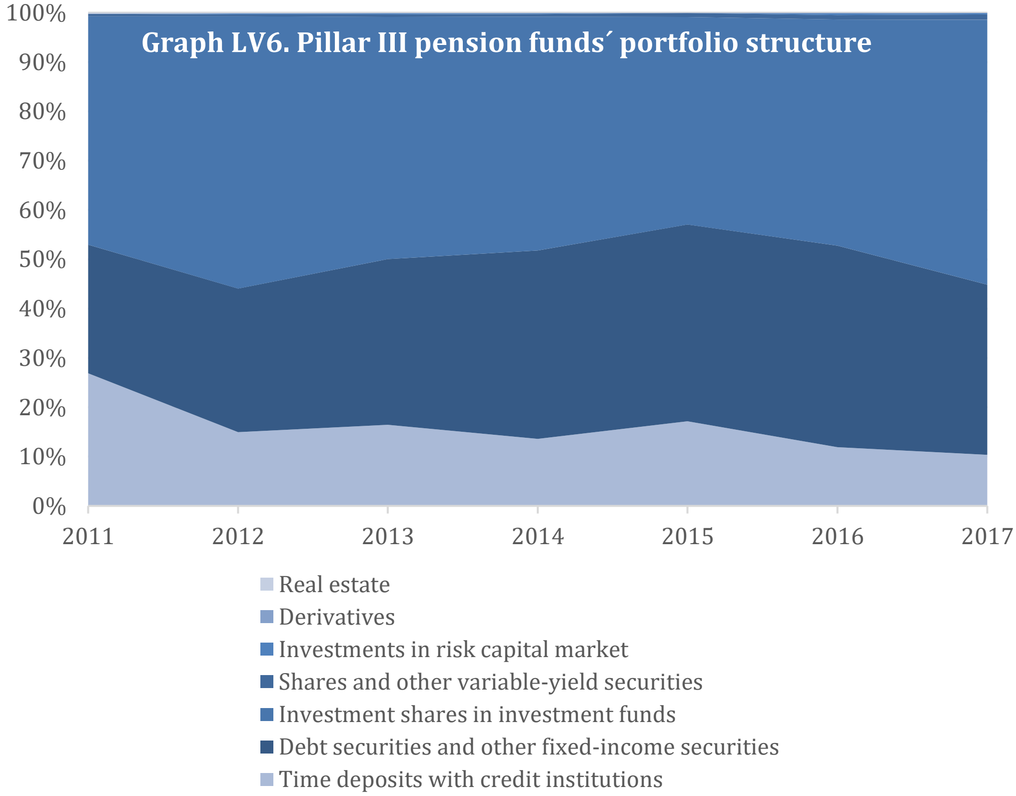
Graph LV5. Number of participants and average size of individual accounts in Latvian Pillar III

Source: Own calculation based on Manapensija data (http://www.manapensija.lv/en/3rd-pension-pillar/history-and-statistics/), 2018

It should be noted that balanced pension funds accounted for about 50% of market share based on AuM in 2017, where only four funds are offered. Active funds – for which the investment strategy allows more equity investments - are gaining market share (from 25% in 2011 to 36.6% in 2017). It should be noted that conservative funds have market share close to 0%.

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 15% of market share based on assets under management (data as of 2017), 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 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.



Graph LV6. Pillar III pension funds´ portfolio structure

Source: Own elaboration based on Financial and Capital Market Commission data, 2018 (available at: http://www.fktk.lv/en/statistics/pension-funds/quarterly-reports.html)

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.

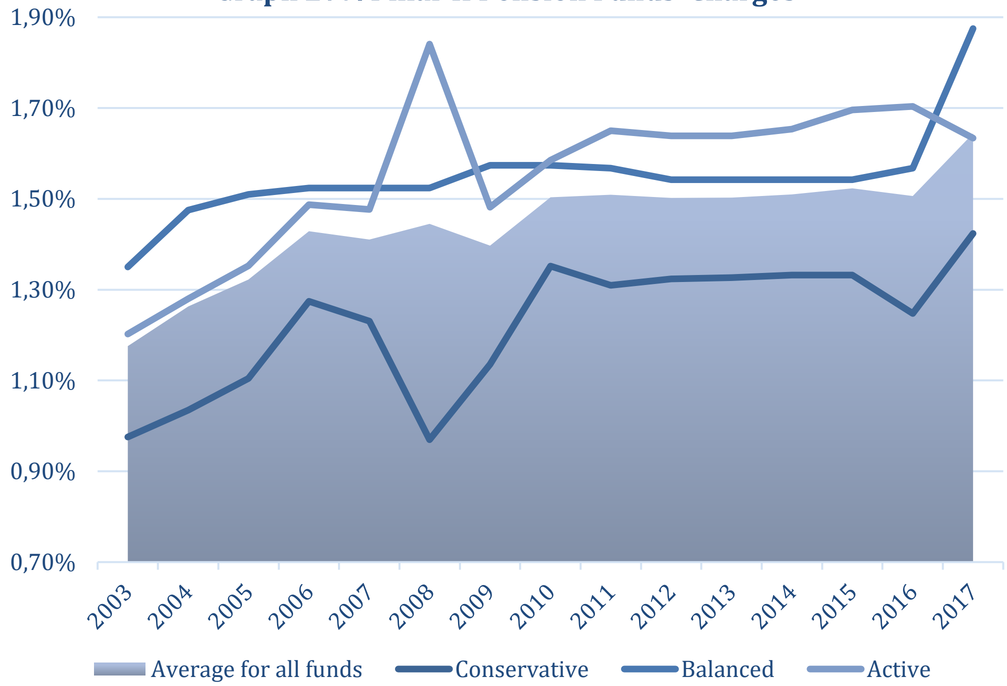
Fees that can be charged to pension funds by fund managers are recognized by law as having a fixed and variable part. The law stipulates that payment for the management of an investment plan shall include:

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.

The average level of fees charged to the pension funds are increasing, both on a relative as well as absolute level, which might be detrimental to the long-term savings of Latvian savers. Generally, the fees applied to the pension funds in Pillars II and III are among the highest. Several Pillar II pension funds now apply performance-based fees, where this additional fee is charged if the fund manager reaches a positive return.

Graph LV7. Pillar II Pension Funds' Charges



Source: Own research based on the most recent terms of respective pension funds, 2018

Pillar III – Voluntary private pensions

Voluntary private pension funds have a 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. However, the portal Manapensija (http://www.manapensija.lv/en/) has significantly enhanced the information on actual charges and fees applied by Pillar III pension funds and their administrators in 2016.

Charges of voluntary private pension funds for the years 2015 and 2016 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 uses mixed Administration costs, which are a combination of entry fees (fees on contributions paid) and ongoing charges (AuM based). CBL funds uses also a performance fee if the fund returns outperform the benchmark (12-month RIGIBID). Aggressive fee policy is applied for INVL funds (Sabalansētais 47+, Activais 16+ and Konservatīvais 58+), where the participant only pays fees on first year contributions. Otherwise, no additional charges are applied.

Table LV7. Voluntary Private Pension Funds´ Fees and Charges

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

	Custodian bank´s commission	0.20%	0.20%	0.20%
	Performance fee	10% (RIGIBID)	10% (RIGIBID)	10% (RIGIBID)
INVL plāns "Dzintars - Konservatīvais"	Administration Cost	2.00%	2.00%	2.00%
	Fund Manager´s commission	0.70%	0.70%	0.70%
	Custodian bank´s commission	0.50%	0.50%	0.01%
INVL plāns "Jūra - Aktīvais"	Administration Cost	1.00%	1.00%	1.00%
	Fund Manager´s commission	1.00%	1.00%	1.00%
	Custodian bank´s commission	0.50%	0.50%	0.01%
INVL plāns "Saule - Sabalansētais"	Administration Cost	1.00%	1.00%	1.00%
	Fund Manager´s commission	1.00%	1.00%	1.00%
	Custodian bank´s commission	0.50%	0.50%	0.01%
INVL Sabalansētais 47+	Administration Cost		0.00%	0.00%
	Fund Manager´s commission		0.00%	0.00%
	Custodian bank´s commission		0.00%	0.00%
	Fee from contributions during the first year of participation		30.00%	30.00%
INVL Activais 16+	Administration Cost		0.00%	0.00%
	Fund Manager´s commission		0.00%	0.00%
	Custodian bank´s commission		0.00%	0.00%
	Fee from contributions during the first year of participation		30.00%	30.00%

INVL Konservatīvais 58+	Administration Cost		0.00%	0.00%
	Fund Manager´s commission		0.00%	0.00%
	Custodian bank´s commission		0.00%	0.00%
	Fee from contributions during the first year of participation		30.00%	30.00%
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 value of assets
	Fund Manager´s commission	1.60%	1.60%	1.60%
	Custodian bank´s commission	0.15%	0.15%	0.15%
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 value of assets
	Fund Manager´s commission	1.10%	1.10%	1.10%
	Custodian bank´s commission	0.15%	0.15%	0.15%
"Pirmais Pensiju Plāns"	Administration Cost	1.50%	1.50%	1.50%
	Fund Manager´s commission	1.30%	1.30%	1.30%
	Custodian bank´s commission	0.20%	0.20%	0.20%
"SEB Aktīvais" pensiju plāns	Administration Cost	1.50%	1.50%	0.90% - 3.00% (in accordance with the amount of savings at SEB pension fund)

	Fund Manager´s commission	0.90%	0.90%	0.60% (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%)
	Custodian bank´s commission	0.20%	0.20%	0.10%
"SEB - Sabalansētais" pensiju plāns	Administration Cost	1.50%	1.50%	0.90% - 3.00% (in accordance with the amount of savings at SEB pension fund)

	Fund Manager´s commission	0.90%	0.90%	0.6% (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%)
	Custodian bank´s commission	0.20%	0.20%	0.10%
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	0.60%
	Fund Manager´s commission	1.25%	1.25%	0.90%
	Custodian bank´s commission	0.20%	0.20%	0.18%
Swedbank pensiju plāns Dinamika+100	Administration Cost	2% from payments + 1% from assets / yr	2% from payments + 1% from assets / yr	0.60%

	Fund Manager´s commission	1.60%	1.60%	0.90%
	Custodian bank´s commission	0.20%	0.20%	0.10%
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	0.60%
	Fund Manager´s commission	1.25%	1.25%	0.90%
	Custodian bank´s commission	0.20%	0.20%	0.10%
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	0.60%
	Fund Manager´s commission	0.90%	0.90%	0.50%
	Custodian bank´s commission	0.20%	0.20%	0.10%

Source: Own research based on Manapensija data and supplementary pension funds´ Prospectuses and Terms, 2017

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.

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.

<u>Taxation of contributions</u>

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.

<u>Taxation of the Fund</u>

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.

<u>Taxation of pension benefits</u>

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:

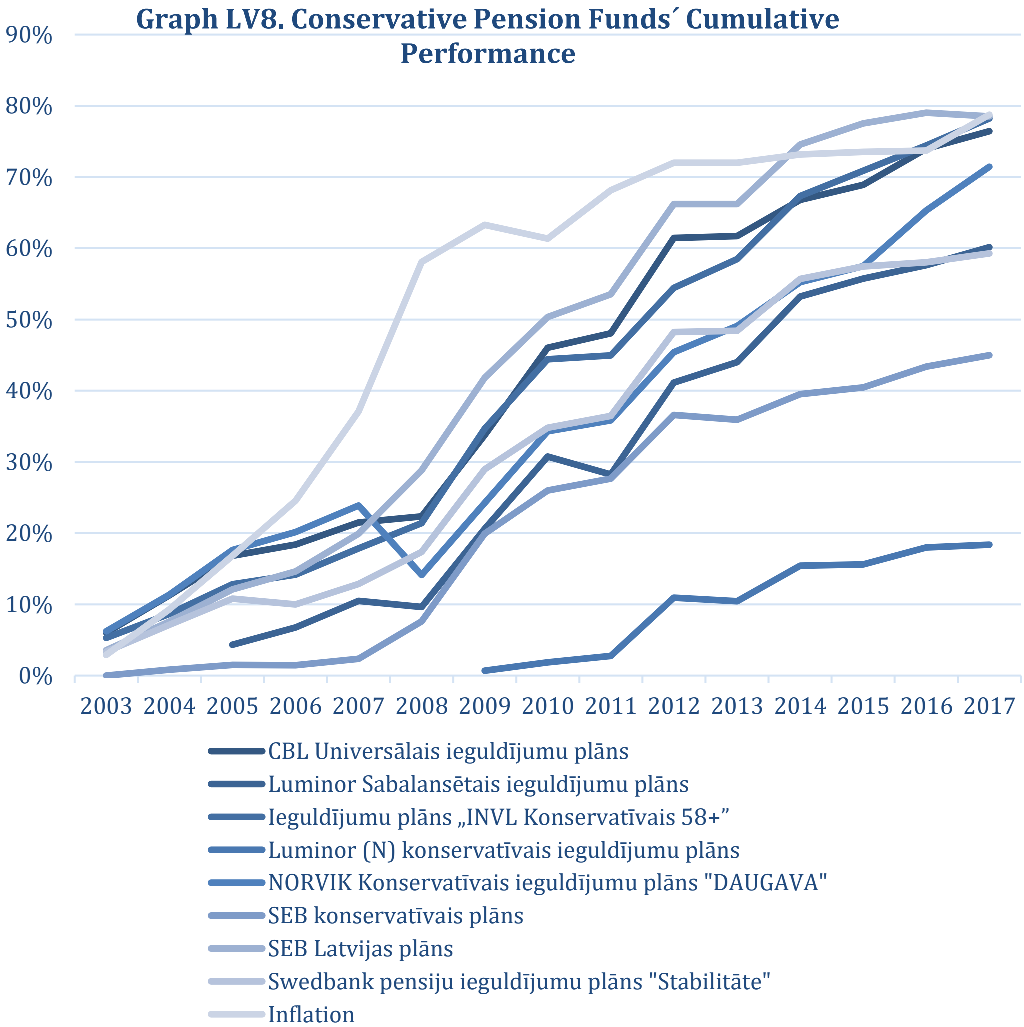
- 35% for securities guaranteed by a state or international financial institution;
- 5% for securities issued or guaranteed by a local government;
- 10% for securities of a single issuer, except government securities; for deposits at one credit institution (investments in debt and capital securities 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.

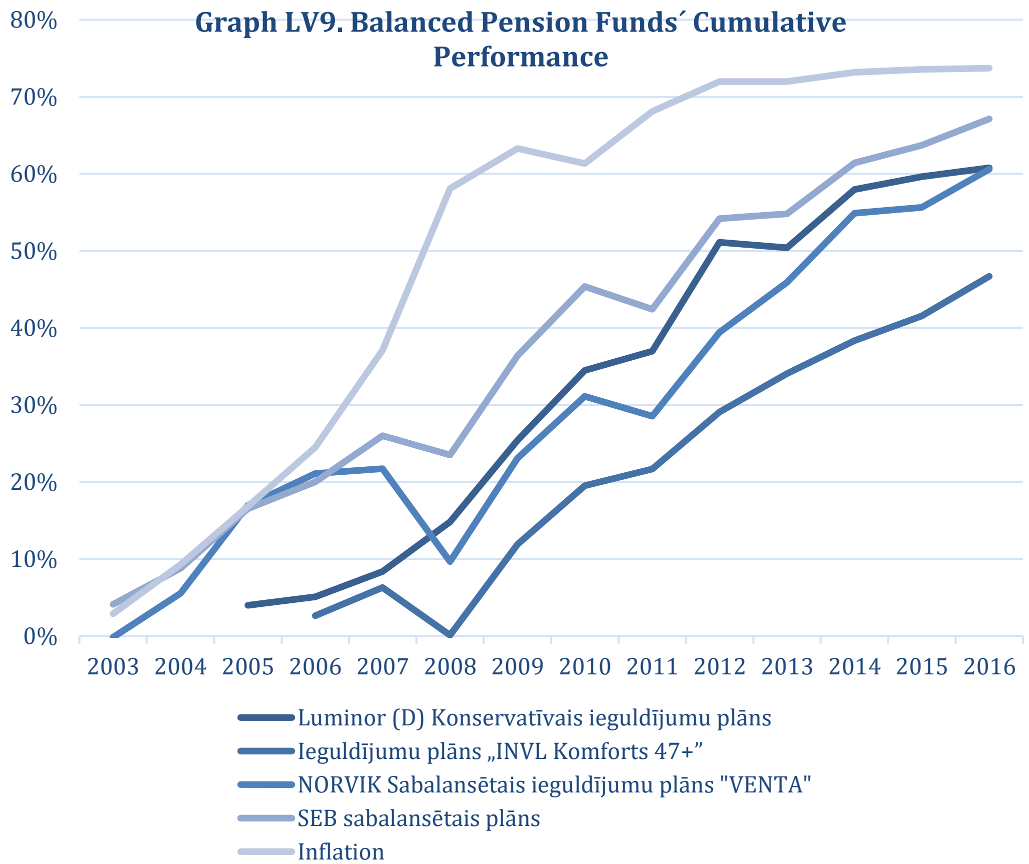
Pension reform introduced Pillar II in July 2001. However, pension funds started their effective operation from January 2003, so only data for the period from 2003 to 2017 is presented.

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



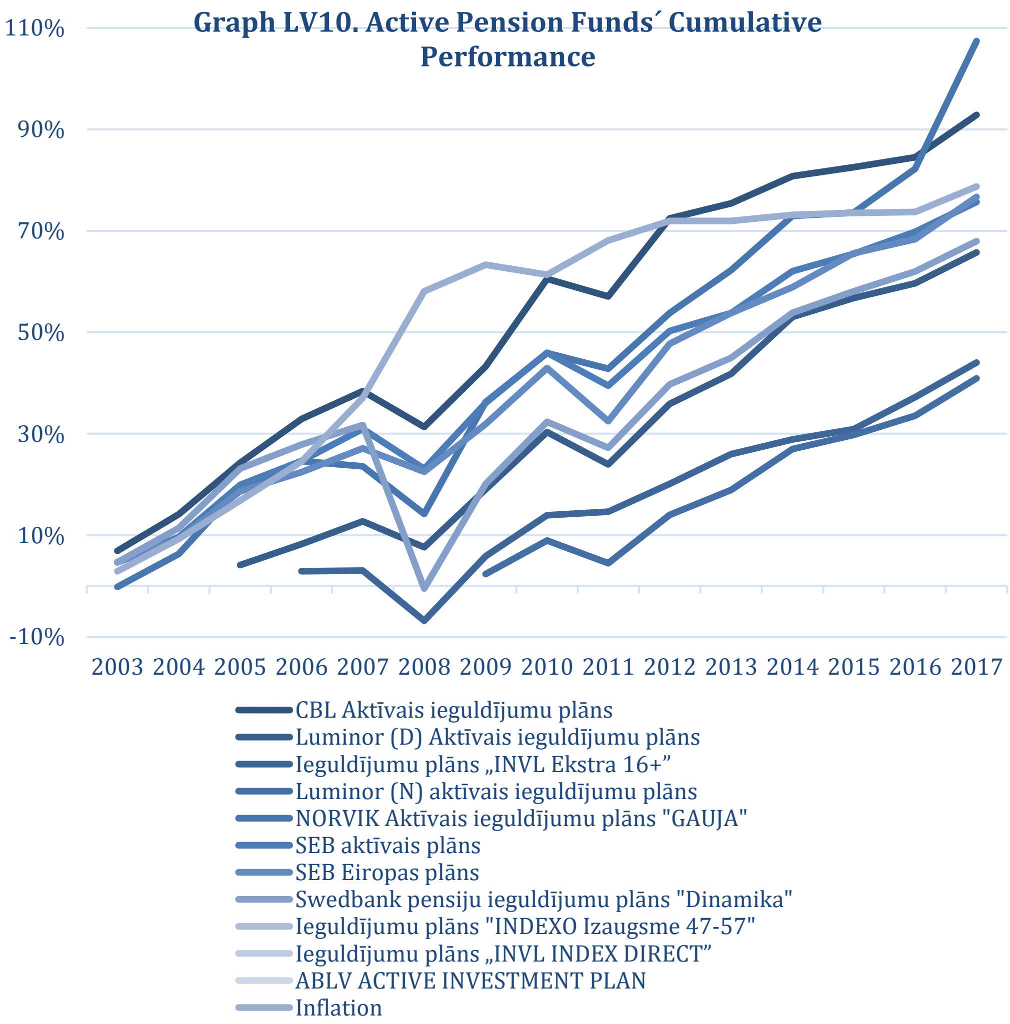
<u>Source</u>: Own calculation based on http://www.manapensija.lv/en/2nd-pension-pillar/statistics/ and supplementary pension funds´ Prospectuses and Terms, 2018

Balanced pension funds´ cumulative performance comparing to the Latvian inflation is presented in graphs below.



__Source__: Own calculation based on http://www.manapensija.lv/en/2nd-pension-pillar/statistics/ and supplementary pension funds´ Prospectuses and Terms, 2018

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



Source: Own calculation based on http://www.manapensija.lv/en/2nd-pension-pillar/statistics/ and supplementary pension funds´ Prospectuses and Terms, 2018

It should be noted that only two active pension funds (out of 23) existing since the start of Pillar II were able to "beat" the inflation, and thus able to deliver the positive real returns to the savers. Nominal as well as real returns of state funded pension funds in Latvia weighted by AuM are presented in a summary table below.

Table LV8. Nominal and Real Returns of State Funded Pension Funds in Latvia						
2003		4.86%			1.96%	
2004		5.69%			-0.51%	
2005		8.93%			2.03%	
2006		3.91%			-2.69%	
2007		3.51%			-6.59%	
2008		-10.04%			-25.34%	
2009		13.51%			10.21%	
2010	**Nominal return after charges, before inflation and taxes**	8.45%	**3.90%**	**Real return after charges and inflation and before taxes**	9.65%	**-0.38%**
2011		-2.10%			-6.30%	
2012		9.06%			6.76%	
2013		2.32%			2.32%	
2014		5.25%			4.55%	
2015		1.93%			1.73%	
2016		2.02%			1.92%	
2017		3.26%			0.36%	

Source: Own calculation based on Manapensija data (http://www.manapensija.lv/en/2nd-pension-pillar/statistics/), 2018

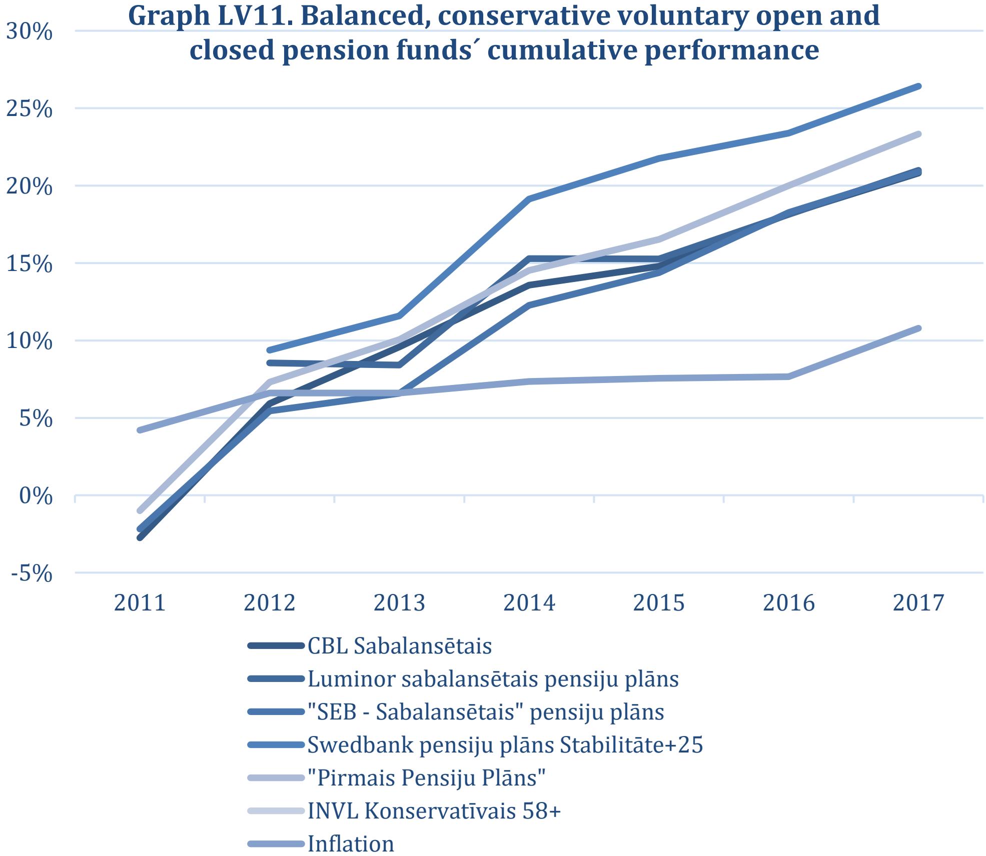
Pillar III – Voluntary private pensions

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.

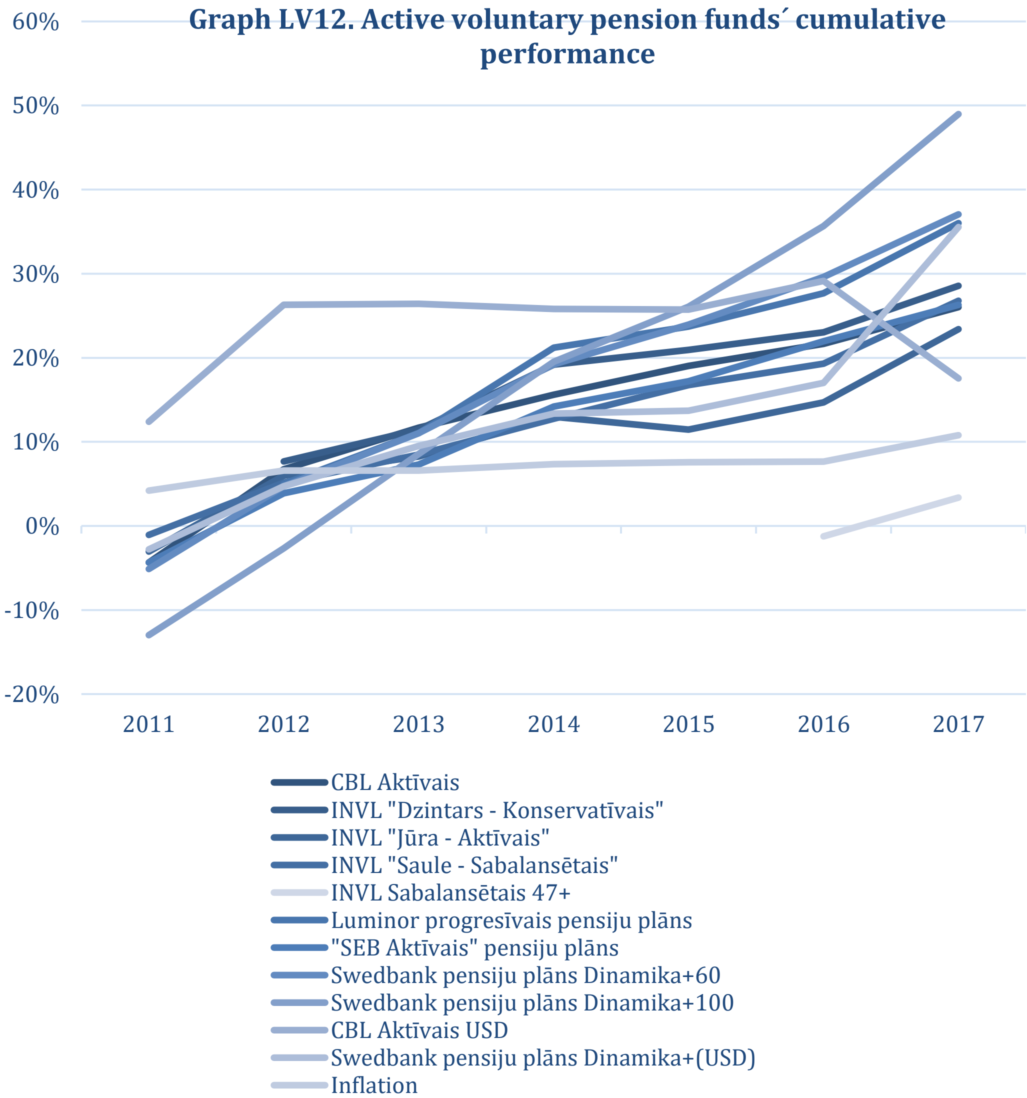
Graph LV11. Balanced, conservative voluntary open and closed pension funds´ cumulative performance



Source: Own calculation based on Manapensija data (http://www.manapensija.lv/en/3rd-pension-pillar/history-and-statistics/), 2018

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 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.



__Source__: Own calculation based on Manapensija data (http://www.manapensija.lv/en/3rd-pension-pillar/history-and-statistics/), 2018

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

Table LV9. Nominal and Real Returns of Voluntary pension funds in Latvia						
2011	**Nominal return after charges, before inflation and taxes**	-2.61%	**3.38%**	**Real return after charges and inflation and before taxes**	-6.81%	**1.87%**
2012		8.77%			6.47%	
2013		3.08%			3.08%	
2014		5.56%			4.86%	
2015		2.28%			2.08%	
2016		3.35%			3.25%	
2017		3.62%			0.72%	

Source: Own calculation based on Manapensija data (http://www.manapensija.lv/en/3rd-pension-pillar/history-and-statistics/), 2018

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 and Pillar III funds managers enjoy relatively high fees charged to pension funds savers. 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.

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