# Will You Afford to Retire?

## The Real Return on Long-Term and Pension Savings

**2024 Edition**

BETTER FINANCE

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

# Will You Afford to Retire?

## The Real Return of Long-term and Pension Savings

**2024 Edition — Estonia**

A research report by BETTER FINANCE


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# Executive Summary

Was 2023 the year when European retail investors finally obtain the "fairer deal" that the outgoing European Commissioner Mairead McGuiness wished for them (McGuinness, 2023)? As far as long-term and pension products are concerned, this report presents mixed results. While European capital markets performed strongly in 2023, helping many pension funds and life insurance companies to rebound after a calamitous 2022, we find that many of the products we analyse failed to pass on the benefits of this renewed performance to pension savers. One or even two years of past performance, however, do not tell us much about the long-term performance of saving products. What matters for individuals who invest part of their income into those products is how much income they will be able draw from them in the distant future, in particular for retirement purposes. The objective of this report therefore is to provide readers with a long-term perspective on performance that aligns with the extended investment horizon. We analyse the costs and performance of a broad range of products across various holding periods, spanning up to 24 years. Over this longer period good years supposedly make up for bad ones. Nevertheless, we observe that many of the product categories do not offer sufficient nominal returns in the long run to compensate for inflation, even with the moderate inflation rates of the of the 2000s and 2010s. This weak performance then results in a loss of purchasing power for many European savers and investors.

## The real net return of European long-term and pension savings

The object of this report is to assess the ability of long-term and pension savings products to at least preserve the purchasing power of European retail investors' savings over more than two decades, and at best increase the real value of these savings, increasing the capital on which European pension savers may rely on to maintain their living standard in retirement. That is why we focus our analysis on time-weighted returns.

The risk of financial losses is inherent in any investment in capital markets: capital markets are volatile—as their performance over the last two years clearly shows (see Figure XS.4). Nevertheless, we share European Insurance and Occupational Pensions Authority (EIOPA)'s view that

> the riskiness of a personal pension product is its potential inability to outperform inflation, and so to lose savings in real terms, or not being sufficiently "aggressive" to reach higher investment returns to compensate for potentially low contribution levels (European Insurance and Occupational Pensions Authority [EIOPA], 2020, p. 3),

and generalise it to any long-term and pension savings product. Short-term volatility—the alternance of good and bad years—is of little consequence for most pension savers; what matters is the cumulated performance over the life of the contract, the holding period, which often spans more than two decades. Over such long periods, the crucial risks are those arising from cumulated costs—which divert a portion of the accumulated capital towards financial intermediaries profit and loss accounts—and inflation—which progressively erodes the purchasing power of savings. The *real net rate of return* is therefore the main metric of interest for pension savers.

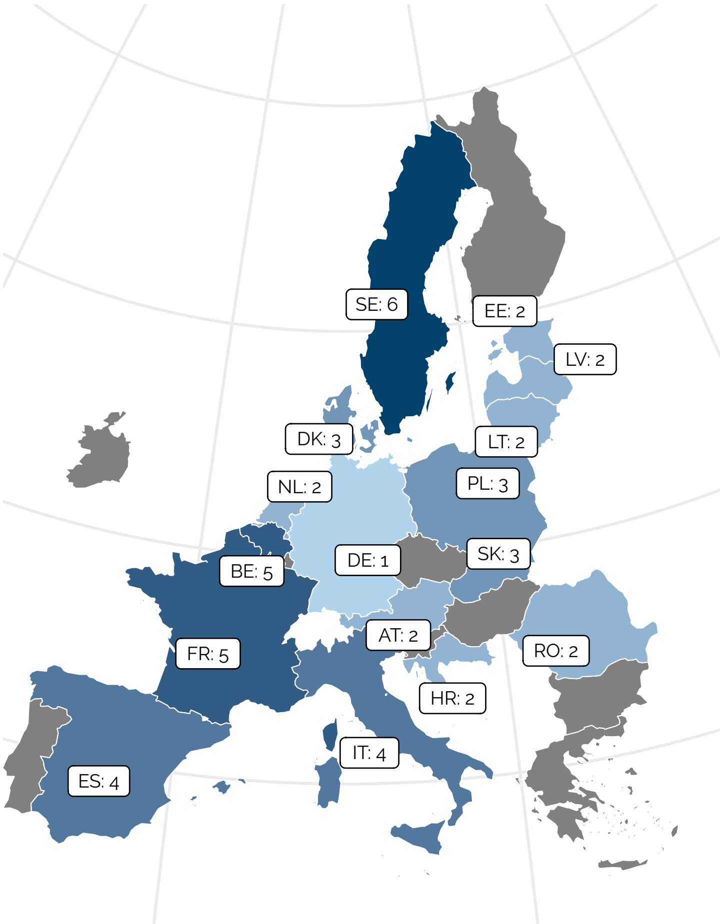
This research report by BETTER FINANCE covers 16 of the 27 European Union (EU) Member States. In each of these countries the team of contributors analyses the costs and performance of up to 6 product categories. Our goal is to calculate, based on publicly available data about these product categories, the *real net return* that long-term and pension savers may expect to obtain from their investments, going back as far as the year 2000. When we refer to real net return, we are indicating the rate of return on an investment after deducting all costs and charges levied by the product provider. This calculation also accounts for inflation, which reduces the purchasing power of both the invested capital and returns. The map in Figure XS.1 shows the countries included in this study, and the total number of product categories analysed in each country.

Assessing the real net return of a category of pensions products requires three classes of information about these products: (a) reliable data about the nominal, gross return of investments made on behalf of pension savers in relation to the total amount of accumulated capital; (b) total costs being levied for the management of these investments (administrative costs of managing the investor's contract, cost of management of investment fund "units", entry fees, exit fees, etc.) and; (c) the rate of inflation in one's country for each year of the investment period.

These are but typical examples of the data availability issues that our team of expert contributors face across countries and product categories. While data about average inflation is easy to come by—thanks, inter alia, to the work of Eurostat—, we can hardly say the same for data about returns and costs. The availability of such data often limits the scope of our study. Reliable information about the average performance of a product category may be unavailable, as is the case of most German long-term and pension saving products, or not fully appropriate for an assessment of what the client actually get, as is the case with Belgium's *Assurance Groupe* products. Costs data are even more difficult to obtain: for many of the product categories we analyse, cost information is too scarce to assess the impact of costs on performance.

Long-time followers of BETTER FINANCE's work on pensions might remember that past editions of the report also included Bulgarian pensions products and may be surprised to see that we analyse no product category in Bulgaria in this report. In the case of Bulgaria, despite BETTER FINANCE's multiple calls to the relevant authorities, essential data necessary to calculate the real net returns of Bulgarian pension savings remain unavailable, forcing us to renounce including any Bulgarian long-term or pension savings product category in our study.

**Figure XS.1** – **Countries and number of product categories included in the report**

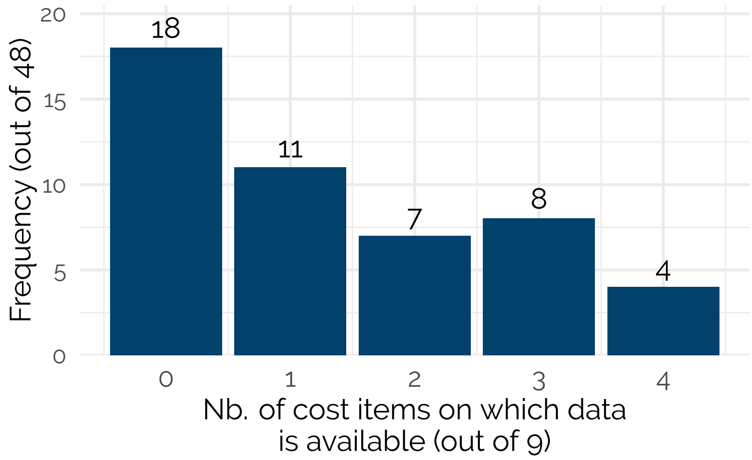



Besides performance data, information on costs is very often patchy and displayed in a way that makes it impossible for investors to compare cost levels across product providers, and for our contributors to aggregate this information at the level of product categories. The reader can appreciate this reality in Figure XS.2: for none of the 48 product categories included in our study could our contributors find data for more than 4 out of the 9 cost items defined in our methodology. Additionally, for more than a third of the product categories in our study, there is simply no cost information available.

For the 18 product categories for which no cost data is available, the lack of information on costs and charges prevents us from evaluating the average effect of charges on investors' returns. Consequently, we are forced to start our analysis with disclosed nominal *net* returns, whereas providers' marketing communications usually communicate on the basis of nominal *gross* returns.

Given the challenges in obtaining fundamental data on the average costs and performance of long-term and pension savings products, which capture a large share

**Figure XS.2** – **Availability of cost and charges data for 2023**




of the wealth of European households, we advocate for EU and national authorities to urgently enact and implement the proposed rules on product oversight, governance, and information to investors, as outlined in the recent Retail Investment Strategy (RIS) proposals made by the European Commission (see our policy recommendations on Page xiii). Costs and performance disclosures are key to properly assess the functioning of the European market for pension savings products.

While opacity on cost and charges presents a challenge for many of the product categories we study, it is only fair to acknowledge the few cases in which industry and supervisors made significant efforts to define and implement coherent reporting frameworks, such as that of the Dutch pension funds or the Italian *Commissione di Vigilanza sui Fondi Pensione* (COVIP)'s annual report on pension funds and *Piani Individuali Pensionistici* (PIP).

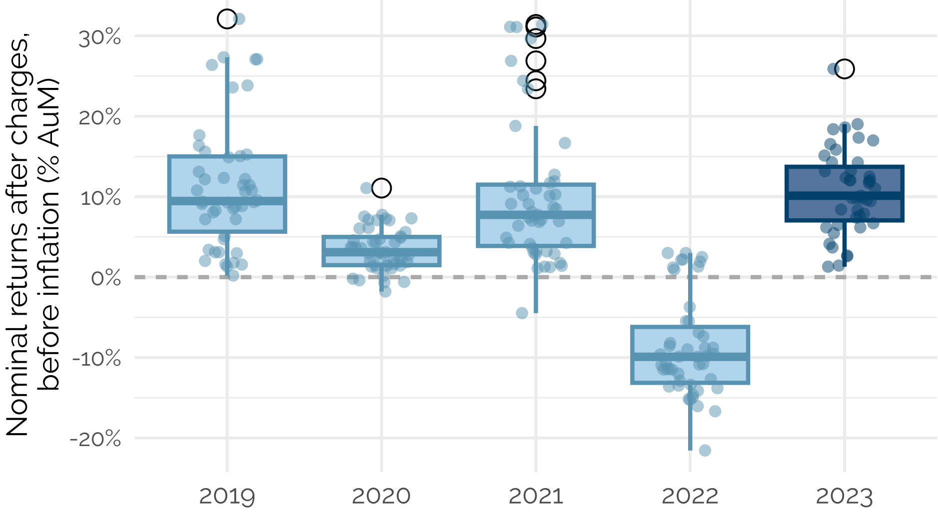
## 2023: Recovering from the slump

The product categories included in our study generally performed strongly in 2023. All of the 43 product categories for which we could obtain performance data for 2023 had a positive nominal net return. As can be appreciated in Figure XS.3, this performance is in sharp contrast with the previous year, when out of 47 product categories, 38 returned a loss in nominal terms, after charges.[1]

These good results reflect the good performance of, in particular, equity markets between January and December 2023, which recovered strongly after the slump of 2022. Figure XS.4 shows the performance of European capital markets. Using two pan-European market indices as proxies—one for equities and one for bonds, we calculate the cumulative return of a hypothetical portfolio composed of European equity and bonds in equal proportion, with annual rebalancing. The cumulated return, in nominal terms, of this portfolio dropped by 44.8 percentage points between

[1] In box plots such as Figure XS.3, the central box represents the interquartile range (i.e., 50% of the data), the thick central line is the median, the whiskers (vertical lines) indicate where roughly 99% of the data points are located, and the black circles at each end of the whiskers represent outliers.

**Figure XS.3** – **Average 1-year return rates of analysed product categories (2019–2023)**



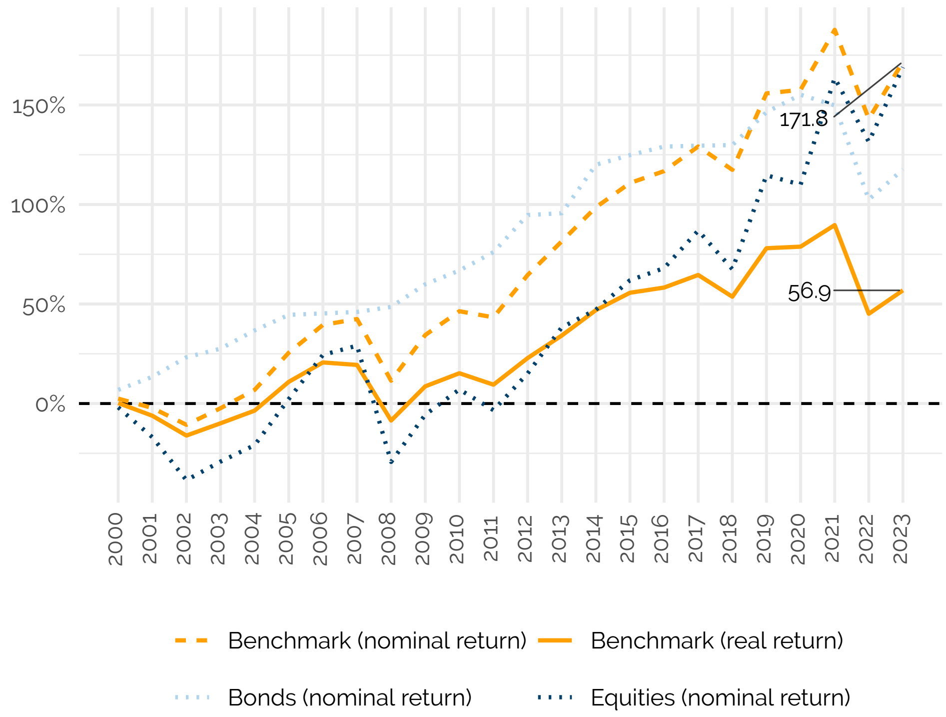

*Data:* NCAs and sectoral associations (see Country Cases); *Calculations:* BETTER FINANC

end-2021 and end-2022 before rebounding to 171.8% by the end of 2023. After adjusting for the average inflation across the EU, we obtain a 56.9% real net return, +11.8 percentage points (p.p.) from end-2022.

Inflation, in turn, slowed down in most EU countries in 2023, after the peak of 2022. In 8 of the 16 countries of our study, inflation in 2023 was below the annual average over the period 2000–2003. Nevertheless, for most of our sample, inflation remained high, as can be observed in Figure XS.5. Inflation across the Euro Area, stood at 2.93%, still significantly above the close-to-but-below-2% target of the European Central Bank (ECB).

The result of this combination of strong capital market performance and slowing inflation is a reduced gap between nominal net returns and real net returns for 2023: With a median net return standing at 10.1% in nominal terms and 7.4% after inflation, the gap is reduced to 2.8 p.p. (see Figure XS.6), down from 8.6 p.p. in 2022, when the already severly negative median nominal returns (-9.9%) where further depressed by the strongest inflation seen in Europe is decades, yielding a median real net return of -18.5%. These median values, it should be noted, hide markedly contrasting differences: The maximum performance for 2023, in nominal terms and after deduction of charges, stands at +25.9% (Poland's Employee Capital Plans), while the poorest performance with +1.3% (ironically, that of Italian PIP "with profits" contracts) narrowly avoids returning a loss in real terms thanks to the low level of inflation in Italy (+0.46%).

**Figure XS.4** – **Cumulated performance of European capital markets (2000–2023)**




## Pan-European Pension Product (PEPP): First full year of return data

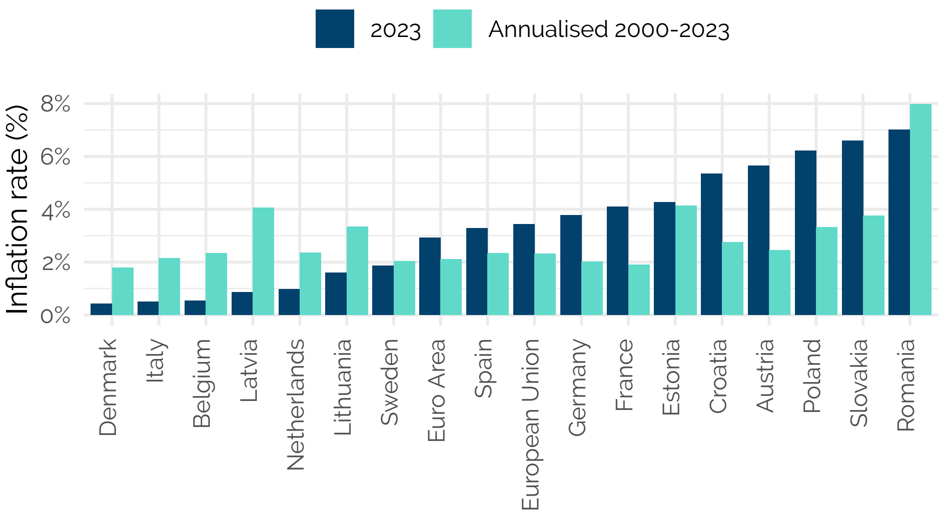
We wish to highlight the good performance of the first PEPP to be included in our study: with a nominal return before charges and inflation standing at +15% and charges amounting to 0.72% of assets under management (AuM), the Slovak PEPP yielded a net return of +14.3% in nominal terms and 7.2% in real terms, largely outperforming its capital markets benchmard (11.8% and 4.9% in nominal and real terms, respectively). Find more information in the Slovak country case in part II of this report.

These data show that the PEPP is indeed a promising personal pension product. The Slovak case shows that it is indeed possible to offer a PEPP under the conditions set by the current PEPP regulation, including the “1% fee cap”, that is, the limiting of fees to 1% of accumulated capital per annuum for the Basic PEPP.

BETTER FINANCE will keep monitoring its development not only in Slovakia, but also in Poland—another of the country cases of this report, where PEPP was introduced in the course of the year 2023—and other countries.

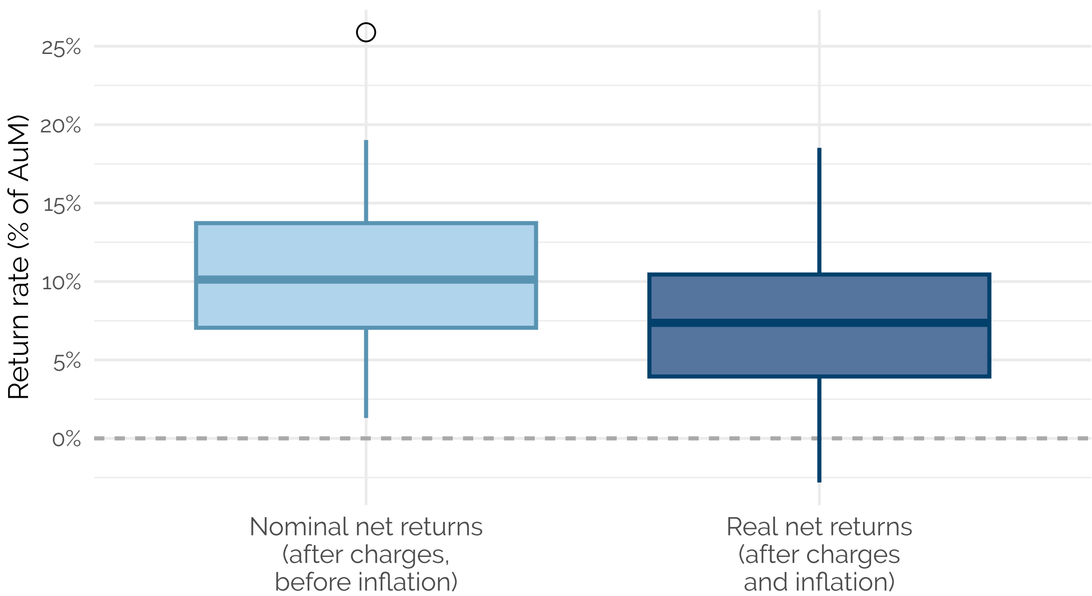
In the meantime, we urge Member State governments to offer the PEPP the same treatment, as regards taxation, subsidies and transferability of accrued pension benefits, that existing national personal pension products enjoy (see our policy recommendation on this topic on Page xvii).

**Figure XS.5** – **Inflation 2023 vs. 2000–2023 annual average**




*Data:* Eurostat (HICP monthly index); *Calculations:* BETTER FINANCE.

**Figure XS.6** – **Average 1-year nominal vs. real return in 2023 (after charges, % of AuM)**

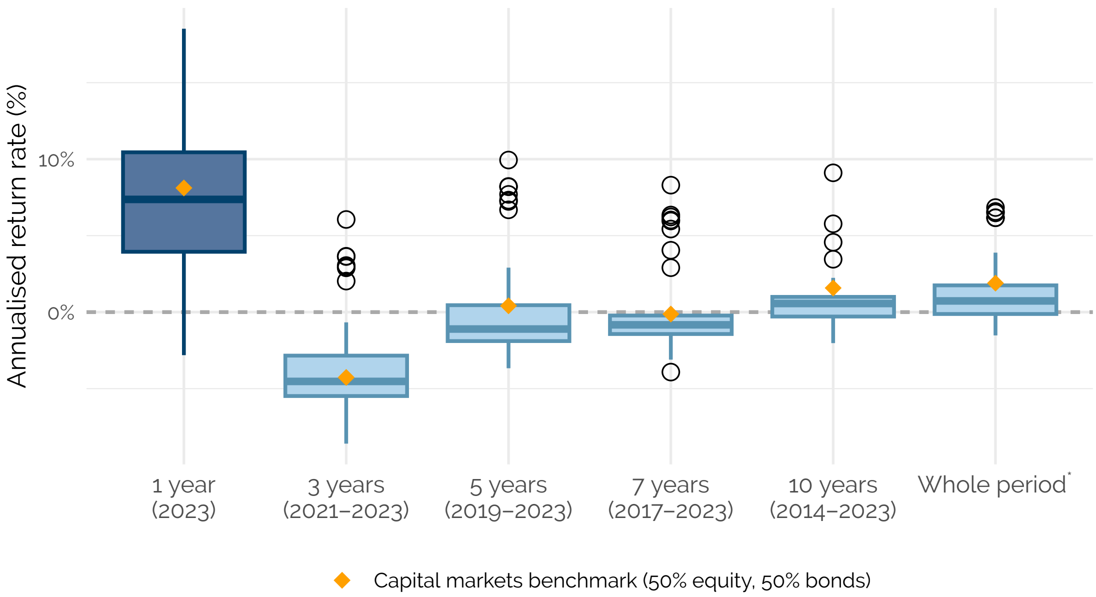



*Calculations:* BETTER FINANCE

## The long-term view on long-term savings

Naturally, one should not assess the performance of long-term and pension savings products based on the results obtained in one bad year but rather take a long-term view. That is why our ambition in this report is to gather data about costs and performance for a period of up to 24 years (2000–2023).

**Figure XS.7 – Average annualised real net returns over varying holding periods**




*Calculations:* BETTER FINANCE; * Up to 24 years, the reporting period varies across products

Figure XS.7 displays the distribution of average performances after charges and inflation of the long-term and pension saving products analysed in our report, over varying holding periods from 1 year (2023) to the whole period for which data could be found ("whole period", up to 24 years). We immediately observe that the capital markets slump of 2022 still weighs down on performance over shorter periods (3, 5 and even 7 years), with annualised rates after charges and inflation negative for a large majority of product categories. Over 7 years (2017–2023), the negative performance of 2022 comes atop that of the year 2018, with the result that only a few outliers manage to yield a positive real net return over that period.

Market volatility, whether upwards or downwards, is cancelled out over longer periods (the standard devaition falls from 4.9 p.p. for 1 year to 2 p.p. for 10 years, see Table XS.1), allowing us to more accurately assess the returns offered by the various product categories. Over 10 years and over whole reporting periods (up to 24 years), we see that the most of the interquartile range (the boxes in Figure XS.7) lies in positive territory. This may seem reassuring, until one notes that over 7 years, 10 years and whole periods, the annualised real performance of our capital markets benchmark (50% equity–50% bonds, rebalanced annually), shown with a yellow diamond in the figure, lies in the top quartile of the returns of product categories (above the upper bound of the box), meaning that 75% of the product categories fail to beat the benchmark.

**Table XS.1 – Summary statistics of real performance over varying holding periods**

| Holding period | Nb. of product cat. | Median | Mean | Standard Deviation | Best performance | Worst performance |
|---|---|---|---|---|---|---|
| 1 year | 43 | 7.4% | 7.3% | 4.9pp. | 18.5% | -2.8% |
| 3 years | 47 | -4.5% | -3.6% | 3.4pp. | 6.1% | -8.6% |
| 5 years | 46 | -1.1% | 0.2% | 3.5pp. | 9.9% | -3.7% |
| 7 years | 46 | -0.8% | 0.0% | 2.8pp. | 8.3% | -3.9% |
| 10 years | 40 | 0.6% | 0.7% | 2.0pp. | 9.1% | -2.0% |
| Whole period* | 48 | 0.8% | 1.3% | 2.3pp. | 7.2% | -1.5% |

*Calculations:* BETTER FINANCE

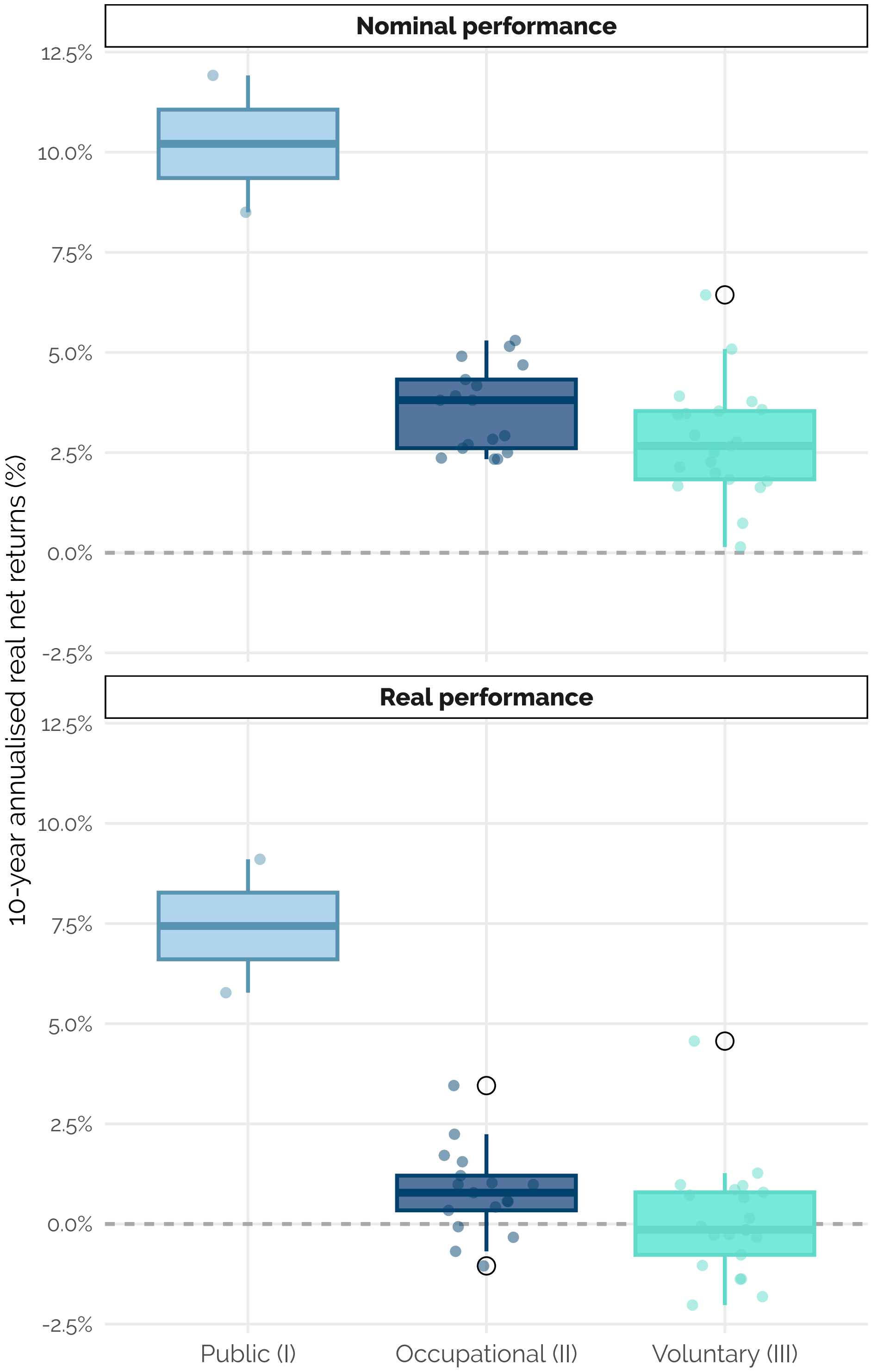
* Whole period varies across products (up to 24 years).

Observing the distribution of performance levels across pension system pillars, we also note that occupational pension schemes in Pillar II generally outperform voluntary products within Pillar III. Figure XS.8 illustrates the distribution of 10-year performance per pillar.

Swedish Premium pensions, which show very strong performance compared to the rest of the analysed product categories, are classified as Pillar I but although they are funded, earnings-based pensions that bear strong resemblance to occupational pension schemes (Pillar II). Leaving these extreme positive outliers aside, we observe that median 10-year performance of Pillar II products (central line of the middle box) is above the upper limit of the interquartile range of Pillar III performances (upper bound of the right-hand box), meaning that 75% of Pillar III products have a performance below the median performance of Pillar II products.

It is beyond the scope of this report to explore the significance of the trend, although future research should investigate the factors that may explain it, including differences in asset allocation, management costs, distribution costs, and the potential effect of auto-enrolment schemes. Additional cost data would be particularly valuable to consistently analyse whether the observed divergence in performance might arise from higher costs associated with Pillar III products. We hope that such data becomes available if the EU legislator follows the much-welcomed proposals regarding cost disclosures under the Markets in Financial Instruments Directive (MiFID) and Insurance Distribution Directive (IDD), crucial elements of the European Commission's proposals for the Retail Investment Strategy (RIS).

**Figure XS.8 – Average 10-year annualised performance per Pillar**




*Calculations:* BETTER FINANCE, returns are shown after charges and inflation.

# Policy recommendations

**Policy recommendation 1 — Supervisory reporting and statistics**

**Step up efforts to collect and disclose data on long-term and pension savings products, both at the national and EU level (ESAs's cost and past performance reports) to empower European citizens as retail investors.**

The contributors to this report can testify of the difficult to obtain even basic, aggregated data about long-term and pension products in many EU countries. If a team of expert contributors, with knowledge and experience in the field, find it challenging, how can we expect EU citizens to make any use of these data to assess the performance of their own pension products in relation to the market? Making available full historical data sets of both aggregated and provider-level data would enable non-profit organisations like BETTER FINANCE to provide an independent, consumer-friendly analysis of this market. But national competent authorities (NCAs) could also step up their efforts to create consumer-friendly reports and comparison tools.

Harmonised frameworks for reporting from product providers to NCAs and pension scheme participants already exist for various of the product categories we analyse in this report. These commendable efforts should be assessed through a peer-review process to be organised by the European supervisory agencies (ESAs) in order to identify best practices, but also discard misleading disclosure practices that prevent retail investors to obtain a clear picture of the cost and performance of the products on offer. As part of these efforts to better report on the costs and performance of retail investment products, BETTER FINANCE calls on the ESAs to keep improving their annual costs and performance reports. Currently, the data and coverage of these reports are incomplete and based on commercial databases or surveys. The European Securities Markets Authority (ESMA), the EIOPA and—in the future—the European Banking Authority (EBA) should be able to rely on regular reporting of supervisory data from NCAs, which themselves should have the necessary powers to require regular reporting of data on the costs and performance of saving and investment products in their respective areas of competence.

Going further, the EU legislator should draw inspiration from these examples and incorporate into EU law - specifically, theMiFID and IDD legislation for Pillar III products, currently under review as part of the Retail Investment Strategy (RIS), or the next revision of the IORP II directive on occupational pensions - requirements for NCAs to adequately report figures on a quarterly or monthly basis. This should include the constant updating and public reporting of AuM and net AuM, unit value, asset allocation, as well as the number of participants for all supervised vehicles in the area of long-term and pension savings.

## Policy recommendation 2 — Conflicts of interest in scheme management and product distribution

**Harmonise and reinforce rules to curb the conflicts of interests in the distribution of long-term and pension saving products, and improve the governance of collective long-term pension schemes.**

Conflicts of interest plague the management and distribution of long-term and pension saving products in Europe. The sales commissions-based distribution system of voluntary long-term and pension saving products (Pillar III) directs retail investors towards fee-laden and often underperforming products. Our report showcases various product categories with high average fees and poor long-term returns that so-called "advisors" are paid to recommend to consumers, against the best interest of the latter.

BETTER FINANCE has consistently opposed this system, and strongly supported the European Commission's proposal to partially ban so-called "inducements" as part of the RIS. We believe that the inducements-based distribution system hurts retail investors through higher charges, the illusion of "free" investment advice and a selection bias in distributors' recommendations, all of which result in lower returns and inadequate retirement income for European citizens (BETTER FINANCE, 2023b, pp. 4–13). The financial industry failure to acknowledge the problem and its intense lobbying efforts to maintain a damaging status quo resulted in the utterly disappointing provisional positions of the Council and, especially, the European Parliament (BETTER FINANCE et al., 2024), which should not be expected to improve outcomes for consumers in any meaningful way. Nevertheless, ignoring the problem will hardly make it disappear, and so we urge all involved policy-makers, supervisors, but also willing representatives of the indsutry, to keep working towards the generalisation of high-quality bias-free financial advice that EU citizens can rely for their retail investments.

In occupational pension schemes (Pillar II), the issue of conflicts of interest takes on a different form. In those schemes, it is crucial that the board, which takes decisions on behalf of the scheme's members, includes independent members representing the interests of beneficial owners.

## Policy recommendation 3 — Information to (prospective) investors

**Provide simple, intelligible, and comparable information on cost and performance of long-term and pension saving products.**

Obtaining information on long-term and pension vehicles, as well as monitoring them, should not be difficult for non-professional savers. This implies also reinstating standardised actual cost and past performance disclosure, and in real terms alongside the less relevant nominal ones.

The proposed revisions to the EU's MiFID and IDD legislation, along with the amendments to the PRIIPs regulation, offer the opportunity to finally provide investors with the information they actually need to compare the costs of products. BETTER FINANCE strongly supports, in particular, the provision of annual statements to holders of investment funds' shares distributed under MiFID and to life insurance policyholders distributed under IDD, including the provision of information on the cost of distribution and the possibility to obtain a detailed breakdown of all charges.

Although we welcome the innovations introduced to the format of Key Information Documents (KIDs) by the proposed amendments to the PRIIPs regulation, we still call for a thorough review of this legislation to drastically improve the understandability and comparability of the information provided in the KID. We strongly believe that providers of packaged retail and insurance-based investment products (PRIIPs) should include the actual most recent costs of their products in the KID.

PRIIPs providers should also be required to provide 10 years of past performance data together with the benchmark that is used as investment objective by the product provider. While past performance is not indicative of future performance, it is a good indicator of whether a PRIIP has ever made money or not for the investor, and of an asset manager or insurance company's ability to meet its investment objectives, and to generate returns for the client. Furthermore, it is comparable across product providers and timelines, as it does not rely on assumptions and hypothetical scenarios. The past performance of various products shows how their respective providers navigated through a similar set of real-world circumstances. Finally, displaying past performance in comparison with the product's stated benchmark enables the prospective investor to clearly see whether the provider has been able to make good on their commitment to meet its target.

While we are generally disappointed with the current state of the legislative negotiations on the EU's RIS, we urge the co-legislators to adopt these proposals on disclosures. For more information about our recommendations regarding information to investors and prospective investors, see BETTER FINANCE (2023b, pp. 17–22).

Readers may also refer to BETTER FINANCE's response to the consultation conducted by EIOPA on the review of the Directive on institutions for occupational retirement provision (IORPs) (BETTER FINANCE, 2023a). In occupational pension schemes too, managers should provide pension scheme participants with the information necessary to keep track of their pension benefits and effectively plan their savings and investments to ensure adequate levels of retirement income.

Finally, we urge EU and member state authorities to step up efforts towards the implementation of comprehensive individual pension tracking systems, following the recommendation of the High-Level Forum on the Future of the Capital Markets Union (HLF CMU). These constitute crucial empowering tools, enabling individuals to keep track of their accumulated pension rights across employers and across borders.

### Policy recommendation 4 — Sustainability

**Provide clear, intelligible information on the sustainability of European long-term and pension savings and investments.**

An increasing number of retail investors expresses a desire to invest in financial products that consider sustainability criteria and pursue environmental, social and governance (ESG) objectives (2° Investing Initiative [2DII], 2020). Despite significant progress in recent years, much remains to be done to provide retail investors with an investing environment that accommodates both their financial and sustainability preferences.

First, EU policymakers should increase their efforts to develop a clear, precise, and standardised taxonomy of economic activities. This taxonomy should be grounded in scientific analyses and address all three major aspects of sustainability: environmental, social and governance (ESG). These efforts should also include the development of a well-designed EU-wide Ecolabel for retail investment products that avoids the pitfalls of existing national labels.

EU policy-makers should also address the short-termism of the financial industry by reinforcing the consistent linkage between sustainability and long-term value creation. It must be clearly emphasised that exemplarity with regard to investor protection rules first and ensuring decent returns for individual investors is compatible with investing in a way that respects environment and society. To this end, clear and intelligible ESG disclosures should be combined with financial disclosures, preferably integrated into one document providing savers and investors with a holistic picture of the products they buy.

Finally, EU and national policymakers should require sustainability and ESG knowledge and training for board members in long-term and pension savings vehicles, as well as for financial advisors and sales personnel distributing such products. Regarding the latter, BETTER FINANCE supports the European Parliament's proposal, within the framework of the RIS to impose on financial advisors and sales personnel a yearly training requirement on sustainable investing (see BETTER FINANCE, 2023b, pp. 12–13).

### Policy recommendation 5 — Asset allocation

**End the fixed-income bias in the asset allocation of long-term savings.**

Prudential rules, designed to protect investors against the risk of excessive risk-taking leading to financial losses, require pension fund managers and life insurance providers to allocate a significant portion of participants' and policyholders' funds into fixed-income assets, particularly sovereign debt from EU Member States.

However, in doing so, these rules excessively restrict the possibility for long-term and pension savers to take advantage of investment opportunities in equity markets, which, while more volatile, also offer higher yields in the long term.

Regulations governing long-term and pension savings should not discriminate against long-term equity investments. Specifically, life-cycling strategies that adjust risk to the investment horizon of the saver should enable managers to invest a substantial portion of younger investors' contributions or premiums in equity market instruments (as is the case of Sweden's Premium pensions, in particular the AP7 Såfa fund).

**Policy recommendation 6 — Taxation**

**Stop penalising taxation of long-term and pension products.**

Taxation on pensions, whether on contributions, returns, or payouts, should be based on real values rather than nominal ones. Taxes should be applied to values adjusted for inflation, using the harmonised index of consumer prices (HICP). To recoup the value of pension pots, at least occupational schemes (Pillar II) should apply an "EEE" regime. Pillar II contributions should be deductible from the income base tax.

**Policy recommendation 7 — Pan-European Pension Product (PEPP)**

**Create a friendly environment for the PEPP**

This year's report, for the first time, includes cost and performance data on PEPP, as implemented in Slovakia. As previously mentioned, these data are encouraging. Nevertheless, we note that the current environment is not conducive to the take up of this product, despite its intrinsic qualities from the point of view of retail investors:

- As noted by EIOPA:

  > [t]he higher costs of products considered "competitors" to PEPP may diminish its appeal to potential providers. [...] Offering a cheaper enquotecompetitor product might raise concerns about the risk of product cannibalisation, potentially resulting in a loss of sales and revenue from existing products4 (EIOPA, 2024).

  Shielded from competition by the opacity of costs and performance disclosures, and the dominant inducements-based distribution system that biases "enquote" towards high-fee products, incumbent providers have little incentives to add a low-cost product to their range of personal pension products.

- Member State governments have generally failed to ensure that PEPP competes on a level playing field with existing personal pension products: rules on tax rebates and subsidies applicable to equivalent personal pension products have only in a few cases been extended to the PEPP, and transferability of accrued personal pension benefits from existing products to PEPP is only possible in a handful of Member States (EIOPA Occupational Pensions Stakeholder Group [OPSG], 2024).

BETTER FINANCE urges policy-makers not to give in to industry pressures to delete the 1% fee cap for the Basic PEPP. Instead,

- Member States should amend their respective legislations to ensure that PEPP receives the same treatment as any other personal pension product marketed in their jurisdiction.
- EU and Member State authorities must further explore the suggestions put forward by EIOPA in its recent paper to expand the target market for PEPP with a view to offer potential PEPP providers the perspective of greater economies of scale.

### Policy recommendation 8 — Auto-enrolment

**Introduce auto-enrolment in occupational pensions.**

The active labour force should be automatically enrolled in a default pension fund, with the option to withdraw or switch provider at no additional cost. Romania, Sweden, Slovakia and other serve as best practice examples: This auto-enrolment ensures that working individuals start saving early and consistently for their retirement, reducing the risk of insufficient income in retirement. This was also a recommendation of the HLF CMU.

In this regard, we consider with interest EIOPA's suggestion, in its paper from September 11, 2024 to enable the use of PEPP as an occupational pension product, in which employers could then automatically enrol their workforce (EIOPA, 2024).

### Policy recommendation 9 — Suspensions

**Allow savers to defer contributions to pensions without penalties.**

Savers should be allowed to suspend payments into a pension savings or life insurance plan without incurring a penalty. In an era characterised by uncertainty, it can never be assumed that an individual will always have an income sufficient to cover their immediate needs as well as pay their premium or set contribution towards their pension plan.

When an individual, for whatever reason, cannot, for a short period of time, contribute to their pension product, they should not be faced with the choice between foregoing their pension plan or paying a penalty. Instead, they should be able to suspend payments and resume as soon as they have a new income stream.

### Policy recommendation 10 — Insurance guarantee schemes

**Urgently establish harmonised insurance guarantee schemes in the EU.**

EU citizens are partially covered against the default of product manufacturers through

Directive 2014/49/EU on deposit guarantee schemes (DGSs) and Directive 97/9/EC on investor compensation schemes (ICSs). However, many pension savers across the EU lack an appropriate protection for insurance-based investment products (IBIPs), a shortcoming of the EU's protection regime that is particularly problematic as IBIPs (such as life insurance) are predominant in some pensions systems in the EU (e.g., in France).

BETTER FINANCE calls on the EU legislator to revamp the project for a Regulation on insurance guarantee schemes (IGSs), which should mimic the rules of the DGS Directive, and urgently harmonise protection against defaults at a minimum level across the EU.

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## Country Case 4

# Estonia

**Kokkuvõte**

Eesti pensionisüsteem on tüüpiline Maailmapanga mitmesambaline süsteem, mis põhineb isiklikel pensionikontodel. 2023. aastat ilmestasid tõusvad aktsiaturud ja langev inflatsioon, mis koos mõjusid positiivselt Eesti pensionisäästude ostujõule. Teise samba fondide kaalutud keskmine nominaaltootlus oli 11,69%, võrreldes kolmanda samba positiivse tootlusega 15,12%. Endiselt kõrge inflatsiooni tõttu oli teise samba fondide reaaltootlus peale inflatsiooniga korrigeerimist 7,1%. Kolmanda samba reaaltootlus oli 10,4%. Isegi kui 2023. aasta tootlus oli üldiselt positiivne, ei suutnud see korvata 2022. aasta kahjumit. Teise samba fondide pikaajaline kaalutud keskmine reaaltootlus perioodil 20032023 oli 0,2% aastas. Kolmanda samba fondide puhul oli see näitaja samal perioodil 1,0% aastas. Aastal 2020 jõustunud vastuoluline pensionireform muutis varem kohustuslikud II samba vabatahtlikuks ja võimaldas pensionisäästjatel likvideerida oma II samba säästud enne pensionile jäämist. Selle tulemusel on 2023. aasta detsembri lõpu seisuga 32% II sambasse säästjatest oma pensionivara ennetähtaegselt lunastanud.

**Summary**

The Estonian pension system is a typical World Bank multi-pillar system based on personal pension accounts. The year 2023 was characterised by raising stock markets with falling inflation, which in combination had a positive impact on the purchasing power of Estonian pension savings. The weighted average return of second pillar funds was 11.69% compared to a positive return of 15.12% in the third pillar, both in nominal returns. Due to the still elevated inflation, the inflation-adjusted real return on second pillar funds was 7.1%. The third pillar's real return was 10.4%. Even if the 2023 returns were overall positive, it could not recover from the 2022 losses. The long-term weighted average real return for second pillar funds over the period 2003-2023 was -0.2% per annum. For third pillar funds, the figure was 1.0% per annum over the same period. The controversial pension reform, which came into force in 2020, made the formerly mandatory Pillar II pension funds voluntary and allowed pension savers to liquidate their Pillar II savings before retirement. As a result, as of December 2023, 32% of Pillar II savers have redeemed their pension assets early.

# Introduction: The Estonian pension system

This country case aims to present an overview of the Estonian pension system, with a particular emphasis on savings-based pensions products, especially pension funds that are part of the auto-enrolled (formerly mandatory) Pillar II pension funds and the voluntary Pillar III pension funds.

**Table EE.1 – Long-term and pension savings vehicles analysed in Estonia**

| Product | Pillar | Reporting period | |
|---|---|---|---|
| | | *Earliest data* | *Latest data* |
| Pillar II pension funds | Occupational (II) | 2003 | 2023 |
| Pillar III pension funds | Voluntary (III) | 2003 | 2023 |

The year 2023 was quite positive for Estonian pension savings. Pillar II pension funds returned almost 12% nominal returns on average (7.1% when adjusted for purchasing power), while savings invested in Pillar III funds increased by over 15% on average (more than 10% when adjusted for inflation).

**Table EE.2 – Annualised real net returns of Estonian long-term and pension savings vehicles (before tax, % of AuM)**

| | Pillar II pension funds | Pillar III pension funds |
|---|---|---|
| 1 year (2023) | 7.1% | 10.4% |
| 3 years (2021–2023) | -5.7% | -4.6% |
| 5 years (2019–2023) | -1.1% | 0.6% |
| 7 years (2017–2023) | -1.7% | -0.7% |
| 10 years (2014–2023) | -0.3% | 0.8% |
| Whole period | -0.2% | 1.0% |

*Data:* Pensionikeskus, Eurostat; *Calculations:* BETTER FINANCE.

As can be seen in Table EE.2 even the positive real returns in 2023 have not been able to deliver positive long-term real returns. While -0.2% does not sound like a lot, then it is important to consider that pension savings are a very long-term investment. The period before first starting to work (and auto-enrolling in the Pillar II pension) and the first pension payment may be as long as 45 years.[1]

Since the introduction of the current pension system in the early 2000s, successive governments have made various changes to the laws governing the pension system in general and Pillar II pension funds in particular. Many of these changes have been

[1] For example, this would be the case for someone starting work at 20 years of age in 2003 and retiring at 65—which according to current regulation would be the minimum pension age for someone of that cohort.

to add additional flexibility and fix issues in the early conservative design in the system with the aim of helping achieve better returns in the long run. However, the most recent reform which took place in 2021, proved also to be the most controversial.

The previously mandatory Pillar II, in effect, was changed into a voluntary pension fund with auto-enrolment. Pension savers who had been enrolled in the Pillar II could now take out any accumulated savings at any age and opt out of the Pillar II entirely. About 32% of people with an Pillar II pension savings account had liquidated their assets between 2021 and end of August 2023. The amounts withdrawn amount to over 5% of Estonia's GDP.[2]

## Pension system in Estonia: An overview

The Estonian old-age pension system is based on the World Bank multi-pillar approach. This is the result of a fundamental pension reform which began in 1998 and became fully operational by 2003. Accordingly, this report analyses the returns from the first full year of operation (2003) until the last full year of data availability (2023).

The state pension (Pillar I) should guarantee the minimum income necessary for subsistence after retirement. It is based on the PAYG principle of redistribution, i.e. the social taxes paid by today's employees cover the pensions of today's pensioners.

For those, who qualify for the old-age pension by reaching the pensionable age and minimum of 15 years of service, the old-age pension consisting of various components individual to each pensioner, related to the years of pensionable service and the social security deductions during that pensionable service, which in turn depend on the salary of the person (Sotsiaalkindlustusamet, n.d.). The old-age pension consists of three parts:

- The main or basic part
- The pensionable service period component, which is calculated for employment until 31 December 1998
- The insurance component– the personally calculated additional payment

The amount of the pensionable service period component depends on the length of employment, or the working years of the pensioner. Additional pension is calculated for the years deemed equal to employment, e.g. raising of children, compulsory military, studies at a university or vocational education institution, but also for the time the employee was temporarily incapable for work. The specific list is available in the State Pension Insurance Act. There are also pension supplements for parents for each child raised.

The average I pillar old-age pension in Estonia was EUR 615.13 in 2023, which guaranteed a replacement ratio of 38% compared to the average gross salary (Statistikaamet, n.d.). Due to the progressive nature of the tax-free allowances, the replacement ratio would be 48.1% in net terms, assuming no additional annual in-

[2] BETTER FINANCE calculation based on Pensionikeskus and Statistikaamet data.

**Table EE.3 – Overview of the Estonian pension system**

| Pillar I | Pillar II | Pillar III |
|---|---|---|
| State Pension | Funded pension | Supplementary pension |
| Mandatory | Formerly mandatory, voluntary with auto-enrollment from 2021 | Voluntary |
| pay-as-you-go (PAYG) | Funded | |
| defined benefit (DB) | defined contribution (DC) – Individual pension accounts | |
| Publicly managed by Social Insurance Board (government entity) | Self-managed or investment fund | Investment fund or insurance contract |
| Retirement is possible up to 5 years earlier than the statutory retirement age, provided minimum requirements in terms of pensionable service are fulfilled. Early retirement will however reduce future pension payments. It's also possible to retire later than the statutory pension age, which will result in higher future pension payments. It's also possible to retire later than the statutory pension age. Early or late retirement respectively lowers or increases later pension payments. | Funded by a combination of a formerly mandatory contribution (2% of gross salary) and a part of the person's Social Security deduction (4% of gross salary). Since 2023, individuals can decide to contribute 4% or 6% of their salary. Since 2021 early withdrawal is possible at fixed dates several times a year, regardless of the age of the person.[a] | The supplementary III pillar has always been purely flexible and voluntary. The contribution amount can be freely chosen and is subject to a tax deduction up to certain limits.[b] Savings can be taken out at any time, but payouts other than post-retirement annuities will be subject to income tax. |
| **Quick facts** | | |
| Number of old-age pensioners: 0.309 mln. | Administrators: 5 | Administrators: 5 investment fund providers and 5 providers of unit-linked pension insurance[c] |
| Average old-age pension: EUR 615.13[d] | Funds: 26 | Funds: 17 |
| Average salary (gross): EUR 1 832[d] | AuM: EUR 4 902 mln. | AuM: EUR 602 mln. |
| Average replacement ratio (Pillar I): 33.58% gross | Participants: 0.574 mln. | Participants: 0.198 mln. |

[a] subject to 20% income tax payment if the person in more than 5 years from retirement age and a 10% income tax if the person is within 5 years of the applicable retirement age.
[b] A full income tax deduction is applicable to the annual total III pillar pay-in, up to 15% of the person's annual gross income or 6000 EUR per year, whichever is lower.
[c] Two entities, SEB and Swedbank, offer both III pillar investment funds and insurance contracts.
[d] Data: Statistikaamet.

come or deductions apply to the average pension and salary respectively.[3] A person needs to have had at least 15 years of pensionable service to qualify for a old-age pension. However, those who have reached retirement age, but do not qualify for old-age pension are eligible for a minimum "national pension", provided they had legally resided in Estonia at least 5 years before applying and do not receive a pension from any other jurisdiction [@SotsiaalkindlustusametPensionsandBenefits]. As of April 2023, this minimum national pension is EUR 336.39 per month and EUR 372.05 per month as of April 2024. This amount is also indexed annually along with old-age pensions (Sotsiaalkindlustusamet, n.d.).

The statutory retirement age in Estonia was 64 years and 3 months in 2023 (for those born in 1958) and is set to rise to 65 years by 2026. From 2027 onward, the retirement age will be increased in line with increases in life expectancy, but not more than 3 months of increase in any calendar year (Sotsiaalkindlustusamet, n.d.).

# Long-term and pension savings vehicles in Estonia

## Second pillar: Formerly mandatory pension funds and personal Pension Investment Accounts

As can be seen from Figure EE.1, the vast majority of Estonian pension savings are collected in Pillar II pension funds.

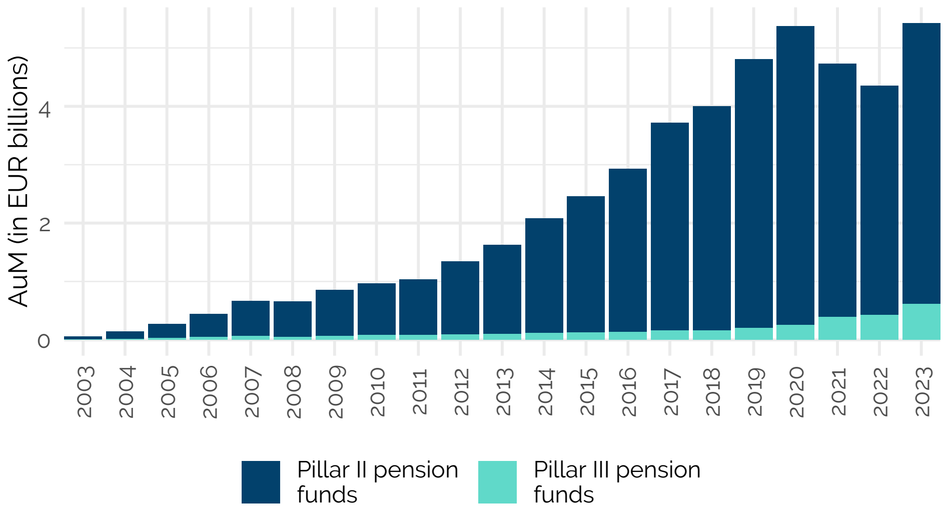
The funded Pillar II pension is based on the accumulation of assets (savings) – a working person saves for their pension, paying 2% of the gross salary to the selected pension fund. In addition to the 2% that is paid by the individual, the state adds 4% out of the current social tax that is paid by the employee and retains 29% (out of 33%). The salary linked "insurance element" of the I pillar state pension of a person who has subscribed to the funded pension is also lower respectively (for the years in which one receives 16% for the state pension instead of 20%).

Subscription to the funded pension was compulsory for those born in 1983 or later, but it has become voluntary starting January 1, 2021. The funded pension has always been voluntary for those born between 1942 and 1983. For these people, subscription was possible in seven years; from May 1, 2001, until October 31, 2010. From January 1, 2021, all persons born in 1970 or later, who are not already subscribed to the Pillar II pensions, will be able to apply to subscribe to pillar II pensions. Persons who have previously unsubscribed may re-apply after at least ten years from the date when they were unsubscribed.

From 2021, it became possible to opt-out of the second pillar pension and to liquidate any previous savings held under it. This has led to a large number of savers taking out their accrued savings before their statutory retirement age and significantly decreasing the coverage of the second pillar. At the time of writing of this report, about 491 000 people had assets in their second pillar pension account, while over 234 500 people had taken out their savings, totalling approximately EUR 2 billion.

[3] Own calculation, based on Statistikamet data.

**Figure EE.1** – **AuM of Estonian long-term and pension savings vehicles**




*Data:* Pensionikeskus; *Calculations:* BETTER FINANCE.

This was the reason for the significant reduction in AuM of Pillar II pension funds in 2021 and 2022, which can be seen in Figure EE.1. The withdrawals were largest in 2021. However, the impact was somewhat mitigated by high nominal returns on investment that year. In 2022, while the amounts being withdrawn early from the system decreased, the AuM still declined significantly from the combination of both early withdrawals and negative nominal performance of investments.

From 2021 onwards, it became possible for savers to manage their Pillar II pension assets themselves through personal Pension Investment Accounts. However, the penetration of this new form of pension savings remained insignificant in 2023, with only approx. 1% of Pillar II participants actively use this option in 2022–2023 (Pensionikeskuse Statisika, n.d.).

## Third pillar: Supplementary Pension Funds and Pension Insurance accounts

The supplementary funded pensions scheme, or Pillar III, is a part of the Estonian pension system and is governed by the same act that governs Pillar II, the Funded Pension Act.

This scheme has been introduced with the aim of helping to maintain the same standard of living and adding more flexibility in securing a higher and/or stable stream of income after one reaches the age of 55. Therefore, the supplementary pension has been designed to help achieve a recommended level of 65% gross replacement ratio of an individual's previous income in order to maintain the established standard of living.

Supplementary pension participation is voluntary for all persons who can decide to save either by contributing to a voluntary pension fund or by entering a respective supplementary pension insurance contract with a life insurance company. The amount of the contributions is determined solely by the free choice of an individual and can be changed during the duration of the accumulation phase. There is also a possibility to discontinue contributions (as well as to finish the contract).

The supplementary funded pension contracts can be made with life insurers as pension insurance or by acquiring pension fund units from fund managers. As there is unfortunately very little transparency regarding the charges and return of Pillar III pension insurance contracts, this report focuses only on supplementary pension funds as third pillar savings products.

## Charges

Starting from the data year 2017, Estonian Pillar II investment funds are obliged to report the Total Expense Ratio (TER) for a given year. This ratio is designed to present investors with a transparent and easily comparable summary of the annual costs and fees deducted from their pension savings, expressed as a percentage of invested assets.

The TER includes:

- the fee paid to the fund manager for the management of the fund or the fees, charges and expenses directly related to the management of a public limited fund (management fee);
- the fee paid to the depositary for the services provided (depositary's charge);
- the transfer fees and service charges directly related to transactions performed for the account of the fund and other fees, charges and expenses related to the management of the fund and specified in the basic documents of the fund;
- success fees.

In addition to the above fees, it is also possible for the pension funds to charge unit redemption fees, however these are capped by law at just 0.05% for conservative pension funds and 0.1% for all other Pillar II funds and in practice no redemption fees are usually charged by Pillar II investment funds on the Estonian market.

The option of applying a success fee became possible as of January 1, 2019 and intended to better align the interests of the investors and asset managers. The success fee for a given year is limited by law to a maximum of 20% of the excess of the increase in net asset values over the reference index and to 2% of the asset value of this pension fund, whichever limit is lower. Conservative pension funds do not have the right to apply a success fee.

As of September 2, 2019, the management fees of Pillar II pension funds were legally capped at 1.2% for conservative pension funds and 2% for all other Pillar II funds. These funds are also legally required to reduced their management fees in line with the growth of assets of the fund. Namely, after a Pillar II pension fund reaches EUR 100 million of AuM , the fund manager is obliged by law to reduce the base management fee for each additional EUR 100 million of AuM by at least 15 per cent compared to the rate of the base management fee applicable to the previous EUR 100 million. Funds are no longer required to enforce this reduction when the yearly base management fee reaches 0.4% of AuM .

The idea of the obligatory reduction of management fees was to bring down the overall level of fees and charges when economies of scale are achieved, while allowing for higher initial fees to ensure sufficient competition between fund providers and more choice for consumers in Estonia's relatively small pension market.

As can be seen from Table EE.4, this decrease in charges was initially slow to materialise. This was likely due to a combination of factors:

- The fragmentation of the small market between relatively many investment funds — average fees even increased at times, due to the entrance of new funds with higher fees into the market;
- Relatively slow initial asset accumulations — since the Pillar II was mandatory only to people who were at the beginning of their working life. As we saw in figure 1 in the previous section, only in 2014, more than a decade after the launch of the system, did total AuM reach EUR 2 billion, whereas already by the end of 2018 the EUR 4 billion limit was in sight.

However, between 2013 and 2020 a very significant decline in average management fees can be observed, with management fees falling from 1.5% to just 0.6%. Again, there were likely several contributing factors, including:

- Accelerating increases in AuM during those years;
- Consolidation in the market, with Danske Bank's Pillar II funds sold to LHV in 2016.

The entrance into the market of low-cost index funds from 2016 onwards, first by LHV and Tuleva (a new entrant offering only passively managed mutual funds), but eventually followed by all Pillar II market participants

While data regarding the TER is available only starting from 2017, it's likely this followed a similar trend overall. However, in 2023 the TER of funds decreased. This decrease was likely due to a combination of increasing competitive pressure from passively managed funds which have been quickly winning market share as well as the lack of success fees charged for 2022, when most funds had negative nominal returns. Here it's important to note that success fees, which are inherently backward-looking, are charged based on the previous year's results and figure in the TER of the year following the one where the "success" was achieved.

**Table EE.4 – Costs and charges of Estonian Pillar II pension funds (% of assets)**

| Year | Admin. and mgt. fees | Total Expense Ratio |
|---|---|---|
| 2003 | 1.53% | — |
| 2004 | 1.54% | — |
| 2005 | 1.55% | — |
| 2006 | 1.55% | — |
| 2007 | 1.55% | — |
| 2008 | 1.56% | — |
| 2009 | 1.56% | — |
| 2010 | 1.48% | — |
| 2011 | 1.49% | — |
| 2012 | 1.47% | — |
| 2013 | 1.46% | — |
| 2014 | 1.45% | — |
| 2015 | 1.25% | — |
| 2016 | 1.22% | — |
| 2017 | 1.08% | 1.19% |
| 2018 | 1.01% | 1.18% |
| 2019 | 0.70% | 0.86% |
| 2020 | 0.60% | 0.87% |
| 2021 | 0.58% | 0.97% |
| 2022 | 0.57% | 1.06% |
| 2023 | 0.54% | 0.77% |

*Data:* Pensionikeskus; *Calculations:* BF.

## Charges of Pillar III supplementary pension funds

The structure of charges that can be applied to Pillar III pension funds is similar to Pillar II funds, with the biggest difference being that caps on the various types of fees and charges (such as management fees or redemption fees) are higher in many instances. This combined with much smaller assets under management and the associated lack of economies of scale meant that the average fees were often higher in the third pillar compared to the second pillar.

However, in the last years, the proliferation of new index funds in the supplementary pension fund market—from 2021 onward every fund provider offered at least one index fund—and the relative success of these funds in attracting savings has led to the TER of Pillar III funds dropping slightly lower than Pillar II funds on average.

Unfortunately, due to changes in the way data on the charges of supplementary pension funds is presented in public databases, it was not possible to retrieve long-term comparable data series on the charges of Pillar III funds, but overall, the dynamic has been fairly similar to that of Pillar II funds.

**Table EE.5 – Costs and charges of Estonian Pillar III pension funds (% of assets)**

| Year | Admin. and mgt. fees | Total Expense Ratio |
|---|---|---|
| 2021 | 0.80% | 0.96% |
| 2022 | 0.72% | 0.87% |
| 2023 | 0.65% | 0.76% |

*Data:* Supplementary pension funds reports; *Calculations:* BF.

## Taxation

Now that both second and third pillar pension funds are effectively voluntary savings products, their tax treatment remains perhaps the biggest attraction of saving under either or both Pillar II and III pension vehicles compared to other potential savings and investment products

**Table EE.6 – Taxation of pension savings in Estonia**

| Product | Phase | | | Regime |
|---|---|---|---|---|
| | *Contributions* | *Investment returns* | *Payouts* | |
| Pillar II pension funds | Exempted | Exempted | Taxed | EET |
| Pillar III pension funds | Exempted | Exempted | Taxed | EET |

*Source:* Pensionikeskus (n.d.); *Note:* Taxation of payouts depends on the timing and method of payout.

As can be seen from Table EE.6, contributions to II and III pillar pension funds are exempted from all taxes, although in the case of the III pillar, the annual tax deductibility is limited to a maximum of 15% of the savers' annual income or to EUR 6 000, whichever is lower. The investment returns/capital gains of both II and III pillar pension products are also entirely exempted from tax in the accumulation phase. In the payout phase, the taxation depends on the pillar and specific circumstances. The Pillar I pension is subject to income tax. Estonia has a maximum effective income tax rate of 20%, but the government which came to power after the March 2023 elections has agreed to raise the income tax rate to 22% from January 2025. However, basic exemptions (non-taxable amounts) apply to both the working population as well as pensioners.

There has long been a tacit political agreement under successive governments, regardless of their composition, that the amount of annual income tax exemption applying to pensioners be at least as high as the average state (Pillar I) old-age pension. This was the case in 2023 and is set to continue in the next few years. For the Pillar II and Pillar III savings-based pension, the taxation regime depends on when and how the payout of savings is settled. For both Pillars, when a saver has less than 5 years left until pensionable age, it's possible to sign an agreement with a life insurance company for a lifetime annuity pension. Under this option, the pension payments are exempted from taxes (Pensionikeskus, n.d.). Alternatively, it's possible to make a fixed duration agreement, either with an insurance company or directly with the pension fund—what is called a "fund pension". As long as the fixed duration at the moment of the agreement is as long or longer as the average life expectancy of the person and the payments are monthly or quarterly, the payouts are also exempted from taxation.

For both Pillars II and III, in the case of either a one-time payout or a fixed-term pension contract that is shorter than the "recommended" duration, calculated based on life expectancy, a 10% tax rate applies, as long as the payout starts at less than 5 years before pensionable age. However, if the pension savings are paid out more than 5 years before reaching the pensionable age, the full income tax rate is applied. Units of Pillar II and III pension funds are also inheritable. Payments to successors are taxable with the income tax rate established by law. However, successors may also choose to transfer the inherited pension fund units to their own pension account, which would not be taxable.

# Performance of Estonian long-term and pension savings

## Real net returns of Estonian long-term and pension savings

For the pension saver, the most important metric of the performance of a savings or investment product is how it helps to conserve and ideally increase the purchasing power of their savings over the long term to allow a more economically comfortable retirement. For this, the net investment returns of pension savings should exceed inflation.

As can be seen from Figure EE.2, inflation surged to very high levels in 2021 and 2022 in the European Union, but especially in Estonia. The main drivers of inflation in 2021–2023 are well-known and much discussed: post-pandemic savings and supply chain issues, the invasion of Ukraine by the Russian Federation and the energy crisis this caused. The fact that inflation reached much higher levels in Estonia than in the EU on average can be attributed to both the comparatively small and open economy of Estonia as well as to the relatively closer proximity and stronger economic and social ties to Ukraine and Russia. The extraordinarily high inflation was mirrored in other Eastern European countries.

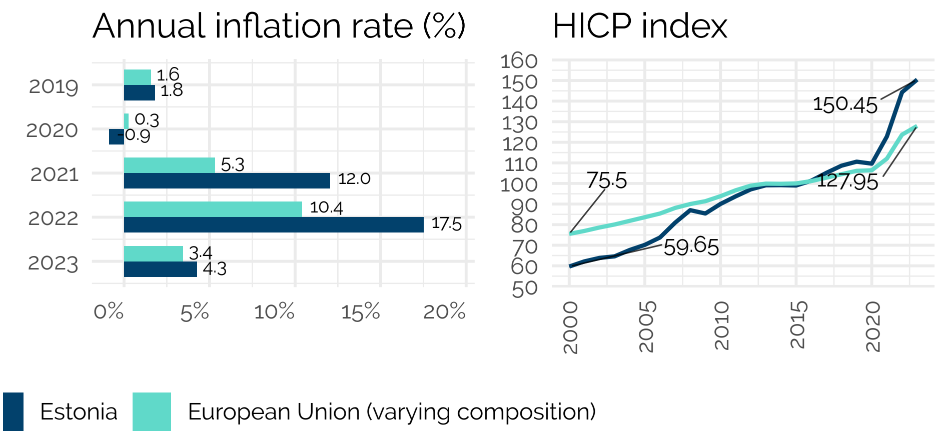
As can be seen from Figures EE.3 and EE.4, positive nominal returns in 2023 helped to offset the impact of high inflation on the purchasing power of pension savings. However, overall positive returns in 2023 were not able to offset the 2022 "perfect" storm of high inflation and sharply negative nominal returns that led to massive losses in the purchasing power of pension savings, with Pillar II funds declining approximately 22% on an inflation-adjusted basis while losses in the Pillar III exceeded 25%.

Of course, what matters most in pension savings is the long term. Unfortunately,

**Figure EE.2 – Inflation in Estonia**

Period 2000–2023

| | Annualised | Cumulated |
|---|---|---|
| *Estonia* | 4.1% | 164.9% |
| *European Union (varying composition)* | 2.3% | 73.2% |



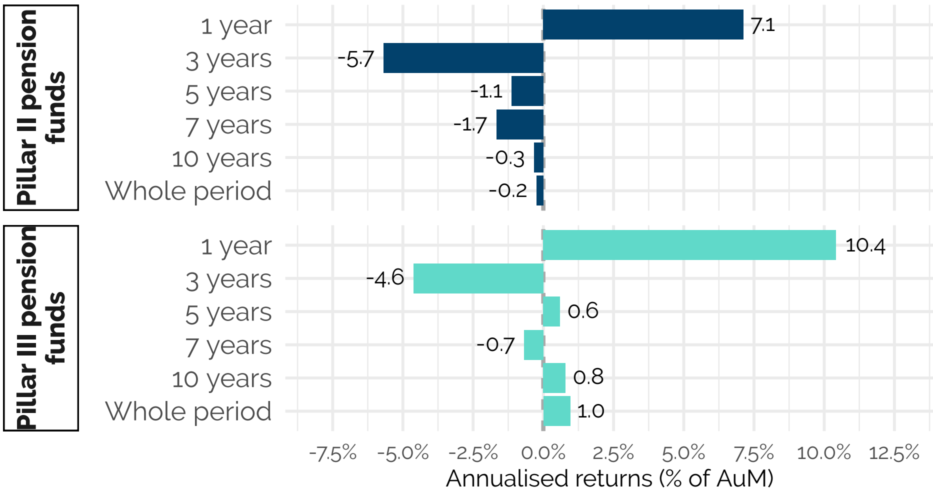

*Data:* Eurostat, HICP monthly index (2015 = 100); *Calculations:* BETTER FINANCE

as can be seen from the figures in Figure EE.5, the underwhelming past real returns combined with the disastrous results of 2022 led to the average (asset-weighted) annual returns of Pillar II pension savings to be negative across all time horizons observed, with a -0.3% negative return over 10 years and -0.2% since the launch of pension investment funds in 2003.

In the case of the supplementary Pillar III pension funds, 10-year returns are still in positive territory of 0.8%, with returns for shorter periods being close to 0 and the long-term return since the introduction of the supplementary pension system being slightly positive at 1% on an annualised basis (see Figure EE.6).

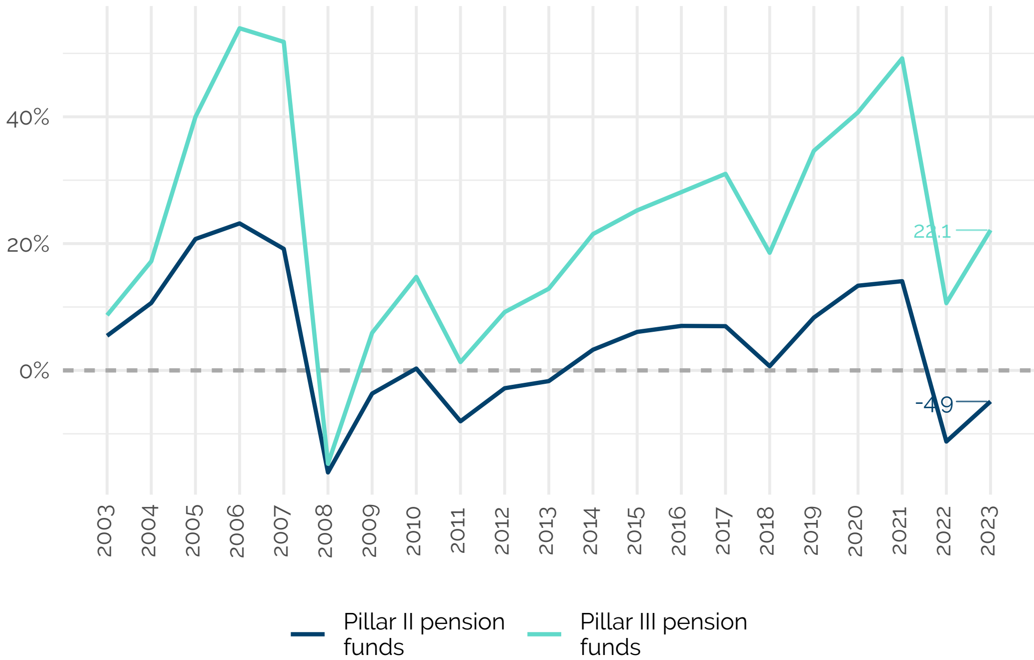
The cumulative effect of these long-term returns means that any savings deposited in a Pillar II fund at the inception of the system would have fallen in purchasing power by 4%, while the same amount invested in Pillar III funds would have increased by 20% over the same period.

**Figure EE.3 – Annualised returns of Estonian long-term and pension vehicles over varying holding periods (before tax, % of AuM)**



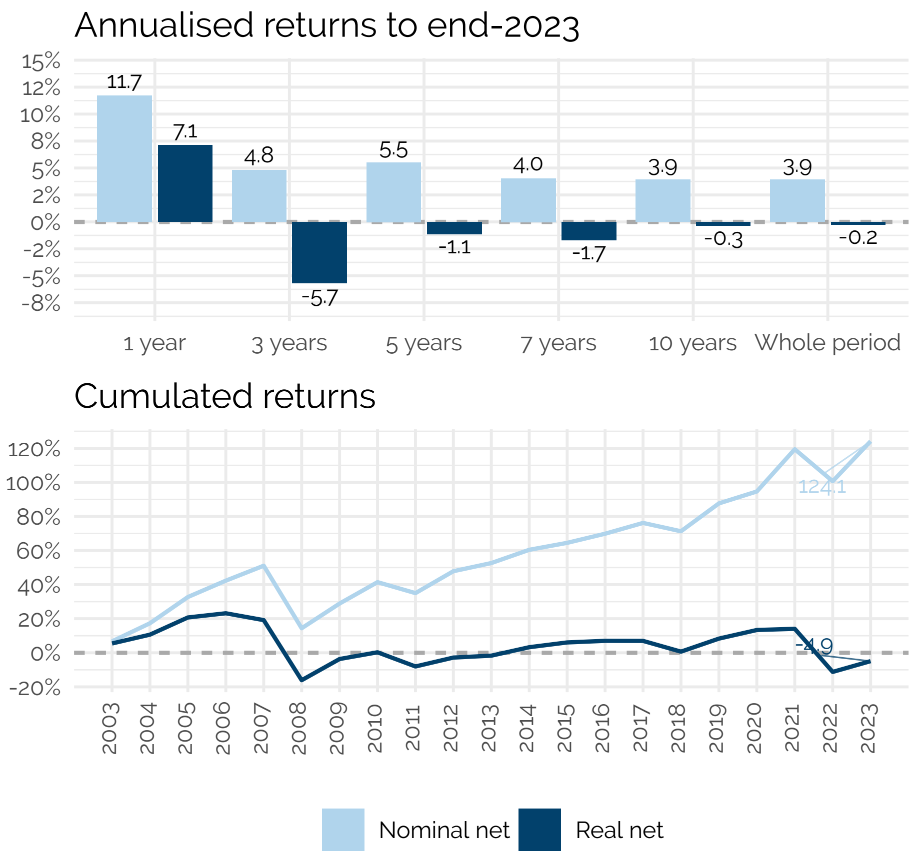

*Data:* Pensionikeskus, Supplementary pension funds reports, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-2023.

**Figure EE.4 – Cumulated returns of Estonian long-term and pension savings vehicles (2003–2023, before tax, % of AuM)**



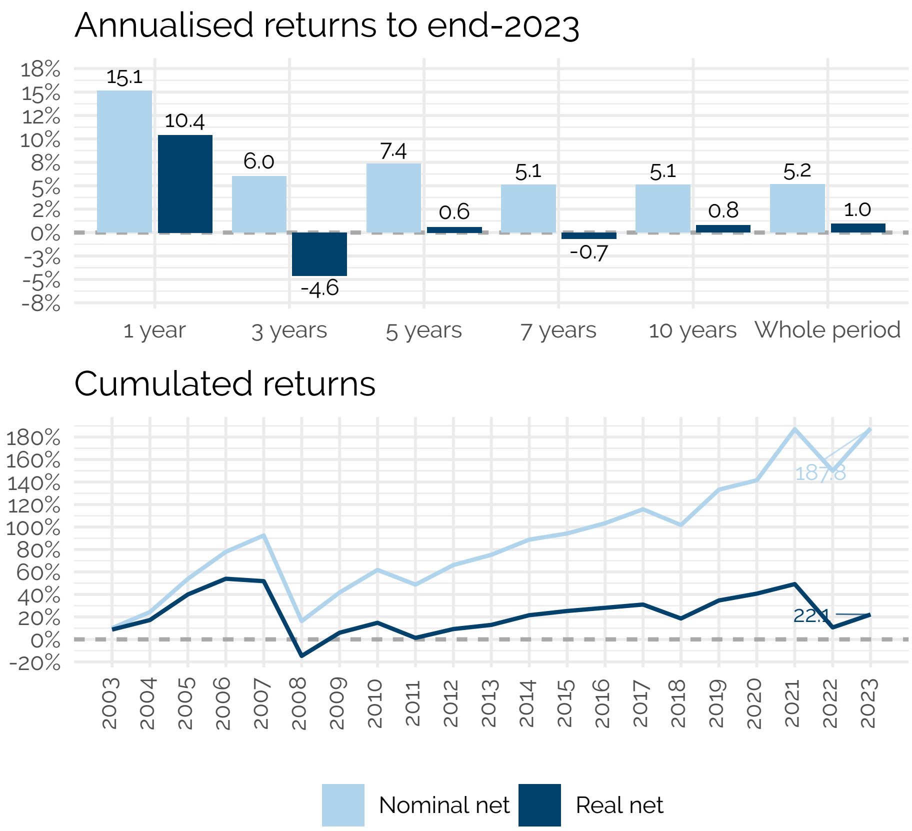

*Data:* Pensionikeskus, Supplementary pension funds reports, Eurostat; *Calculations:* BETTER FINANCE.

**Figure EE.5 – Returns of Estonian Pillar II pension funds (before tax, % of AuM)**




*Data:* Pensionikeskus, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end

**Figure EE.6** – **Returns of Estonian Pillar III pension funds (before tax, % of AuM)**




*Data:* Pensionikeskus, Supplementary pension funds reports, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-2023.

## Do Estonian savings products beat capital markets?

To put the performance of Estonian Pillar II and III investment funds into context and draw conclusions, it is important to compare the performance with capital-market benchmarks. Table EE.7 shows the chosen benchmark. Two benchmark indexes are used as a basis, of which the first is a broad European equities index and the second is a similarly broad European bond index.

**Table EE.7 – Capital market benchmarks to assess the performance of Estonian pension vehicles**

| Product | Equity index | Bonds index | Allocation |
|---|---|---|---|
| Pillar II pension funds | STOXX All Europe Total Market | Barclays Pan-European Aggregate Index | 50.0%–50.0% |
| Pillar III pension funds | STOXX All Europe Total Market | Barclays Pan-European Aggregate Index | 75.0%–25.0% |

*Note:* Benchmark porfolios are rebalanced annually.

For Pillar II funds, the benchmark is a 50-50 split between the two indexes, while for Pillar III a more "aggressive" allocation, with the bond index counting for 25% and the equity index counting for 75% of the Pillar II benchmark.

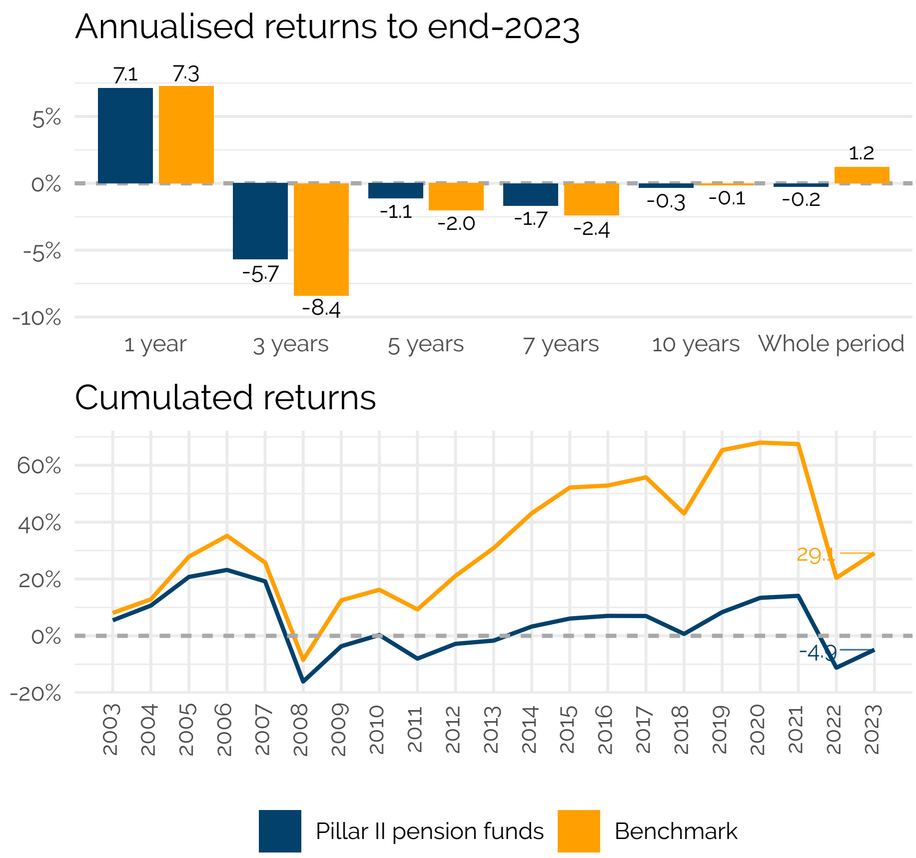
The equity exposure of the chosen benchmarks (50% and 75% respectively) were chosen because they roughly reflect the equity exposure of Estonian Pillar II and Pillar III investment funds in the last 3 years, based on Finantsintspektsioon data. For both pillars, the equity exposure was lower on average historically compared to recent years.[4] However, the Author considers the more recent allocation the best benchmark since it reflects the direction of travel of the Estonian pension system where successive reforms have allowed for and encouraged higher equity allocations, with the objective of increasing long-term returns.

As can be seen in Figures EE.7 and EE.8, when discounted for the Estonian inflation rate, the real performance of the benchmarks correlates significantly with the performances of both Pillars II and III. However, in the long term, both pillars significantly underperform their benchmarks.

There are two likely causes for this significant underperformance: fees and asset allocation. The benchmarks show the change in the value of the underlying assets, assuming all dividends and interest payments are reinvested in the same index with no fees or charges deducted. This contrasts with the investment funds, which incur

[4] Estonian pension funds invest a large proportion of their Assets in other investment funds and while the available data does provide a breakdown between "equity funds" and "other investment funds", there is no data for exactly how much equity exposure these two types of funds have. I.e. if "equity funds" might have 100%, 90% or 75% invested in equities while "other investment funds" may also have some degree of equity exposure. References to the current or historic equity exposure of Estonian pension funds reflect the Author's best estimate given the limitations in data, but have a large and uncertain margin of error.

**Figure EE.7** – **Performance of Estonian Pillar II pension funds against a capital market benchmark (returns before tax, after inflation, % of AuM)**

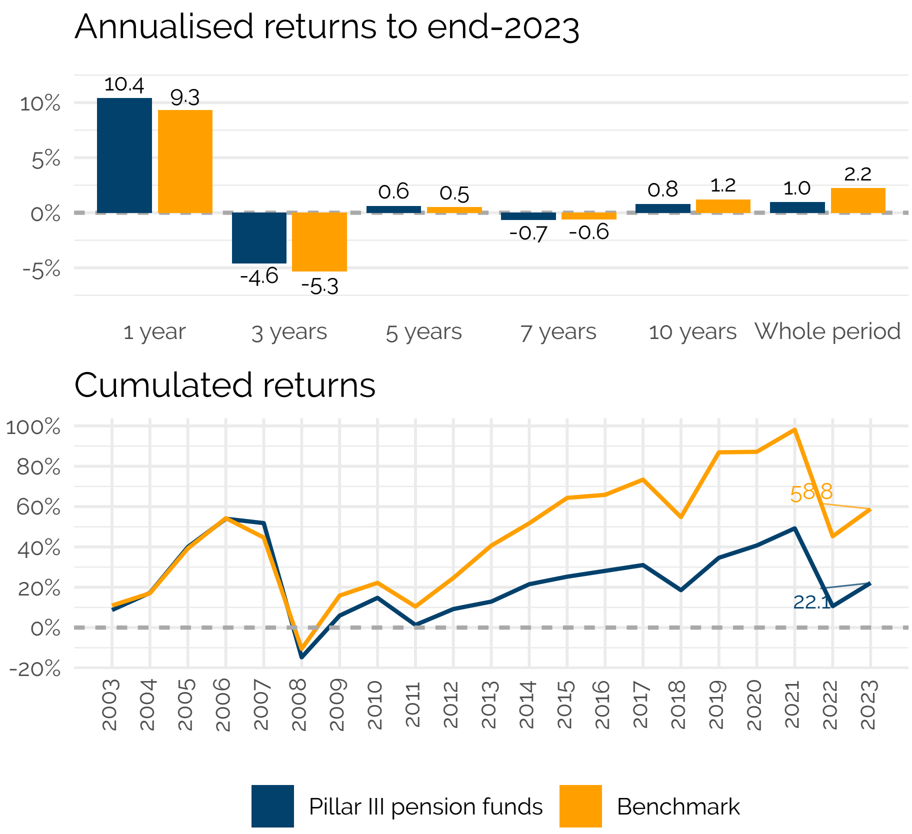



*Data:* Pensionikeskus, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end

various expenses, including management fees charged by the company managing the funds. As explained in the charges section of this report, while average expenses in both pillars have fallen to relatively low levels in recent years, relatively high administration and management fees were charged for most of the period since the inception of the system, with fees starting to significantly decline only after 2013.

Thus it can be assumed that eliminating the effect of charges would eliminate most of the difference between the benchmark and actual returns. In addition, as referenced before, it seems to be the case that the asset allocation for most of the period in both pillars included less equity and more exposure to bonds and other asset classes such as cash deposits and money market funds, which generally yield less in the long-term compared to equities.

**Figure EE.8 – Performance of Estonian Pillar III pension funds against a capital market benchmark (returns before tax, after inflation, % of AuM)**




*Data:* Pensionikeskus, Supplementary pension funds reports, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-2023.

## Conclusions

Estonia is an early pension system reformer among the formerly communist countries of Central and Eastern Europe. The system which came fully into effect in 2003, is a typical multi-pillar pension system that combines an unfunded, defined contribution state pension (Pillar I), as well as an auto-enrolled second pillar and voluntary pillars, the latter two of which are fully funded. Different types of pension vehicles in Pillars II and III allow savers to choose from a wide variety of investment strategies. Lower transparency in fee history contrasts with the high transparency of performance disclosed on a daily basis. The exception is Pillar III insurance contracts, where no information about performance or fees is publicly disclosed, which is why this relatively least used pension vehicle was not examined in this report.

The performance volatility of most pension vehicles is relatively high. However, Estonian savers tend to accept higher risk with regard to their savings. Pillar III vehicles are a typical example of highly volatile pension vehicles. A new trend emerged in 2016——the introduction of low-cost indexed pension funds for both funded pension pillars, which could deliver higher value to savers due to lower charges compared to peers. The competitive pressure from these new low—cost funds has led to an overall decrease in fees for both Pillar II and Pillar II funds, which should increase the ability of the funds to deliver performances closer to capital-market benchmarks in future years. The increasing tendency for larger equity exposure on average in both pillars should also boost real returns in the long term.

Overall, achieving an adequate gross salary replacement ratio in retirement remains a challenge in Estonia, especially due to high inflation, which led to Pillar II real (purchasing power adjusted) returns turning negative over all time horizons in 2023. The challenge has only become greater since 2021 after about one third of all Pillar II pension savers withdrew their savings before retirement. This was enabled by a controversial change to the Pension system, which BETTER FINANCE strongly criticised in the past. It is a sad irony that this partial dismantling of the formerly mandatory II pension pillar was undertaken just as a combination of successive reforms and market tendencies had well-positioned Pillar II investment funds to achieve significantly higher long-term investment returns in the future.

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