Will You Afford to Retire?

The Real Return on Long-Term and Pension Savings

2024 Edition

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

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The Real Return of Long-term and Pension Savings

2024 Edition — Latvia

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.

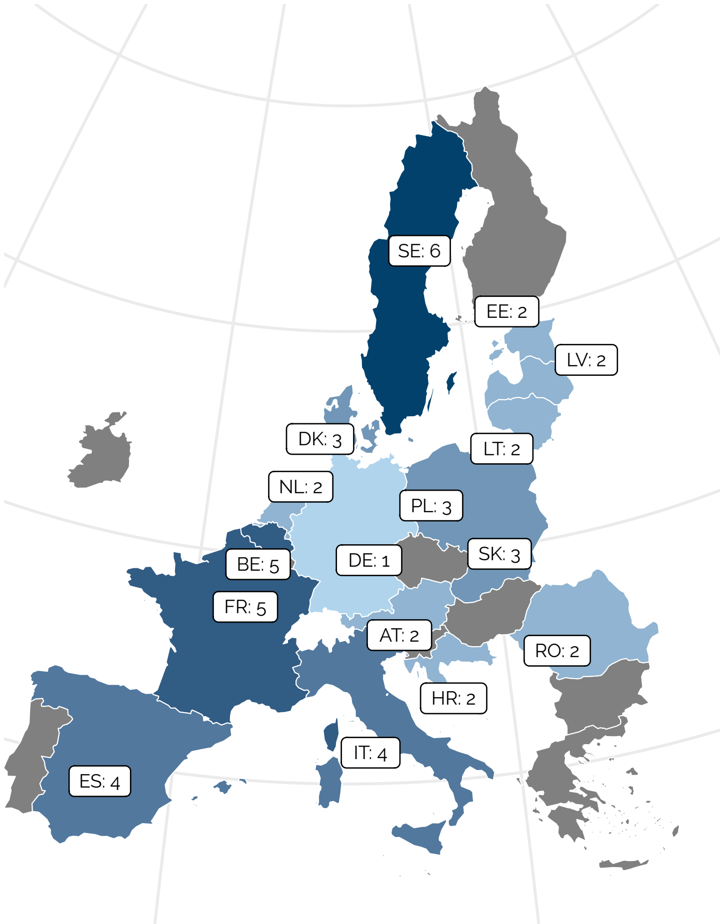
This research report by BETTER FINANCE covers 16 of the 27 European Union (EU) Member States. In each of these countries the team of contributors analyses the costs and performance of up to 6 product categories. Our goal is to calculate, based on publicly available data about these product categories, 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**

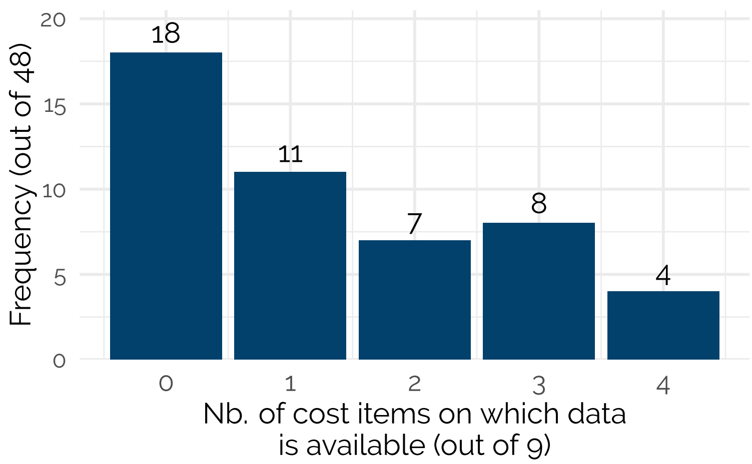


Besides performance data, information on costs is very often patchy and displayed in a way that makes it impossible for investors to compare cost levels across product providers, and for our contributors to aggregate this information at the level of product categories. The reader can appreciate this 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).

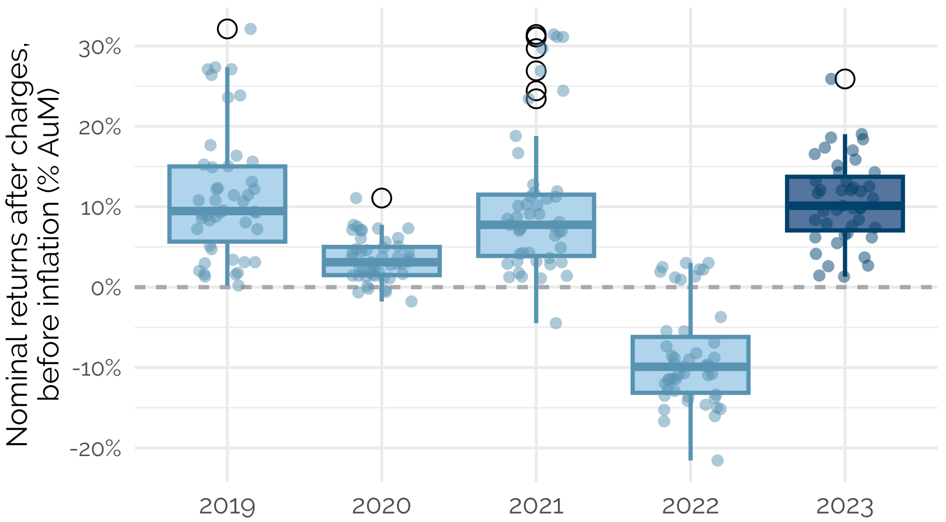
2023: Recovering from the slump

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)**



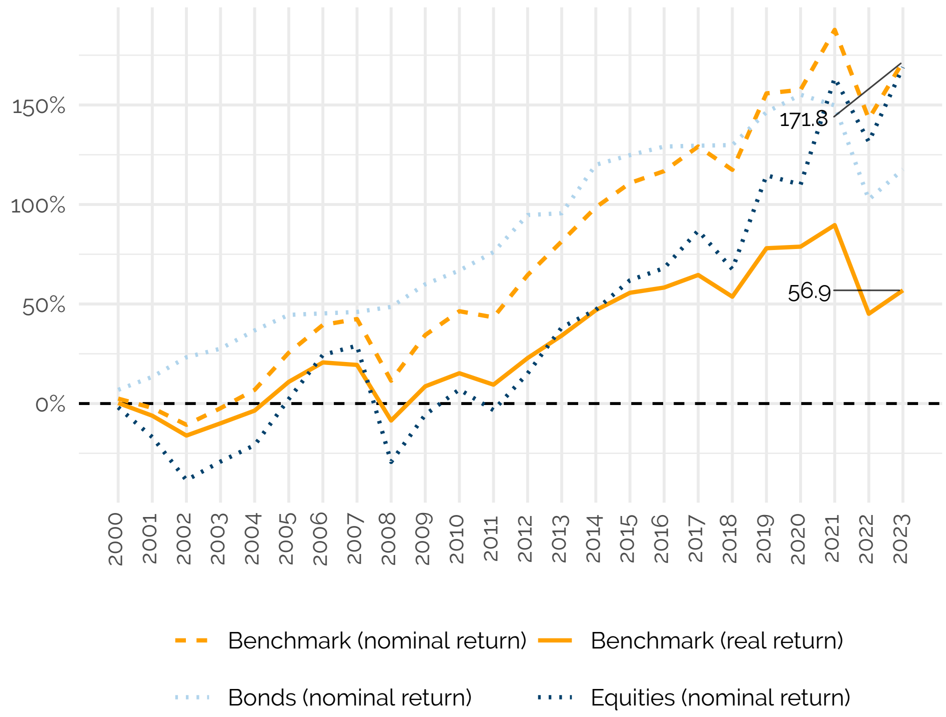
Data: NCAs and sectoral associations (see Country Cases); *Calculations:* BETTER FINANC

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

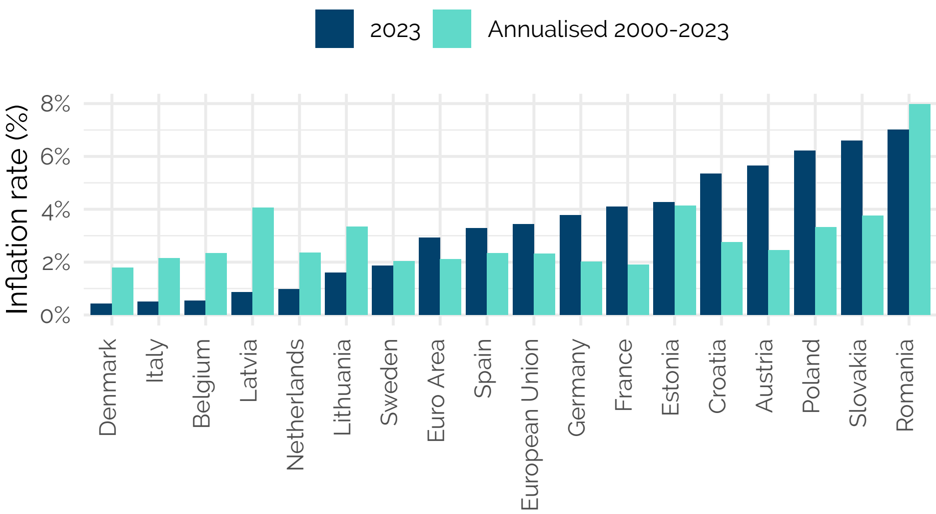
We wish to highlight the good performance of the first PEPP to be included in our study: with a nominal return before charges and inflation standing at +15% and charges amounting to 0.72% of assets under management (AuM), the Slovak PEPP yielded a net return of +14.3% in nominal terms and 7.2% in real 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.

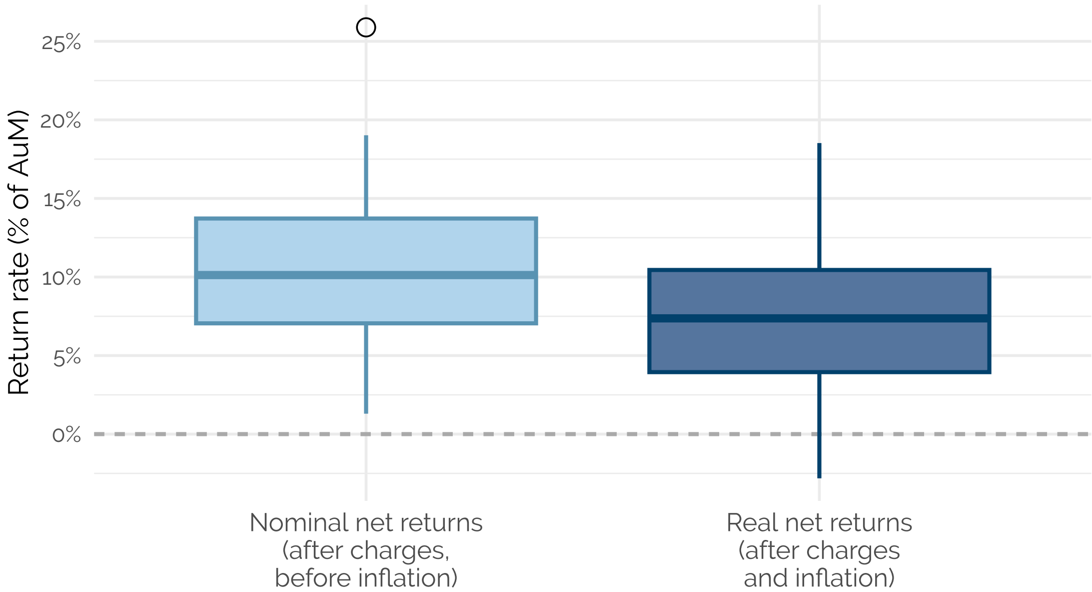
In the meantime, we urge Member State governments to offer the PEPP the same treatment, as regards taxation, subsidies and transferability of accrued pension benefits, that existing national personal pension products enjoy (see our policy recommendation on this topic on Page xvii).

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)**

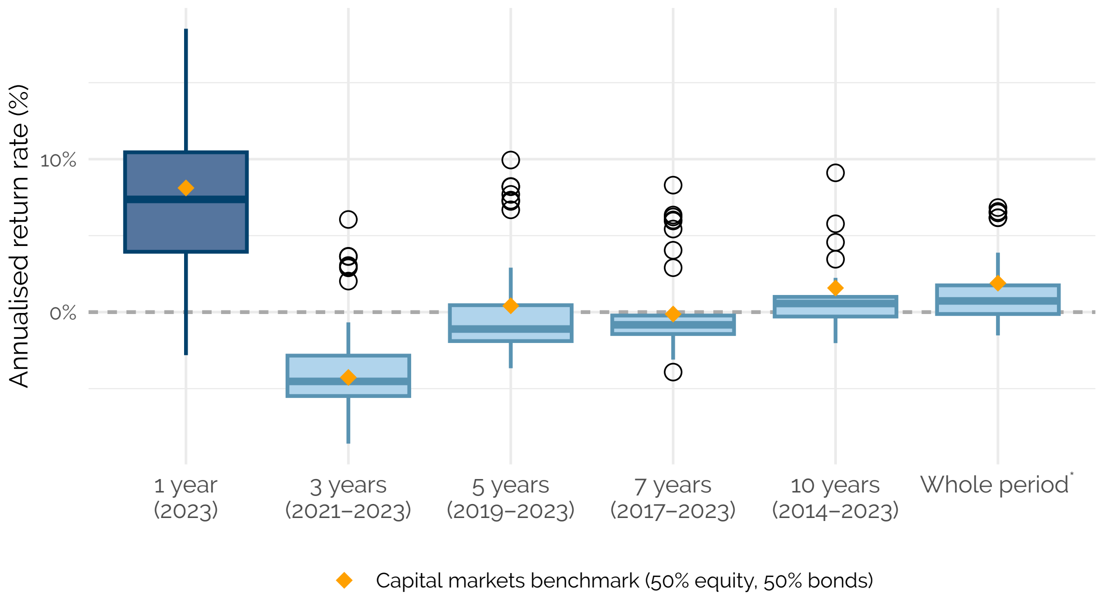


Calculations: BETTER FINANCE

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 Devia-tion	Best perfor-mance	Worst perfor-mance
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%

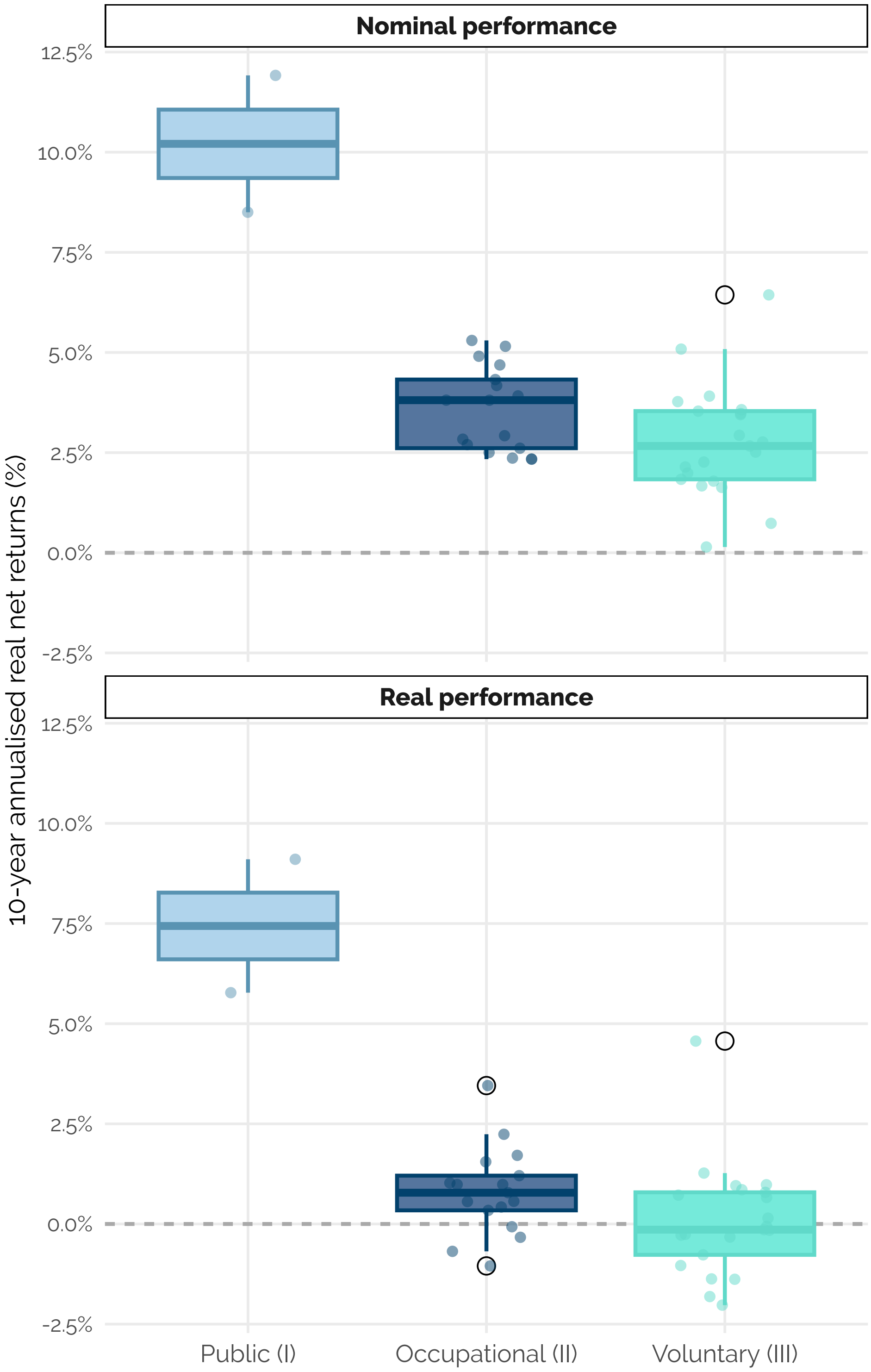
Calculations: BETTER FINANCE
* Whole period varies across products (up to 24 years).

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 8

Latvia

Kopsavilkums

Fondēto pensiju shēmas savas pastāvēšanas laikā ir piedzīvojušas negatīvu vidējo ienesīgumu pat tad, ja pensiju fondu portfelis obligāto pensiju pīlārā ir bijis konservatīvi orientēts. II pīlāra pensiju fondi 2022. gadā uzrādīja vidēji negatīvu nominālo ienesīgumu -14,13% apmērā, savukārt III pīlāra fondi arī uzrādīja vidēji negatīvu nominālo ienesīgumu -14,63% apmērā. Kopumā pozitīva attīstība bija vērojama II pīlāra tirgū, kur pasīvi pārvaldīto fondu ieviešana veicināja turpmāku komisijas maksu samazināšanos. Maksa ir samazinājusies arī III pīlārā, tomēr III pīlāra pensiju fondu sarežģītā maksu struktūra un joprojām augstākas maksas būtiski ietekmē gaidāmos uzkrātos ieguvumus.

Summary

Funded pension schemes have experienced negative average annualized returns during their existence even when the portfolio of pension funds in mandatary pension pillar has been conservatively oriented. Pillar II pension funds recorded on average positive nominal returns of 12.4% in year 2023, while Pillar III funds delivered also on average positive nominal return of 11%. Overall positive development could have been seen on the Pillar II market, where the introduction of passively managed funds contributed to decrease of fees during last 5 years to an average of 0.45% per annuum (p.a.). The fees have decreased also in the Pillar III, however, complex fee structure and still higher fees of around 1.2% p.a. in Pillar III pension funds play a significant role on the expected accumulated benefits.

Introduction: The Latvian pension system

There have been no major changes in the pension system in Latvia announced in 2023. The performance of private pensions (mandatory as well as voluntary) was overall positive in 2023 both in nominal and real terms mainly due to the pick-up of the world markets and unexpectedly low inflation in Latvia compared to neighbours.

Table LV.1 – Long-term and pension savings vehicles analysed in Latvia

Product	Pillar	Reporting period	
		Earliest data	*Latest data*
Mandatory pension funds	Occupational (II)	2003	2023
Voluntary pension funds	Voluntary (III)	2011	2023

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

	Mandatory pension funds	Voluntary pension funds
1 year (2023)	11.4%	10.1%
3 years (2021–2023)	-6.8%	-8.3%
5 years (2019–2023)	-2.2%	-3.1%
7 years (2017–2023)	-2.4%	-3.1%
10 years (2014–2023)	-1.0%	-1.4%
Whole period	-0.9%	-0.8%

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

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

Pension system in Latvia: An overview

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

- Pillar I (state compulsory PAYG pension scheme);
- Pillar II (mandatory state funded pension scheme) which is financed by a part

of the social insurance contributions diverted from Pillar I;

- Pillar III (voluntary private pension scheme).

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

The reform of the Latvian pensions system started in 1995, when it was decided to implement the three-pillar pension system. Firstly, the shift from the old Soviet-styled PAYG pension system to the notional defined contribution pension scheme (NDC PAYG Pillar I) was carried out. The new law on state pensions was adopted by the Parliament in November 1995 and came into force on January 1, 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.

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

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

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 **statutory retirement age** in Latvia in 2023 is 64 years and 6 months both for men

Table LV.3 – Overview of the Latvian pension system

Pillar I	Pillar II	Pillar III
State Pension	Funded pension	Voluntary pension
Mandatory	Mandatory	Voluntary
NDC PAYG	Funded	
Financed by social insurance contributions	defined contribution (DC)	
Publicly managed	Privately (and publicly) managed pension funds	Privately managed pension funds
Benefits paid via State Social Insurance Agency	Financed by social insurance contributions Individual pension accounts	Financed by individual voluntary contributions Two types of pension plans: 1. open (individual) 2. closed (quasi-occupational)
Coverage: Generally entire Latvian population	Coverage: Generally entire working population	42.48%
Quick facts		
Nb. of economically active citizens: 1 064 099	Administrators: 7	Administrators: 7
Nb. of old-age pensioners: 437.3 thousands	Funds: 33	Funds: 16
Avg. old-age pension: EUR 513.72	AuM: EUR 7 060 mln.	AuM: EUR732 mln.
Avg. salary (gross/net): EUR 1 537/EUR 1 119	Participants: 1.305 mln.	Participants: 0.397 mln.
Avg. replacement ratio: 33.42%		

Data: Official Statistical Portal, 2024 and women.[1] However, the law stipulates a gradual increase of the retirement age by three months every year until the general retirement age of 65 years is reached in 2025. Early pension is possible in Latvia if two conditions are met: (1) an individual in 2023 reaches the age of at least 62 years and 6 months (gradually rising by three months a year until 2025) and (2) an individual contributed for a period of at least 30 years.

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

1. K — accumulated life-time notional pension capital, which is an accrued amount of paid contributions since the introduction of NDC system (January 1, 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:
   - average insurance contribution wage from 1996 until 1999 (inclusive);
   - insurance period until January 1, 1996;
2. G — cohort unisex life-expectancy at the time of retirement.

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

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

It can be said that the Latvian NDC PAYG Pillar I has shifted in a direction where the average gross replacement ratio is lower than 35%. The average income replacement ratios for old-age pension in Latvia are shown in Table LV.4.

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

1. persons with insurance period up to 15 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.

Minimum amount of old-age pension is determined by applying a coefficient of 1.1 to the calculation base of the minimum old-age pension and increasing the amount by 2 % of the calculation base of the minimum old-age pension for each additional year beyond the insurance period required for the old-age pension (currently 15 years).

[1] 1https://latvija.lv/en/PPK/socialie-pakalpojumi/sociala-apdrosinasana/p311/ProcesaApraksts

Table LV.4 – Latvian NDC Pillar 1 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	EUR 92	EUR 274	33.6%	EUR 196	46.9%
2004	EUR 101	EUR 300	33.7%	EUR 214	47.2%
2005	EUR 115	EUR 350	32.9%	EUR 250	46.0%
2006	EUR 137	EUR 430	31.9%	EUR 308	44.5%
2007	EUR 158	EUR 566	27.9%	EUR 407	38.8%
2008	EUR 200	EUR 682	29.3%	EUR 498	40.2%
2009	EUR 233	EUR 655	35.6%	EUR 486	47.9%
2010	EUR 250	EUR 633	39.5%	EUR 450	55.6%
2011	EUR 254	EUR 660	38.5%	EUR 470	54.0%
2012	EUR 257	EUR 685	37.5%	EUR 488	52.7%
2013	EUR 259	EUR 716	36.2%	EUR 516	50.2%
2014	EUR 266	EUR 765	34.8%	EUR 560	47.5%
2015	EUR 273	EUR 818	33.4%	EUR 603	45.3%
2016	EUR 280	EUR 859	32.6%	EUR 631	44.4%
2017	EUR 289	EUR 926	31.2%	EUR 676	42.8%
2018	EUR 314	EUR 1 004	31.2%	EUR 742	42.3%
2019	EUR 340	EUR 1 076	31.6%	EUR 793	42.8%
2020	EUR 367	EUR 1 143	32.1%	EUR 841	43.6%
2021	EUR 432	EUR 1 277	33.8%	EUR 939	46.0%
2022	EUR 528	EUR 1 373	38.4%	EUR 1 006	52.4%
2023	EUR 514	EUR 1 536	33.4%	EUR 1 119	45.9%

Data: Central Statistical Bureau of Latvia, 2024.

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 LV.5).

Starting from July 1, 2023, the amount of the minimum old-age pension shall be determined by applying a coefficient of 1.1 to the minimum old-age pension calculation base of EUR 157 (EUR 188 for persons with disabilities from childhood) and EUR 3.14 for each subsequent year over 15 years of service. If the person's insurance period in Latvia is:

- at least 15 years, the amount of the minimum old-age pension cannot be less than EUR 172.70 (EUR 157 x 1.1) and for persons with disabilities since childhood

Table LV.5 – **Amount of the minimum old-age pension according to the year of each insurance period in Latvia**

Years of service (insurance period)	Min. old-age pension since Jan. 2022
Insurance length 15 years	EUR 172.70
Insurance length 30 years	EUR 219.80
Insurance length 40 years	EUR 251.20
Insurance length 50 years	EUR 282.60

Data: Ministry of Welfare, 2024.

EUR 206.80 (188x1.1);

- 16 years and more, the amount of the minimum old-age pension is determined by raising it by EUR 3.14 for each year of insurance; for persons with disability from childhood – by EUR 3.76 for each year of insurance.

The amount of the minimum old-age pension is determined on the day of granting (recalculation) the pension, as well as by reviewing the calculation basis of the minimum old-age pension.

Pillar II pension scheme was launched on July 1, 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 July 1, 2001. Participation in the second tier is compulsory for those who had not reached the age of 30 on July 1, 2001 (born after July 1, 1971).

Gradually all employees will participate in Pillar II. Persons who were between the ages of 30 and 49 (born between and) 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 Table LV.6.

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 analysed in the sub-section dedicated to pension returns.

Table LV.6 – Redistribution of the old-age pension contributions between pillar I and pillar II

Years	Pillar I (NDC)	Pillar II (FDC)
2001-2006	18%	2%
2007	16%	4%
2008	12%	8%
2009-2012	18%	2%
2013-2014	16%	4%
2015	15%	5%
2016 and ongoing	14%	6%

Data: Manapensija and State Social Insurance Agency, 2024.

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 , 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 , the private fund managers were involved, but today participants of Pillar II are in the position to choose their fund manager themselves. The private fund managers offer to invest the pension capital and into corporate bonds, shares and foreign securities. Participants of the system are entitled to change their fund manager once a year and, in addition, investment plans within the frame of one fund manager can be changed twice a year. Operation of private fund managers is supervised by the Finance and Capital Market Commission.

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

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 voluntary pension funds (21 operational in Latvia in 2023)
2. closed voluntary pension funds (only one operating in Latvia in 2023).

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.

Long-term and pension savings vehicles in Latvia

Mandatory pension funds are the only pension vehicles allowed for the Pillar II funded pension scheme. 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.

On the other hand, voluntary pension funds for the Pillar III private pension scheme are less strictly regulated. The law on Private Pension Funds provides a wide range of possibilities to organize and manage private voluntary 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. 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 2023) could be recognized as a typical occupational pension fund. However, open private voluntary pension funds are more personal ones. Pillar III pension vehicles (voluntary pension funds) can be created only by limited types of entities, 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:
    - bank (licensed credit institution);
    - 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:

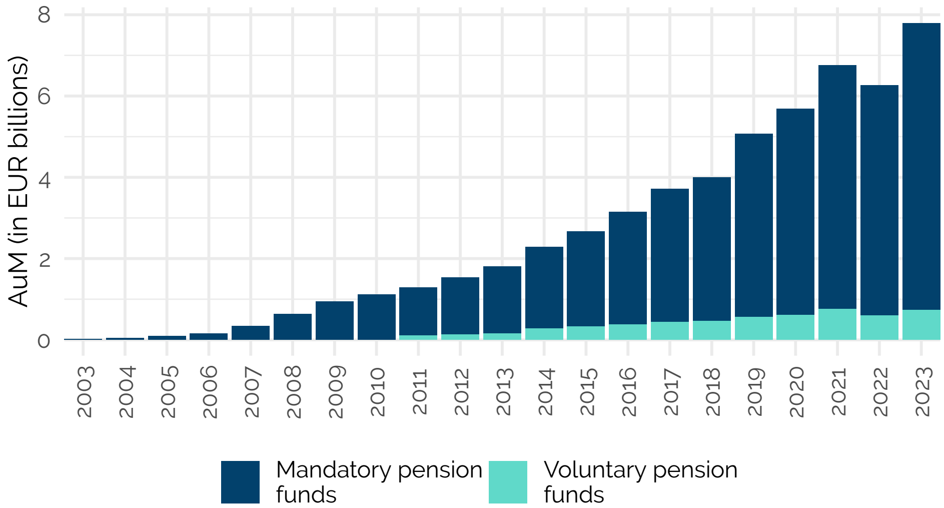
- a credit institution, which is entitled to provide investment services and non-core investment services in Latvia;
- an insurance company, which is entitled to engage in life insurance in Latvia;
- an investment brokerage company, which is entitled to provide investment services in Latvia;
- an investment 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 December 31, 2011. Currently (as of December 31, 2023), 21 open private voluntary pension funds and one closed private pension fund exist on the market.

Second pillar: Mandatory pension funds

Currently (as of December 31, 2023), 33 mandatory pension funds have been operational on the Pillar II market. There were 4 new funds entering the market during 2023 (VAIRO and Luminor), which signals market attractiveness for fund providers. New funds focus on active management and can be characterized as target date funds. 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) — a KID specific to undertaking for collective investment in transferable securities (UCITS) funds, with particular features — for participants of the scheme. The prospectus of a pension fund and the key in-

Figure LV.1 – **AuM of Latvian long-term and pension savings vehicles**



Data: Manapensija; *Calculations:* BETTER FINANCE.

formation document for participants are an integral part of the contract entered into between the Agency and the manager of pension funds. Pension fund prospectus must clearly define the risk-reward profile and indicate proposed investment strategy of the respective expected portfolio structure.

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

1. Conservative funds, with no equity exposure and a 100% share of bonds and money market instruments;
2. Balanced funds with bonds and money market instrument share of at least 50%; in addition, a maximum of 15% of the funds' balances can be invested in equities;
3. Active funds with an equity share (resp. investments in capital securities, alternative investment funds or such investment funds that may make investments in capital securities or other financial instruments of equivalent risk) of up to 100% (since 2021) 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.

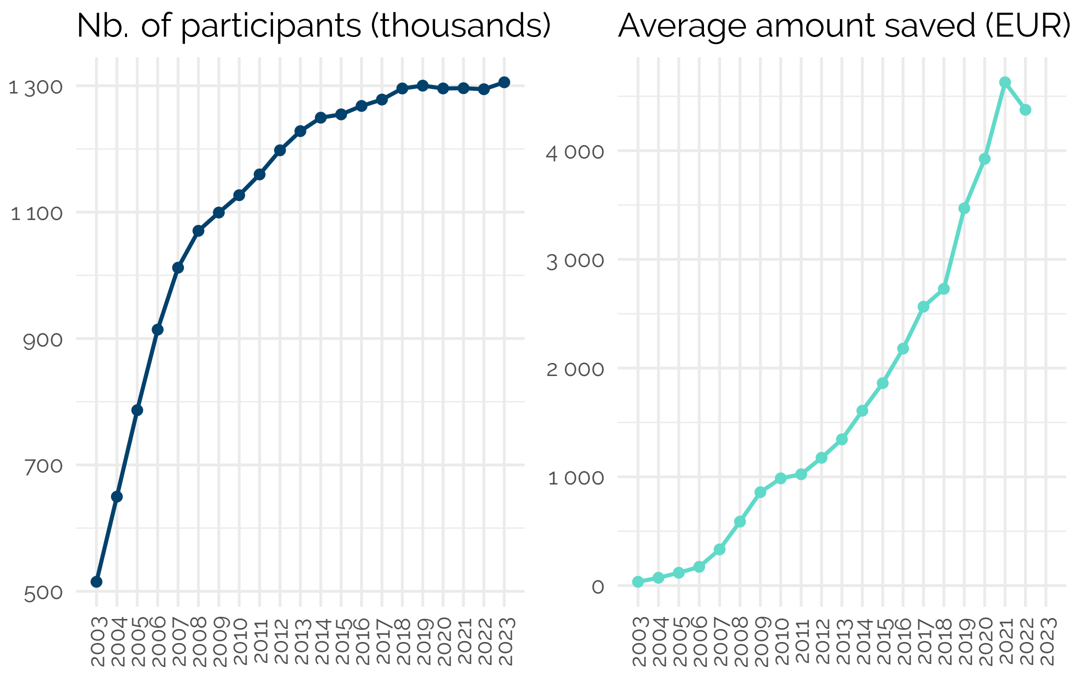
Contrary to many other CEE countries running mandatory pension systems, there is no requirement for pension funds to guarantee a certain minimum return. On the contrary, doing so is explicitly forbidden.

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 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 mandatory pension funds' performance.

The portfolio structure of Pillar II pension funds (Figure LV.3) 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.

Figure LV.2 – Number of participants and average size of individual accounts in Latvian Pillar II



Data: Manapensija, 2023

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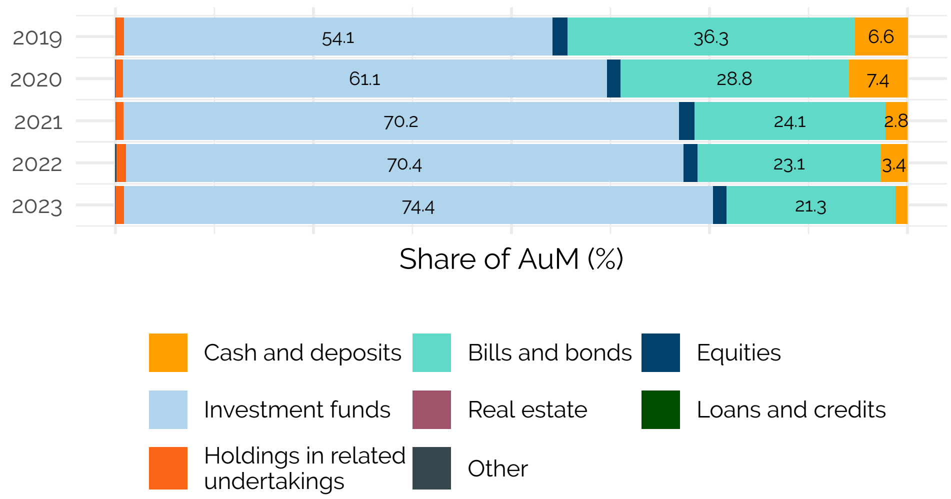
Investment funds are gaining the dominant share on the Pillar II pension funds' port-

Figure LV.3 – Allocation of Latvian mandatory pension funds' assets



Data: Manapensija; *Calculations:* BETTER FINANCE.

folio structure, while the bonds and deposits portions are lowered. This increases the short-term volatility and potential performance of pension funds.

Third pillar: Voluntary pension funds

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.

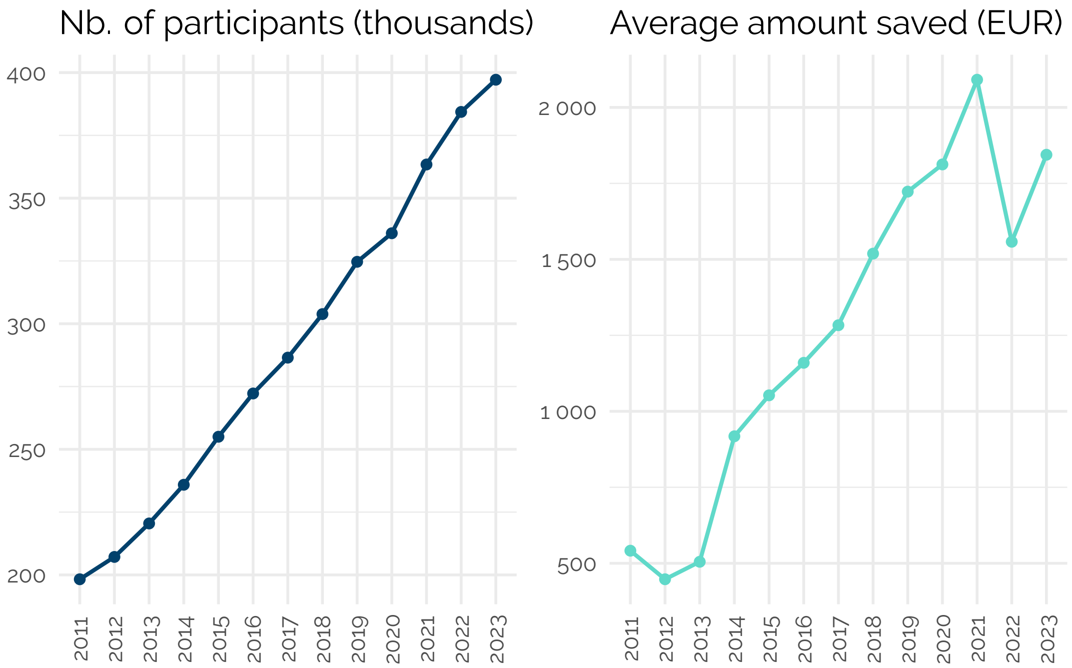
Compared to the mandatory pension funds scheme, the voluntary pension scheme covers significantly less economically active individuals with smaller amount of savings per saver in Pillar III.

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 (21 operational in Latvia in 2023);
2. closed pension funds (only one operating in Latvia in 2023).

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

Figure LV.4 – Number of participants and average size of individual accounts in Latvian Pillar III



Data: Manapensija, 2023

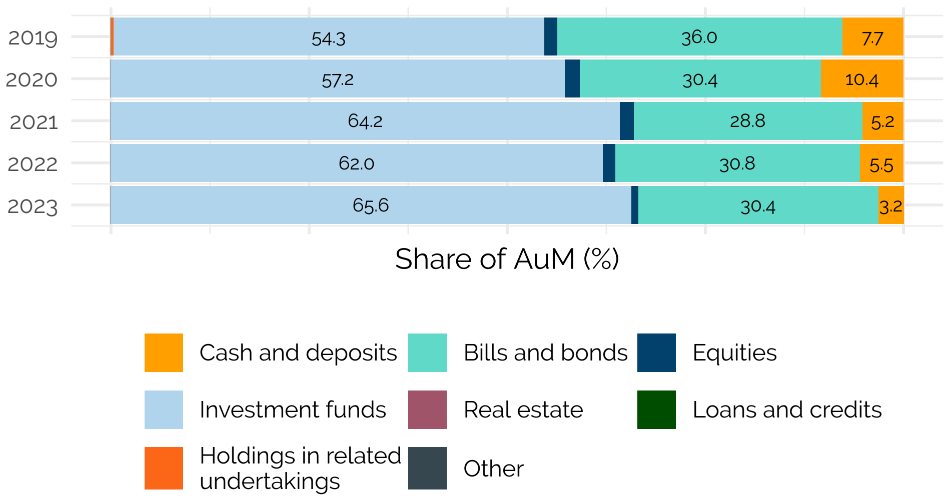
open or closed pension fund. A collective contract with a closed pension fund may be entered into only in such cases when the relevant employer is also one of the founders (stockholders) of the same closed pension fund. Acknowledging the fact that employers might enter into collective agreement with 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.

The portfolio structure of Pillar III pension funds is presented in Figure LV.5.

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.

Figure LV.5 – Allocation of Latvian voluntary pension funds' assets



Data: Manapensija; *Calculations:* BETTER FINANCE.

Charges

Charges of mandatory pension funds

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:

1. 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);

2. 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.

Table LV.7 – Costs and charges of Latvian mandatory pension funds (% of assets)

Year	Total ongoing charges	Total Expense Ratio
2003	1.18%	1.38%
2004	1.26%	1.46%
2005	1.30%	1.50%
2006	1.42%	1.62%
2007	1.40%	1.60%
2008	1.42%	1.62%
2009	1.39%	1.59%
2010	1.50%	1.70%
2011	1.51%	1.71%
2012	1.50%	1.70%
2013	1.50%	1.70%
2014	1.51%	1.71%
2015	1.52%	1.72%
2016	1.52%	1.72%
2017	1.64%	1.84%
2018	0.99%	1.19%
2019	0.80%	1.00%
2020	0.51%	0.71%
2021	0.47%	0.67%
2022	0.41%	0.61%
2023	0.45%	0.45%

Data: Manapensija; *Calculations:* BF.

The year 2023 brought stabilization of fees based on the fund's strategy. Introduction of low-cost passively managed pension funds has spurred price battle after 2018, however divergence between the fees started to emerge in 2021 with an average fee level of 0.45% in 2023.

Charges of voluntary pension funds

Compared to the mandatory pension funds' level of fees, voluntary pension funds fees are higher. Complex fee structure and high fees preserve in Latvian Pillar III even if slight decrease in custodian fees can be observed in Pillar III.

Voluntary private pension funds have typically lower level of transparency when it comes to fee policy. In most cases, only current fees and charges are disclosed. Historical data is almost impossible to track via publicly accessible sources. Charges of voluntary private pension funds for the last 5 years are presented in Table LV.8. Administration cost, Fund Manager's Commission, and Custodian bank's commission are based on the assets under management. Funds managed by Nordea and Swedbank use mixed Administration costs, which are a combination of entry fees

(fees on contributions paid) and ongoing charges (AuM-based). CBL funds also use a performance fee if the fund returns outperform the benchmark (12-month RIGIBID).

Table LV.8 – Costs and charges of Latvian voluntary pension funds (% of assets)

Year	Total ongoing charges	Admin. and mgt. fees	Other ongoing fees	Other fees	Total Expense Ratio
2011	2.83%	—	—	—	2.83%
2012	2.83%	—	—	—	2.83%
2013	2.83%	—	—	—	2.83%
2014	2.83%	—	—	—	2.83%
2015	2.83%	1.50%	1.07%	0.24%	2.83%
2016	2.67%	1.50%	0.94%	0.21%	2.67%
2017	1.90%	0.95%	0.82%	0.12%	1.90%
2018	1.77%	0.91%	0.73%	0.12%	1.77%
2019	1.64%	0.84%	0.69%	0.10%	1.64%
2020	1.32%	0.75%	0.49%	0.08%	1.32%
2021	1.32%	0.75%	0.49%	0.08%	1.32%
2022	1.12%	0.61%	0.42%	0.08%	1.12%
2023	1.20%	0.60%	0.43%	0.17%	1.20%

Data: Manapensija; *Calculations:* BF.

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

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

Taxation

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.

Latvian tax legislation stipulates the use of the "EET" regime (like Pillar II) for voluntary private pension schemes as well.

In Pillar II, contributions paid to the state funded pension scheme are made via so-

Table LV.9 – Taxation of pension savings in Latvia

Product	Phase			Regime
	Contributions	*Investment returns*	*Payouts*	
Mandatory pension funds	Exempted	Exempted	Taxed	EET
Voluntary pension funds	Exempted	Exempted	Taxed	EET

Source: Own elaboration.

cial insurance contributions redirection. As such, these contributions are personal income tax deductible items, so the contributions are not subject to additional personal taxation.

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.

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.

For Pillar III, the "EET" regime for voluntary private pension schemes is also applied. The contribution by individuals is treated in a slightly different way compared to the Pillar II social insurance contributions. 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.

Performance of Latvian long-term and pension savings

Real net returns of Latvian long-term and pension savings

Mandatory pension funds' performance in Pillar II 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).

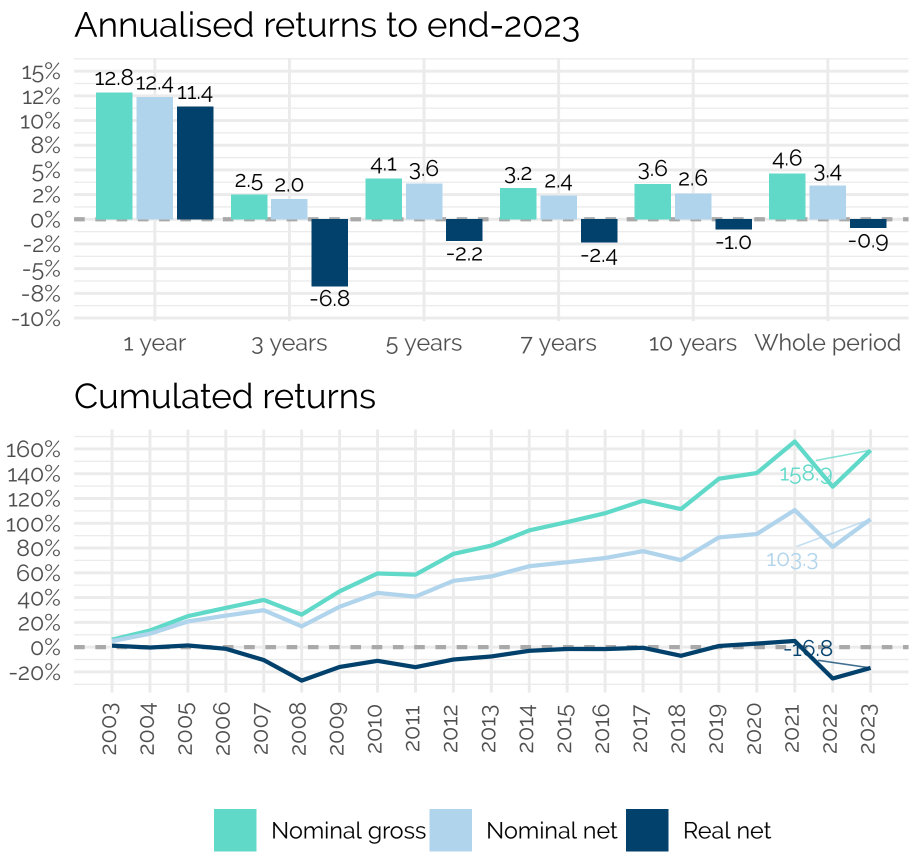
There is no maximum limit for international investments so long as pension funds invest in securities listed on stock exchanges in the Baltics, other EU member states, or the European Free Trade Area (EFTA). However, the law stipulates a 70% currency matching rule. There is also a 10% limit for each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

Pillar III voluntary pension funds investment rules 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 is calculated from the year 2011.

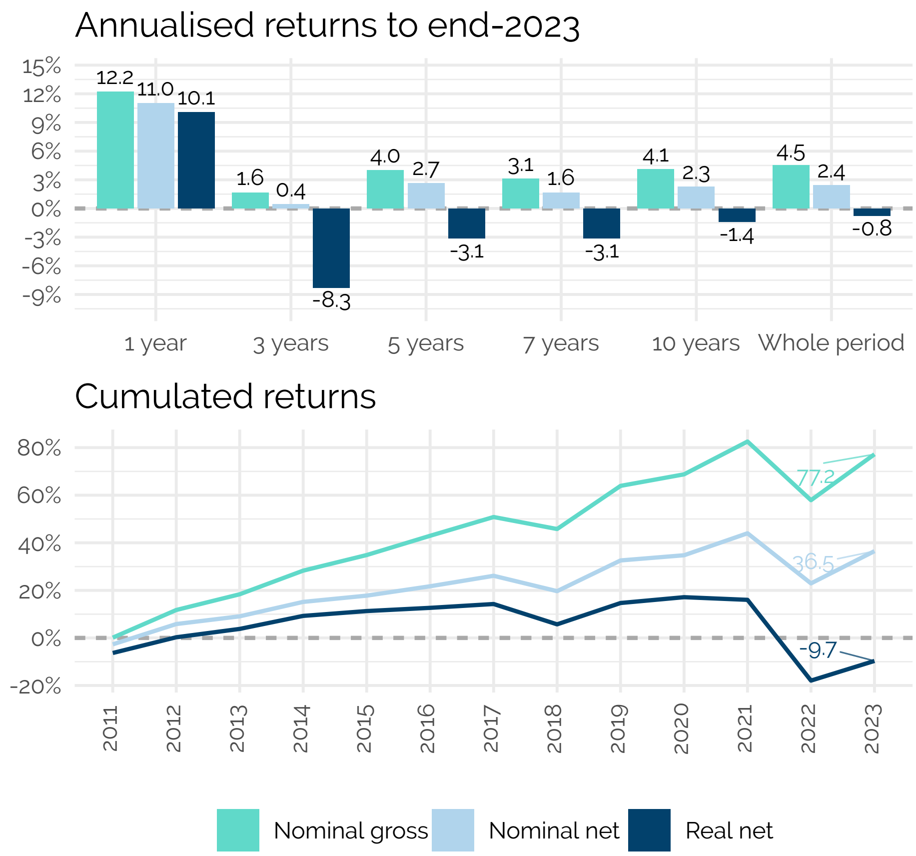
It should be noted that during the year 2021 several fully equity voluntary pension funds emerged (Luminor indeksu ieguldījumu plāns Ilgtspējīgā nākotne *Active 100* has started its operation in June 2021, Swedbank ieguldījumu plāns Dinamika Indekss *Active 100* in August 2021). Some of existing Active 75 increased their equity share are assigned as Active 100 showing rising risk appetite of savers.

Figure LV.6 – **Returns of Latvian mandatory pension funds (before tax, % of AuM)**



Data: Manapensija, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-2c

Figure LV.7 – **Returns of Latvian voluntary pension funds (before tax, % of AuM)**

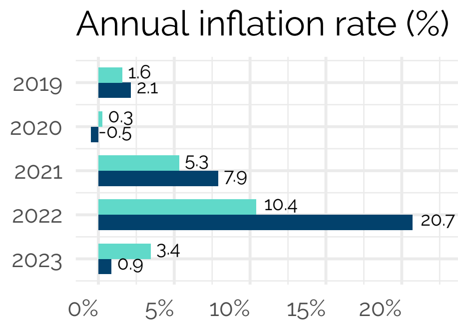


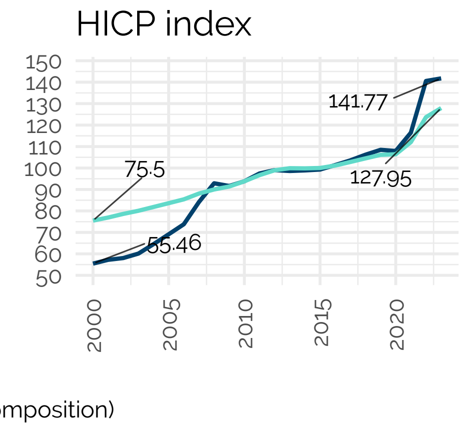
Data: Manapensija, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-20

Figure LV.8 – Inflation in Latvia

Period 2000–2023

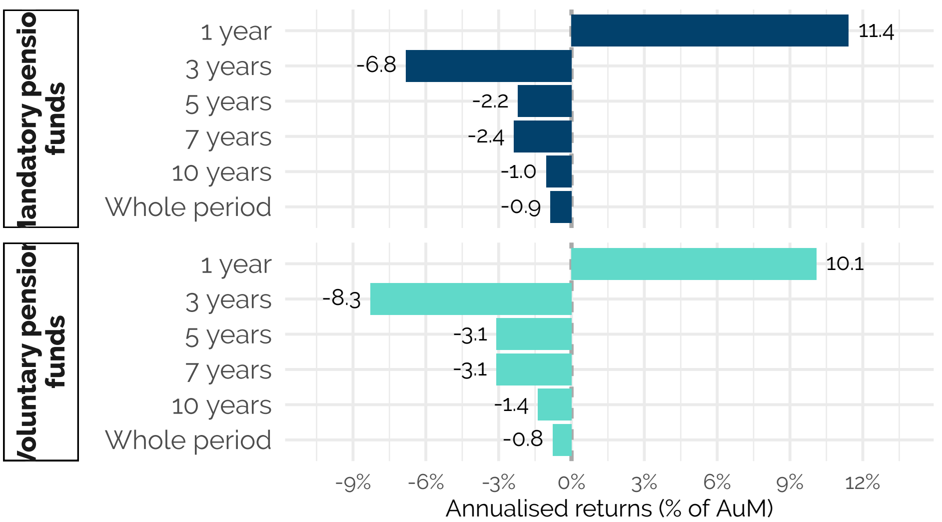
	Annualised	Cumulated
Latvia	4.1%	160.1%
European Union (varying composition)	2.3%	73.2%





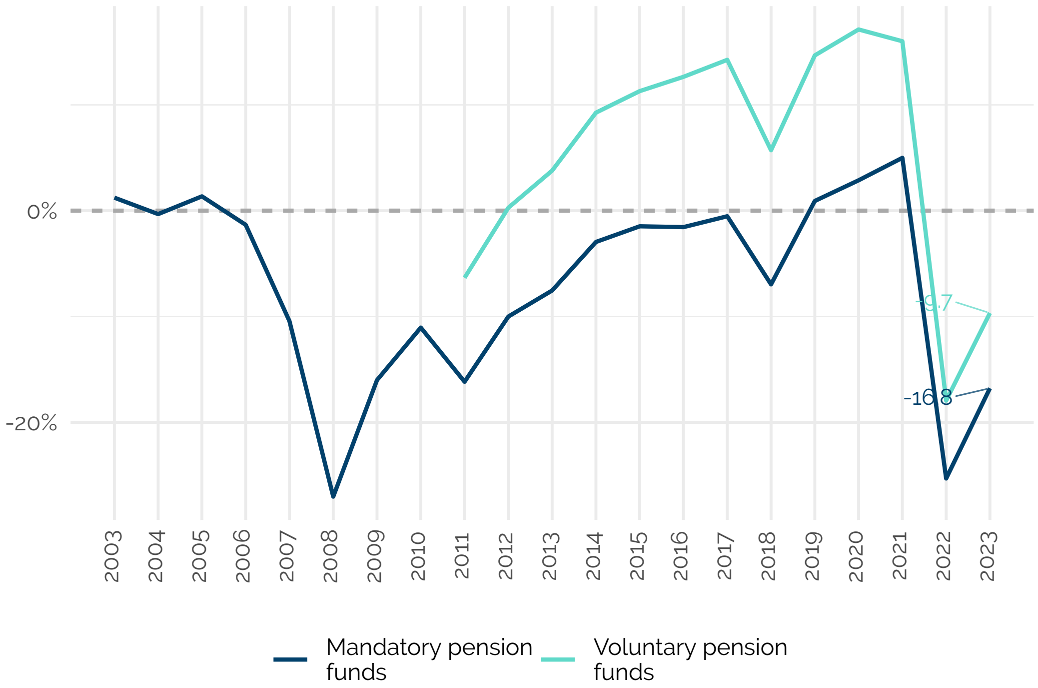
Data: Eurostat, HICP monthly index (2015 = 100); *Calculations:* BETTER FINANCE

Figure LV.9 – Annualised returns of Latvian long-term and pension vehicles over varying holding periods (before tax, % of AuM)



Data: Manapensija, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-202

Figure LV.10 – **Cumulated returns of Latvian long-term and pension savings vehicles (2003–2023, before tax, % of AuM)**



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

Do Latvian savings products beat capital markets?

In this section, we compare the performance of the mandatory and voluntary pension funds in Latvia to the performance of relevant capital market benchmarks. By analysing the portfolio structure of pension funds, we have selected a rather conservative benchmark portfolio (35% equity–65% bonds) for mandatory pension funds, and a more aggressive one (55% equity–45% equity) for voluntary pension funds, both based on two pan-European indices.

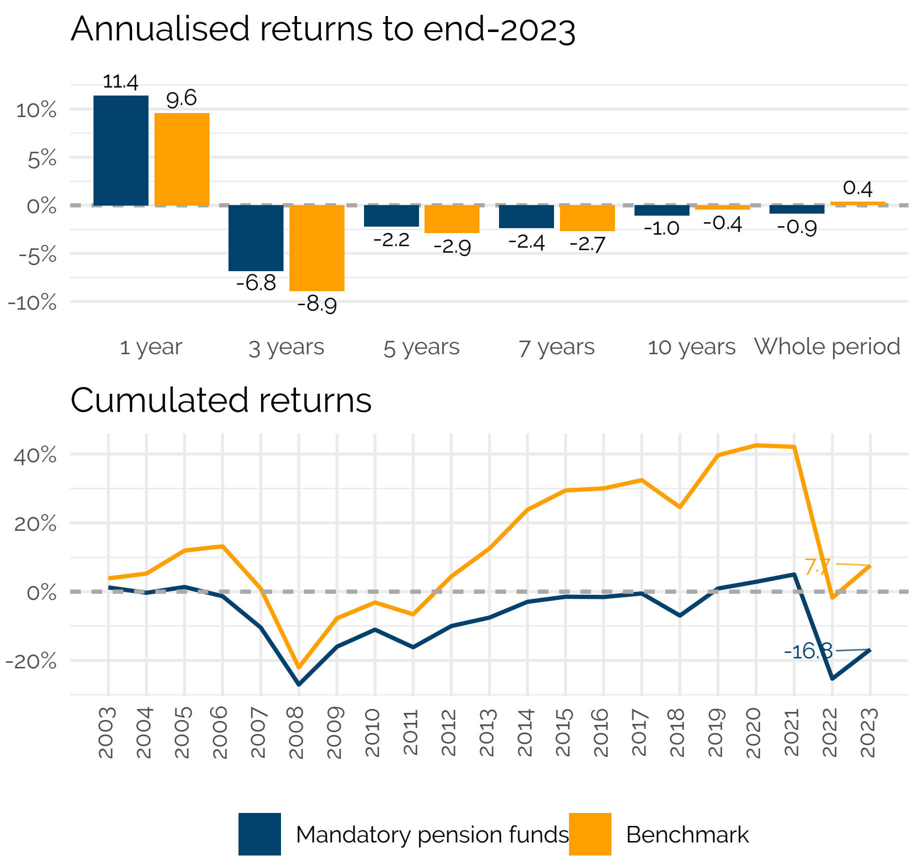
Table LV.10 – Capital market benchmarks to assess the performance of Latvian pension vehicles

Product	Equity index	Bonds index	Allocation
Mandatory pension funds	STOXX All Europe Total Market	Barclays Pan-European Aggregate Index	35.0%–65.0%
Voluntary pension funds	STOXX All Europe Total Market	Barclays Pan-European Aggregate Index	55.0%–45.0%

Note: Benchmark porfolios are rebalanced annually.

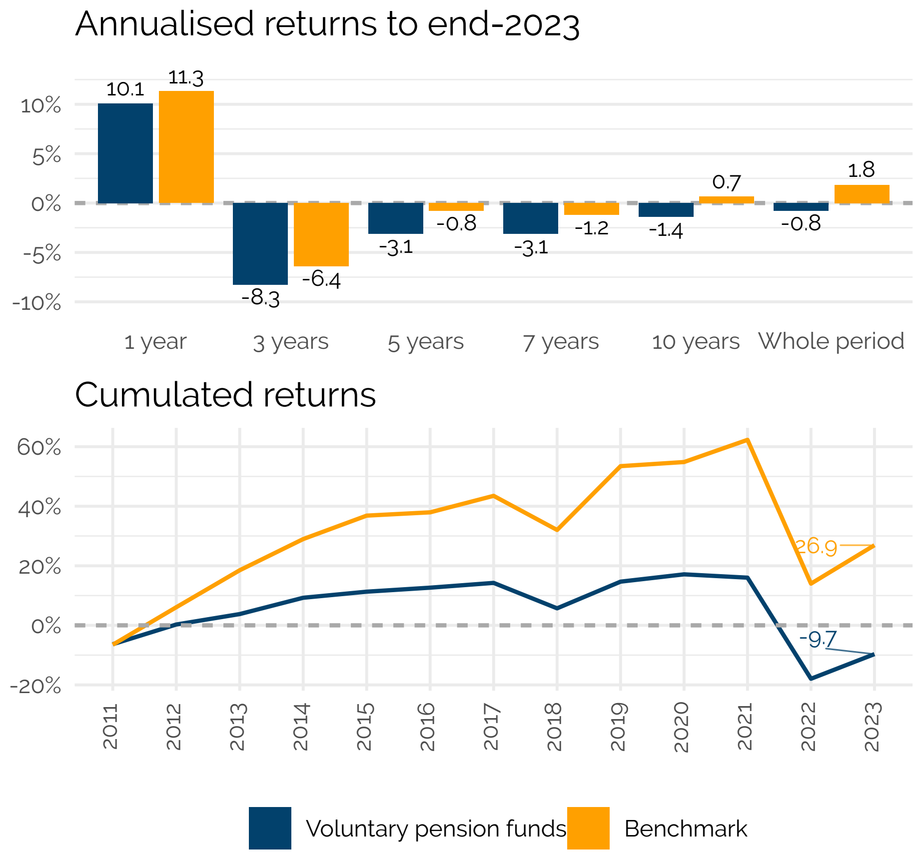
In both cases, we conclude that Latvian pension vehicles are not able to beat the market benchmark. However, detailed analysis of the particular pension funds' performance could show that more aggressive pension funds are able to stay in positive real returns over the analysed period.

Figure LV.11 – **Performance of Latvian mandatory pension funds against a capital market benchmark (returns before tax, after inflation, % of AuM)**



Data: Manapensija, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-2c

Figure LV.12 – Performance of Latvian voluntary pension funds against a capital market benchmark (returns before tax, after inflation, % of AuM)



Data: Manapensija, Eurostat; *Calculations:* BETTER FINANCE, holding periods to end-2c

Conclusions

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

Latvian Pillar II experienced drop in charges starting from 2019 and diversification of fees as well as funds' investment strategies in 2021 driven by a competition from low-cost passively managed funds and ability to charge the fees based on the riskiness of the strategy. Pillar III funds managers enjoy smaller decrease in charges, but Pillar III charges remain relatively high. Delivered real returns on the other hand are negative. Most of the Pillar II pension funds were not able to beat the inflation. One of the reasons is also the relatively conservative risk/return profile of most funds. Pillar III vehicles in Latvia suffer not only from significantly high fees charged by fund managers, but also from low transparency.

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

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

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

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