PENSION SAVINGS

The Real Return

2019 Edition

BF BETTER FINANCE

The European Federation of Investors and Financial Services Users
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Pension Savings: The Real Return
2019 Edition

A Research Report by BETTER FINANCE

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Acronyms

AIF	Alternative Investment Fund
AMC	Annual Management Charges
AuM	Assets under Management
BE	Belgium
BG	Bulgaria
Bln	Billion
BPETR	'Barclay's Pan-European High Yield Total Return' Index
CAC 40	'Cotation Assistée en Continu 40' Index
CMU	Capital Markets Union
DAX 30	'Deutsche Aktieindex 30' Index
DB	Defined Benefit plan
DC	Defined Contribution plan
DE	Germany
DG	Directorate General of the Commission of the European Union
DK	Denmark
DWP	United Kingdom's Governmental Agency Department for Work and Pensions
EBA	European Banking Authority
EE	Estonia
EEE	Exempt-Exempt-Exempt Regime
EET	Exempt-Exempt-Tax Regime
ETF	Exchange-Traded Fund
EIOPA	European Insurance and Occupational Pensions Authority
ES	Spain
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
EU	European Union
EURIBOR	Euro InterBank Offered Rate
EX	Executive Summary
FR	France
FSMA	Financial Services and Market Authority (Belgium)
FSUG	Financial Services Users Group - European Commission's Expert Group
FTSE 100	The Financial Times Stock Exchange 100 Index
FW	Foreword

GDP	Gross Domestic Product
HICP	Harmonised Indices of Consumer Prices
IBEX 35	Índice Bursátil Español 35 Index
IKZE	'Indywidualne konto zabezpieczenia emerytalnego' – Polish specific Individual pension savings account
IRA	United States specific Individual Retirement Account
IT	Italy
JPM	J&P Morgan Indices
KIID	Key Investor Information Document
LV	Latvia
NAV	Net Asset Value
Mln	Million
MSCI	Morgan Stanley Capital International Indices
NL	Netherlands
OECD	The Organisation for Economic Co-Operation and Development
OFT	United Kingdom's Office for Fair Trading
PAYG	Pay-As-You-Go Principle
PIP	Italian specific 'Individual Investment Plan'
PL	Poland
PRIIP(s)	Packaged Retail and Insurance-Based Investment Products
RO	Romania
S&P	Standard & Poor Indexes
SE	Sweden
SK	Slovakia
SME	Small and Medium-sized Enterprise
SPIVA Scorecard	Standard & Poor Dow Jones' Indices Research Report on Active Management performances
TEE	Tax-Exempt-Exempt Regime
TCR/TER	Total Cost Ratio/ Total Expense Ratio
UCITS	Undertakings for the Collective Investment of Transferable Securities
UK	United Kingdom

Glossary of terms

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[2] See European Commission, 'Investment Funds' (28 August 2019) https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_en.

[3] Werner Eichhorst, Maarten Gerard, Michael J. Kendzia, Christine Mayrhruber, Connie Nielsen, Gerhard Runstler, Thomas Url, 'Pension Systems in the EU: Contingent Liabilities and

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

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

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

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

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

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

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

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

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

Assets in the Public and Private Sector' EP Directorate General for Internal Policies IP/A/ECON/ST/2010-26.

[4] Ibid.

[5] For more detail on the concept, see Elke Loichinger, Bernhard Hammer, Alexia Prskawetz, Michael Freiberger, Joze Sambt, 'Economic Dependency Ratios: Present Situation and Future Scenarios' MS13 Policy Paper on Implications of Population Ageing for Transfer Systems, Working Paper no. 74, 18th December 2014, 3.

[6] Article 4(44) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, p. 349–496 (MiFID II).

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

ETF(s) – or Exchange-Traded Funds are investment funds that are sold and bought on the market as an individual security (such as shares, bonds). ETFs are structured financial products, containing a basket of underlying assets, and are increasingly more used due to the very low management fees that they entail.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Pension plan* – is a legally binding contract having an explicit retirement objective (or – in order to satisfy tax-related conditions or contract provisions – the benefits can not be paid at all or without a significant penalty unless the beneficiary is older than a legally defined retirement age). This contract may be part of a broader employment contract, it may be set forth in the plan rules or documents, or it may be required by law. In addition to having an explicit retirement objective, pension plans may offer additional benefits, such as disability, sickness, and survivors' benefits.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Contributors

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Lubomir Christoff, PhD, ChFC is co-founder and Chairman of the Institute of Certified Financial Consultants (ICFC) in Bulgaria, the only non-governmental body in Bulgaria granting financial planning certification to individuals. Christoff was a member of the Securities Markets Stakeholder Group at ESMA (European Securities & Markets Authority). Previously he has served as an Advisor to the Executive Director of the World Bank and Chief Economist of the Bulgarian National Bank.

Michaël Deinema is Chief Commercial Officer and analyst at The Pension Rating Agency (TPRA) based in Amsterdam, The Netherlands. Before joining TPRA in 2015, Michaël worked as postdoctoral researcher and lecturer at the Social and Behavioral Sciences faculty of the University of Amsterdam. He holds a PhD degree in Spatial Sciences (Economic and Social Geography). The Pension Rating Agency (TPRA) is an independent data service firm, benchmarker and rating agency for the Dutch collective pensions sector. It was founded in 2014 as a joint venture by MoneyView, a renowned research agency which focuses on financial retail products, and the econometricians of Broiler. TPRA systematically gathers, utilizes and analyzes publicly available data on Dutch pension funds and pension schemes. It produces annual reports on operating costs, investment charges, returns, cover ratios and trustee compensations which are used by Dutch pension funds, pension service providers, life insurance companies and media outlets. TPRA also publishes The Netherlands' only comprehensive and independent Quality Rating for Pension Schemes.

Laetitia Gabaut is an economist who graduated from the Toulouse School of Economics. She joined the European Savings Institute in 2010, where she is in charge of the "Overview of Savings" publication. She has been involved in European projects related to savers' behaviour and to retirement savings.

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Aleksandra Mączyńska is the Executive Director of BETTER FINANCE. She is a member of the EC Financial Services User Group (FSUG) and she was recently appointed by EIOPA as a member of its Occupational Pensions Stakeholder Group (OPSG). Previously she worked for the Polish consumer and competition watchdog and was an expert on various EU Council Working Parties such as the WP on Financial Services and the WP on Competition.

Alessandra Manis is Research Assistant at BETTER FINANCE and holds a master's degree in law, obtained from the University of Cagliari in Italy. She completed her studies with an in-depth look at "Consumer Protection in the sale of Financial Instruments". She was admitted to the Italian Bar and has prior professional experience in the field of banking, insurance and consumer law. She worked as a junior associate in a boutique law firm boutique specialized in banking and insurance law, carrying out both contentious and non-contentious activities.

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Pension Savings: The Real Return

2019 Edition

Country Case: Slovakia

The Zhrnutie

Zhrnutie

Slovenský dôchodkový systém je typickým modelom Svetovej banky založenom na viac-pilierovom (troj-pilierovom) systéme s individuálnymi (osobnými) účtami sporiteľov. V roku 2018 bol zavedený výkaz dôchodkových dávok v III. pilieri. Zároveň sa začali debaty o stropovoaní dôchodkového veku, ktorý potenciálne zníži očakávané dôchodky z I. piliera a tak zvýši nutnosť dodatočného sporenia na dôchodok. Pokračovali analýzy nákladovej efektívnosti dôchodkových fondov v III. pilieri a nevhodnej alokácie úspor sporiteľov v II. pilieri. Rok 2018 priniesol celkove negatívne zhodnotenie úspor v sporivých schémach poznačených pádom akciových trhov v závere roka 2018

Summary

The Slovak Pension system is a typical World Bank multi-pillar (three pillar) system based on individual (personal) pension savings accounts. The year 2018 brought first pension benefit statement for savers in Pillar III. At the same time, debates on the fixing retirement age that could lower the expected benefits from Pillar I increases the necessity of additional private forms of savings. Relevant ministries started works on the cost-effectiveness of Pillar III funds and the solutions ineffective allocation of Pillar II savings, where almost 80% of savings are allocated into the low-yielding bond funds. Year 2018 brought negative returns to almost all types of pension funds due to the decline on equity markets at the end of year.

Introduction

The Slovak old-age pension system is based on the multi-pillar approach, which consists of three main pillars:

- Pillar I – State pension organized as a mandatory Pay-As-You-Go (PAYG) scheme;
- Pillar II – Funded pension organized as voluntary funded DC based scheme; and

- Pillar III – Supplementary pension organized as a voluntary individual pension DC based scheme.

The Slovakian pension reform started in 1996 with the introduction of Pillar III, which at that time (and until 2009) was organized as voluntary pension pillar offering life insurance contracts and as an occupational pillar as well. Since July 2009, the system was changed to funded saving schemes and voluntary Pillar III pension funds are offered to the savers (members). The organization of Pillar III started to become more personal with the financial support of employers.

The World Bank's approach has been fully implemented by introducing Pillar II at the beginning of 2005, and, from a terminological point of view, it should be called the "1bis pillar", as individual retirement accounts are funded via partial redirection of social security contributions on individual pension savings accounts.

For a person who works a full career (42 years) and retires in 2018, the main income stream derives from the PAYG (Pillar I) pension scheme. On average, the individual replacement ratio of such a person could reach 50% of his gross salary. If the person would have participated since 1996 in Pillar III and contributed on average 3% of his salary into a Pillar III pension scheme, having also entered Pillar II (1bis pillar) in 2005, his income stream during retirement would have been slightly different and his replacement ratio would have been a little higher than 50%. However, still more than 90% of the retirement income stream is provided via the PAYG scheme (Pillar I), around 5% from Pillar II (1bis pillar) and 5% from Pillar III.

Introductory Table - SK Pension System Overview		
Pillar I	**Pillar II**	**Pillar III**
State pension (almost 100% coverage) - Mandatory (PAYG)	Occupational pensions - Mandatory DC (funded schemes) - coverage 60%	Individual pensions - Voluntary fully funded DC - coverage 27%
Managed by the Social Insurance Company	Managed by Pension Asset Management Companies	
Contribution rate: 13.50%; Replacement ratio: 46%; Average pension: €455	Contribution rate: 4.50%; 19 pension funds offerred	15 pensions funds offered
Quick facts		
Retirement age – 62.4 years		
A relatively high old-age dependency ratio of 23.4%		
An average net pre-retirement income replacement ratio of 83.8%		

<u>Source</u>*: authors´ composition, data valid for the year 2018*

Pillar I – State Pensions

Pillar I is a state organized Pay-As-You-Go (PAYG) pension scheme, managed by the State Social Insurance Company. Pensions are funded on an ongoing basis and benefits are calculated based on the number of insured years and paid contributions. The PAYG principle of financing is supplemented by the redistribution principle, where the lowest income groups receive higher replacement ratios and higher income groups (due to the solidarity mechanisms) receive lower replacement ratios.

Pillar I is closely connected to the economic activity and income of the citizens. This pillar is financed by contributions of economically active individuals, amounting to 13.50% (18% if the saver is not participating in Pillar II) of their base income (gross salary). These contributions are directed to the Social Insurance Company, which distributes the allowance to the beneficiaries (current pensioners).

Although Pillar I is a typical PAYG scheme, it has many NDC (notional defined-contribution) scheme features with a certain income solidarity element. The old-age pension of the insured person depends on three parameters:

1. The insurance period (number of insured years with active contribution);
2. The average personal wage point (a ratio representing the contribution base of an individual is compared to the average salary in Slovakia); and
3. The value of the pension unit (this value is annually defined by the Slovak Government to mimic the increase in the average salary in Slovakia).

However, an individual is entitled to an old-age pension only after the statutory retirement age is reached. The pension insurance is comprised of two independent, separately funded sub-schemes managed by the Social Insurance Agency:

- the old-age pension insurance: insurance to secure income in retirement and in the event of death; and
- the disability insurance: insurance in the event of a reduced ability to work due to long-term illness of the insured and in the case of death.

Pension insurance is mandatory; statutory insurance and participation in this scheme is a legal obligation for all eligible persons. However, the Act on Social Insurance also enables voluntary pension insurance participation.

The basic pension insurance parameters that make up the content of the benefit scheme and affect the entitlement to individual pension benefits are: the insurance period, the average personal wage point, the value of pension unit and the retirement age, defined as follows:

- **Number of insured years (insurance period):** given by the number of working years of an individual during which social insurance contributions were paid;
- **Average personal wage point (APWP):** determined as the ratio of the sum of personal wage points calculated for each calendar year of the reference period and the period of pension insurance in the relevant period. The average personal wage point shall be rounded up to four decimal points;
- **Value of pension unit:** the monetary value of one personal wage point. The pension value is adjusted on 1 of January each year through indexation, which is determined as the ratio of the average wage calculated in the third quarter of the previous calendar year and the average wage calculated in the third quarter of the calendar year two years preceding the calendar year on which the pension value is calculated. This way the determined pension value is always valid from 1 January to 31 December of the calendar year. The current pension value, which is used to calculate pension benefits, is the pension value valid at the time of a claim for payment of the pension benefits;
- **Retirement age** – 62 years and 139 days in 2018, valid for both men and women. In order to increase the sustainability of Pillar I pension scheme, the retirement age increases both for men and women from 2017 onwards. The increase in retirement age is reflective of the increase in life expectancy of the retiring population. The first increase in retirement age was at the beginning of 2017 and accounted for additional 76 days. Further increases in retirement age are expected and should rise on average by 2 months every year. However, there are strong political debates on the fixing retirement age at 64 for men and bonification for women that raised children.

To illustrate the calculation of an old-age pension, let us assume that an individual has the following individual parameters and reached the statutory retirement age of 62.4 years in 2018:

1. Number of insured years (N) = 42 (full working career);
2. Average personal wage point (APWP) = 1 (for the entire working career, an individual has been earning on average 100% of average salary in Slovakia)
3. Value of pension unit (VPU) = €11.9379 (for persons retiring in the year 2018).

The old-age pension is then calculated using the following formula: N x APWP x VPU.

Therefore, considering the abovementioned individual parameters of a person claiming old-age pension, he/she will be entitled to a monthly pension equal to:
42 x 1 x €11.9379 = €501.40.

If an individual has earned on average 100% of an average salary during his entire working career and the average salary in 2018 was €1,013, then the individual replacement ratio of such an individual would be: €501.4 / (1 x €1,013) = 49.50%.

Pillar II – Funded pensions

The Slovak Pillar II was established as a defined contribution (DC) pension saving scheme in 2005. Since September 2012, the enrollment is fully voluntary (until September 2012 it was a mandatory one) and eligible for persons up to 35 years of age. The principle of funded pension is based on the accumulation of savings during employment and investing savings in financial markets via special purpose vehicles - pension funds, which are managed and administrated by Pension Fund Management Companies (PFMCs), licensed by National Bank of Slovakia.

The role of old-age pension saving, along with old-age social insurance (Pillar I), is to ensure retirement income for savers and their survivors in the case of his/her death.

The Pillar II market is fairly concentrated. Each saver can choose one out of six currently existing providers (PFMCs) on the Slovak market. The PFMCs are private joint-stock companies with a minimum capital requirement of €10 million and established in the territory of the Slovak Republic. Their exclusive business is the creation and administration of pension funds. As a further condition, they must attain at least 50,000 members within a period of 18 months from the establishment of the pension fund.

According to the applicable law (the Act on Old-Age Saving), each PFMC is obligated to operate at least two pension funds. We can divide these pension funds into two main groups:

1. Bond guaranteed pension fund (Guaranteed scheme);
2. Equity non-guaranteed pension fund (Non-guaranteed scheme).

Each PFMC is free to choose (mostly based on their business model) wether it operates additional pension funds, which are optional. These legislative changes entered into force on 30 April 2013. Before this date, each PFMC had to operate three (respectively four) obligatory pension funds:

1. Bond (Conservative) pension fund (since March 2005);
2. Mixed (Balanced) pension fund (since March 2005);
3. Equity (Growth) pension fund (since March 2005);
4. Index pension fund (since April 2012).

After the legislative changes became effective in May 2013, mixed and index pension funds became optional, and some of PFMCs merged these pension funds with obligatory Equity non-guaranteed pension funds. It is important to say that the first three categories of pension funds are (from an asset management point of view) actively managed pension funds, and Index pension funds are the only funds managed entirely passively. However, changes in the fee policy (strictly regulated) forced providers to change the investment strategy of pension funds towards being passively managed using mostly ETFs as main financial instruments.

PFMCs are subject to a variety of regulations. The Old-age Pension Savings Act defines the range of allowed investment instruments and sets maximum limits for portfolio allocations (quantitative limits). Investment procedures and valuation of investments (daily at market prices) are also regulated. Thus, each category of pension funds has their own investment strategy, as well as general or special quantitative limits and operating conditions. PFMCs and managed pension funds are supervised by the National Bank of Slovakia.

Pillar II as a voluntary DC scheme allows savers to enter the system whenever they wish before the age of 35. In general, pension fund members (Pillar II savers) are free to choose one or two of the aforementioned pension funds provided by the same PFMC.

Each saver has an individual retirement account (IRA). His contributions (savings) are redirected from the Social Insurance Company to the chosen PFMC on his IRA at a rate of 4% of gross salary. However, since 2017, the contributions have started to increase from 4% to 4.25% and will continue to grow by 0.25% annually until they reach the final level of 6% in 2024.

With the possibility to save in one or two pension funds at the same time, it is completely up to a saver how much of his own savings would be invested in one pension fund or another. He can invest, for example, 70% in a Bond guaranteed pension fund and another part (30%) in an Index non-guaranteed pension fund. There is no fee or charge to change this allocation ratio or switch pension funds managed by the same PFMC - even on a daily basis. Switching providers (PFMCs) for free is possible for savers if the change is made after one year, otherwise a fee of €16 is applied.

The reform of the pay-out phase, introduced in 2015, stipulates the following types of pension products that are allowed for the pay-out phase:

1. single annuity (for most cases) with guaranteed payment period for 84 months;
2. single indexed annuity;
3. single annuity with survivorship benefits (for up to 2 years);
4. programmed withdrawal (phased withdrawal);
5. perpetuity (withdrawal of only annual gains).

Products 1, 2 and 3 are provided by insurance companies, products 4 and 5 by PFMCs.

Pillar III – Supplementary pensions

The Supplementary pension is a voluntary funded DC-based pension saving scheme in which the funds of the participants are administered by Supplementary Pension Fund Management Companies (SPFMCs). The SPFMCs are private joint stock companies established under the Slovak law and able to only provide services tied to the management of supplementary pension funds. SPFMCs and their supplementary pension funds are supervised and regulated by the National Bank of Slovakia.

The purpose of supplementary pension saving is to allow participants to obtain supplementary pension income in old-age and the whole Pillar is mostly oriented towards employers and their employees. However, the coverage ratio is rather low (28% in 2018).

Currently there are four providers (SPFMCs) operating on the market, which could be considered concentrated. Each SPFMC is obliged by law to operate at least one contributory and one "pay-out" supplementary pension fund. The legislation does not determine specific types of contributory pension funds; however, we can divide all existing contributory pension funds according to the portfolio structure into 3 main groups:

- Conservative supplementary pension funds (no equity investments);
- Balanced supplementary pension funds (small portions of equity investments);
- Growth supplementary pension funds (highest portions of equity investments).

Company "NN" has launched the first passively managed equity fund within the Pillar III in July 2018. There are no specific investment restrictions regarding asset classes in supplementary pension funds, but there are some general quantitative limits to restrict the concentration risk of the fund.

The following benefits are paid from the supplementary pension saving upon the completion of the saving period:

- supplementary old-age pension in the form of lifelong or temporary supplementary annuity;
- supplementary pension in the form of programmed withdrawal;
- lump-sum settlement;
- redundancy pay.

Pension Vehicles

Pillar II – Funded pensions

There are six providers - Pension Asset Management Companies (PFMCs) - operating on the market. According to the Assets under Management (AuM) measure, the two biggest, Allianz Slovenska and AXA, represent nearly 60% of the market. More details on the market share of particular providers are presented in the table below.

Table SK1. Pension Asset Management Companies market share (Pillar II)

Pension Fund Management Company	AuM *(in millions €)*	Market share based on AuM
AEGON	694.87	8.62%
Allianz – Slovenska	2,563.02	31.80%
AXA	2,140.79	26.56%
DSS Postovej banky	428.09	5.31%
NN	840.59	10.43%
VUB - Generali	1,392.51	17.28%
TOTAL	**8,059.87**	**100.00%**

Source: Own calculations based on ManazerUspor.sk data, 2019 (data as of 31 December 2018)

The table below (Table SK2) presents the market share of Pillar II pension funds according to their dominant investment strategy and asset allocation. The dominant part of savings is allocated into bond pension funds that invest conservatively and mainly in short-term bonds.

Table SK2. Pillar II Market share by group of pension funds

Scheme	Type of voluntary pension fund	AuM *(in millions €)*	Market share based on AuM
Guaranteed PFs	Bond guaranteed pension funds (6 funds)	6,266.70	77.75%
Nonguaranteed PFs	Mixed non-guaranteed pension funds (2 funds)	81.13	1.01%
	Equity non-guaranteed pension funds (6 funds)	951.52	11.81%
	Index non-guaranteed pension funds (5 funds)	760.52	9.44%
TOTAL	19 Pension funds	8,059.87	100.00%

Source: Own calculations based on ManazerUspor.sk data, 2019 (data as of 31 December 2018)

The increase in assets under management was caused mainly by the stabilization of the market and higher returns of Index pension funds. We see increased number of savers, who mix two funds on their individual retirement savings accounts.

However, the structure of investments does not match the age profile of Slovak savers and thus increases the risk of lower replacement ratio for most of the savers in the future. After the Governmental intervention in 2013, the number of savers in equity pension funds has dropped significantly. Currently, still 78% of all savings in Pillar II are allocated into the Bond guaranteed pension funds and it does not correspond to the age profile of savers. This fact might cause more problems and increase the political risk in the future, as many savers still believe that they save in equity pension funds.

Asset allocation of Pillar II pension funds is regulated by law (Act on Old-Age Saving), laying down the general quantitative investment limits on all pension funds – for example:

- max. 3% of AuM into one financial instrument (does not apply on bond investments or in case of passively managed pension funds);
- max. 10% of AuM into one UCITS fund;
- max. 15% of the whole pension fund portfolio into one issuer (does not apply on bond investments or in case of passive managed pension funds);
- bond investments must have investment grade rating (does not apply in case of passively managed pension funds).

Pillar II savers can choose from two main types of obligatory and two types of optional voluntary pension funds.

<u>Obligatory - Bond guaranteed pension funds</u> are actively managed pension funds and are obliged to invest 100% of the assets into bonds, money market instruments, deposits, investment funds in which assets must be invested in the above securities and deposits and other similar assets. Bond guaranteed pension funds are not allowed to invest in equities and real estate, nor respective investment funds. This conservative strategy focuses on bonds, and its objective is the preservation of capital and moderate growth primarily on shorter horizons. Bond guaranteed pension funds are obliged to hedge at least 95% of the whole portfolio against currency exposure. That means that if the pension fund allocates the assets into the financial instruments that are denominated in a currency other than Euro, fund managers must open the position (usually swaps or other hedging instrument) that fixes the value of such investment in Euro.

<u>Obligatory - Equity non-guaranteed pension funds</u> are actively managed pension funds and proceed in investing in different types of assets from the objective under quantitative limits:

- up to 80% of the assets of the funds can be invested in equities, equity funds and other instruments similar to equity;
- at least 20% of the whole portfolio has to be hedged against currency risks;

- max. 20% of the whole portfolio can be invested in precious metals.

Optional - Mixed non-guaranteed pension funds are actively managed pension funds and they invest in different types of assets, according to their objective and under general quantitative limits. There are no specific limitations applicable.

Optional - Index non-guaranteed pension funds, introduced in April 2012, are the only passively managed pension funds in Slovak pillar II. There are no general nor specific quantitative limits, because of the nature of investing. Slovak Index non-guaranteed pension funds track respective stock market benchmarks (such as MSCI World, Eurostoxx 50, MSCI ACWI, MSCI Euro).

Pillar III – Supplementary pensions

There are four providers – Supplementary Pension Fund Management Companies (SPFMCs) - operating on the market. According to Assets under management, the two biggest, NN Tatry – Sympatia and DDS Tatra banky, represent nearly 70% of the whole market.

DDS Tatra banky has introduced TDFs (target date funds) in 2015, with the aim to provide age specific investment strategy for its members saving for retirement in Pillar III pension vehicles.

Table SK3. Pillar III Supplementary Pension Companies market share

Supplementary Pension Company	Assets under management *(in millions €)*	Market share based on AuM
DDS Tatra banky	622.12	30.97%
AXA	290.19	14.44%
NN Tatry – Sympatia (ING before 2015)	776.47	38.65%
STABILITA	320.30	15.94%
TOTAL	**2,009.08**	**100%**

Source: Own calculations based on ManazerUspor.sk data, 2019 (data as of 31 December 2018)

Under the law, each SPFMC must operate at least two types of pension vehicles for supplementary pension (Pillar III):

1. contributory pension fund; and
2. “pay-out” pension fund.

Although the law does not determine specific types of contributory pension funds, we can divide all existing contributory pension funds according to the portfolio structure into three main groups:

- Conservative supplementary pension funds (no equity investments);

- Balanced supplementary pension funds (small portions of equity investments);
- Growth supplementary pension funds (higher portions of equity investments).

For supplementary pension funds, there are no special investment restrictions regarding asset classes, but there are some general quantitative limits, i.e. no more than:

- max. 5% of AuM in one financial instrument;
- max. 30% of AuM in securities and money market financial instruments from one issuer (does not apply to instruments issued by the EU Member States);
- max. 35% of AuM in securities and money market financial instruments issued by the EU Member State, the EU, ECB, MMF or World bank;
- max. 20% of AuM in one standard mutual fund (UCITS compliant);
- max. 10% of AuM in one alternative investment fund (AIF);
- max. 40% of AuM in mutual funds.

Table SK4. Supplementary Pension vehicles market share by group of funds

Type of the pension fund	Supplementary pension vehicles	AuM *(in millions €)*	Market share, based on AuM
Contributory	Conservative supplementary pension funds (3 funds)	704.49	35.06%
	Balanced supplementary pension funds (4 funds)	883.67	43.98%
	Growth supplementary pension funds (4 funds)	353.10	17.58%
Pay-out	Pay-out supplementary pension funds (4 funds)	67.83	3.38%
TOTAL	**17 Pension funds**	**2,009.08**	**100.00%**

Source: Own calculations based on ManazerUspor.sk data, 2019 (data as of 31 December 2018)

In general, the Pillar III scheme covers only 27% of economically active population, while only 70% of them actively contribute to the scheme. At the same, most of the retirement savings are directed into balanced supplementary pension funds, which apply rather conservative investment strategy with limited long-term investments.

Charges

Pillar II – Funded pension

Charges are highly regulated and capped in the Pillar II scheme by the Old-Age Pension Saving Act.

PFMCs can apply the following types of charges at the expense of the pension funds:

- Management fee (as percentage of NAV in respective pension fund);
- Performance fee (as percentage of new highs reached in performance of respective pension fund –High Water Mark[229] 'HWM' principle);
- Administration fee - Administration of Personal pension account (as percentage of new contributions);
- Depository fee (as percentage of NAV in the respective pension fund); and
- Other charges (mostly trading charges).

It must be mentioned that on top of these charges, each saver in Slovak Pillar II also has to pay an Administration fee to the Social Insurance Company that administers the central collection system, central information, and offering system for annuities. The Social Insurance Company collects the social security contributions and transfers part of savers´ contributions to his personal pension account managed by the Pension Asset Management Company.

The following table compares applied charges in Pillar II.

Table SK5. Pillar II Pension Funds´ Fees

Fee type	Since 2005	as of 31 December 2018
Management fee (for PFMC)	max 0.8% p.a., NAV	max 0.3% p.a. based on AuM *(since 1 April 2012)*
Success Fee (for PFMC)	0%	max 10%, HWM *(since 1 July 2013)*
Administration of Personal pension account (for PFMC)	1% of new contributions	1% of new contributions
Administration fee (for Social Insurance Agency)	0.50% of new contribution	0.25% of new contributions *(since 1 January 2013)*

Source: Own research, data as of 31 December 2018

[229] Slovak legislation defines the HWM method for calculating the success fee as a comparison of new highs of respective pension fund to its historical performance achieved 3 years ago. If today´s closing price is higher than historical highs achieved 3 years ago, the provider has the right to charge 10% success fee from the difference between today's pension unit price and highest historical price. If the difference is negative no success fee can be charged.

Pillar III – Supplementary pensions

Charges in Pillar III are capped by law. Supplementary Pension Fund Management Companies are (since 1 January 2014) allowed to apply the following types of charges:

- Management fee (as percentage of AuM in a respective supplementary pension fund),
- Performance fee (as percentage of new highs reached in performance of a respective supplementary pension fund – High Water Mark principle),
- Depository fee (as percentage of AuM in a respective pension fund),
- Other charges (Switching fee).

The Following table compares charges applied in the Pillar III.

Table SK6. Supplementary Pension Funds´ Fees

	since 2009	Since 1 January 2014
Management Fee *1. contributory SPF*	max **2.5%** AuM (2010) => max **1.98%** (2019+)	max **1.2%** NAV (2018 = 1,4% AuM and each following year decreases by 0.1%)
2. payout SPF	max **0.996%** AuM	max **0.6%** AuM (2018 = 0.70% and each following year -0.05%)
Performance Fee *1. contributory SPF*	max **10%** (2010) => max **20%** (2020+); HWM principle	max **10%**; HWM principle
2. payout SPF		**0%**
Switching Fee	**0%** more than 3 years	**0%** more than 1 year / max **5%** less than 1 year
Early Exit Fee	**20%** (5% SPC + 15% SPF)	**0%**

<u>Source</u>*:* Own research based on Supplementary pension saving Act, data as of 31 December 2017

Taxation

The Act on Income Tax recognizes two different of income tax rates in Slovakia that apply to pension saving schemes.

Personal income tax rate has been set at 19% since 2005. Since 2013, there is higher tax rate of 25% for higher earners, whose monthly income in 2018 was higher than €2,939 (around 4% of working population in 2018).

Corporate income tax rate for 2018 was 21%.

Pillar II – Funded pensions

Pillar II should be viewed as a 1bis pension pillar that is basically a derivate of the basic old-age security scheme, as a part (4.50% in 2018) of the overall (18%) old-age social insurance contributions are diverted from a PAYG pillar into funded DC scheme. Understanding this principle, Pillar II taxation is similar to the PAYG pillar, meaning that an "EEE" taxation regime is applied.

Taxation of contributions

Contributions paid to Pillar II are tax deductible. However, a saver can add voluntary contributions on top of the 4.50% contributions redirected from PAYG pillar. Since 2017, voluntary contributions on top of redirected social insurance contributions are subject to the personal income tax (19%) as well as social and health insurance. Thus, the "T" regime applies for voluntary contributions.

Taxation of the Fund

Fund returns are not subject to Slovak income taxes at the fund level.

Taxation of pay-out phase income

Income generated via purchased pillar II pay-out phase products (annuity, perpetuity, programmed withdrawal) are not subject to personal income tax. In case of heritage, the amount the successor receives as inherited (accumulated) savings is not subject to personal income tax.

Thus, we can say that for Pillar II the "EEE" taxation regime applies in general. However, for voluntary contributions, the "TEE" regime applies.

Pillar III – Supplementary pensions

Taxation of Pillar III differs from the Pillar II taxation approach significantly. There are different taxation treatments of contributions as well as different treatments of the pay-out phase. It is rather difficult to generalize the regime. However, the "EET" regime can be used with several exceptions and specifications.

Taxation of contributions

When considering the taxation treatment of contributions, a slightly different regime is used for savers´ (employees´) contributions and a different regime for employer´s contributions.

Generally, both contributions are income-tax deductible; however, for employees (savers) there is a ceiling of €180 per year. This means that the monthly contributions to the Pillar III supplementary pension fund up to €15 are income tax base deductible. Above this amount, the contributions made to the individual saving account are subject to personal income tax. Considering that the average salary (€1,013 in 2018), employee contributions up to 1.48% of the gross average salary can be deducted from the personal income tax base.

Employer contributions are treated in a slightly different way. Contributions are tied to the monthly salary of employees. Employer´s contributions up to 6% of monthly salary are treated as tax expenses. Therefore, employers are motivated to contribute on behalf of employees up to this tax favorable ceiling. Taking into account the average salary in Slovakia, contributions up to €60.78 per employee per month are considered as tax expenses for contributing employers in 2018. Taking into account the poor supplementary pension funds´ performance and the relatively high level of charges, favorable tax treatment of employer´s contributions are the key drivers for the participants. At the same time, this favorable treatment of employer´s contributions paid on behalf of its employees exclusively in the Pillar III scheme creates an administrative monopoly in form of preferred supplementary retirement product in Slovakia.

Taxation of the Fund returns

Fund returns are exempt from income taxes at the fund level.

Taxation of pay-out phase

There are three different types of products used for the Pillar III pay-out phase (according to the Act on Supplementary Pension Saving):

1) Lump-sum – paid out through SPFMC at maximum of 50% of accumulated savings;
2) Annuities – paid out through insurance company in form of a single annuity;
3) Phased (Programmed) withdrawal – paid out through SPFMC for at least 5 years.

There are 3 general conditions, where at least one should be met when entering the pay-out phase in order to achieve more favorable tax treatment of income stream from Pillar III savings. They concern the member´s age, the entitlement for state retirement pension benefits or the entitlement for early state retirement pension benefits.

When considering the tax treatment of the pay-out phase income stream from the saver's point of view, there is a possible way to adjust the personal income tax base. The Act on Income Tax stipulates that the deduction from income tax base will be applied to the income stream from Pillar III benefits and life insurance contracts. Personal income tax base shall be lowered by the paid contributions (Pillar III) or paid premiums (life insurance contract). The Act on Income Tax also defines the income tax base adjustments in case of paid monthly benefits according to the following formulas:

- In the case of temporary annuity, the income tax base is calculated as positive balance between sum of already received benefits and sum of paid contributions;
- In the case of single annuity, the income tax base is calculated as paid monthly benefits and total paid contributions (or premium) divided by the number of remaining years calculated as life expectancy and the age of the taxpayer (beneficiary) at the moment of the first paid benefit.

Therefore, we can conclude that the income tax treatment of pay-out phase is, in fact, a deferred taxation of investment returns applied not to the supplementary pension fund, but directly to the saver during the pay-out phase. In general, we can say, that the tax regime for Pillar III is "EET".

Pension Returns

Pillar II – Funded pensions

The six asset managers offer 19 pension funds in Slovakia (see table below). Pension funds are divided into 2 main groups:

1. obligatory pension funds
   a) bond guaranteed pension funds (6 offered)
   b) equity nonguaranteed pension funds (6 offered)
2. optional pension funds
   c) mixed nonguaranteed pension funds (3 offered)
   d) index nonguaranteed pension funds (5 offered)

Groups a), b) and c) were launched onto the market by the beginning of Pillar II. Index nonguaranteed pension funds (only passively managed pension funds) were launched in 2012.

Table SK7 Pension vehicles in Pillar II		
Pension vehicle	**Fund Name**	**Fund Inception Day**
Bond guaranteed pension funds (obligatory)	AEGON d.s.s. – BGPF (Solid)	*22 March 2005*
	Allianz - Slovenska d.s.s. – BGPF (Garant)	*22 March 2005*
	AXA d.s.s. – BGPF (Dlhopisovy)	*22 March 2005*
	DSS Postovej banky d.s.s. – BGPF (Stabilita)	*22 March 2005*
	NN d.s.s. – BGPF (Tradícia)	*22 March 2005*
	VUB Generali d.s.s. – BGPF (Klasik)	*22 March 2005*
Mixed non-guaranteed pension funds (optional)	NN d.s.s. – MNGPF (Harmónia)	*22 March 2005*
	VUB Generali d.s.s. – MNGPF (Mix)	*22 March 2005*
Equity non-guaranteed pension funds (obligatory)	AEGON d.s.s. – ENGPF (Vital)	*22 March 2005*
	Allianz - Slovenska d.s.s. – ENGPF (Progres)	*22 March 2005*
	AXA d.s.s. – ENGPF (Akciovy)	*22 March 2005*
	DSS Postovej banky d.s.s. – ENGPF (Prosperita)	*22 March 2005*
	NN d.s.s. – ENGPF (Dynamika)	*22 March 2005*
	VUB Generali d.s.s. – ENGPF (Profit)	*22 March 2005*
Index non-guaranteed pension funds (optional)	AEGON d.s.s. – INGPF (Index)	*2 April 2012*
	AXA d.s.s. – INGPF (Indexovy)	*2 April 2012*
	DSS Postovej banky d.s.s. – INGPF (Perspektiva)	*2 April 2012*
	NN d.s.s. – INGPF (Index)	*2 April 2012*
	VUB Generali d.s.s. – INGPF (Index)	*2 April 2012*

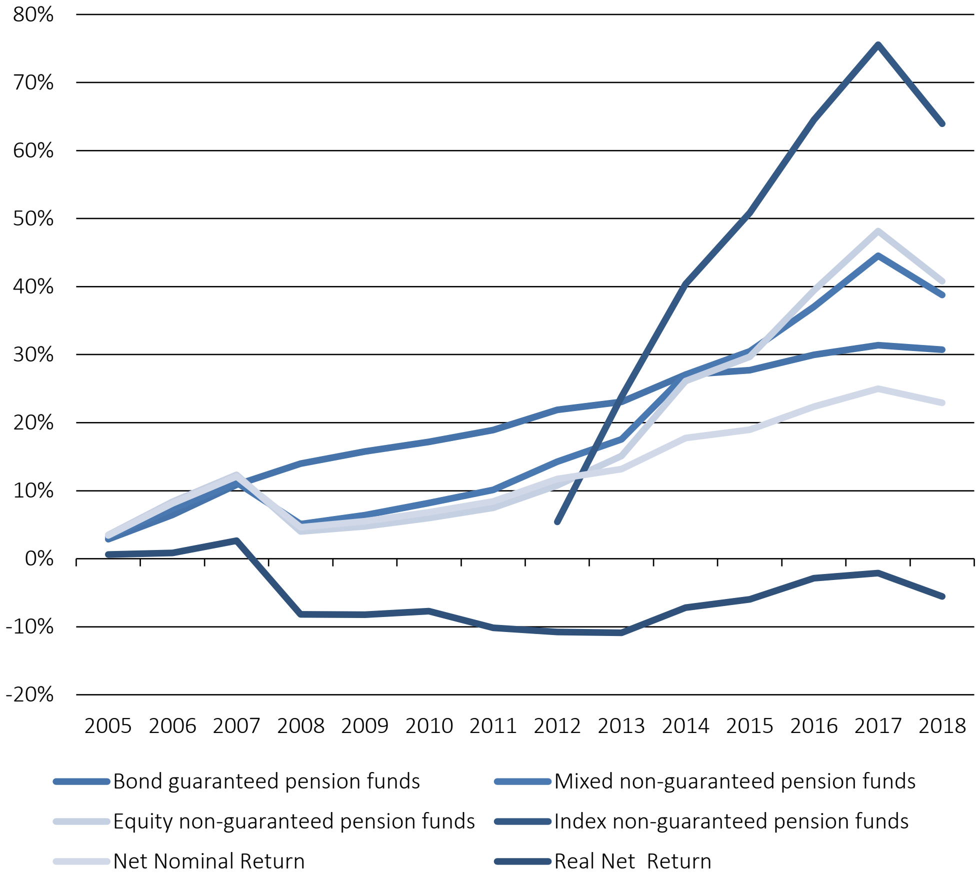
Source: Own elaboration based on Manazeruspor data, 2018

The performance (returns and respective volatility) differs in all four types of pension funds. This is caused by the portfolio structure and different investment strategies.

Bond guaranteed pension funds do not invest in equity investments. Mixed non-guaranteed pension funds invest a small portion in equity investments (currently less than 40% of AuM on average) and equity non-guaranteed pension funds invest higher portion in equity investments (currently more than 50% of AuM on average). Optional Index non-guaranteed pension funds possess the highest level of equity investments (nearly 100% of AuM), because their fully passive investment strategy focusing on the replication of benchmark (various equity market index) performance.

The following graph presents the cumulative performance of Pillar II Pension Funds. At the same time, we present the nominal as well as real cumulative performance, where the returns are weighted by funds´ AuM.

Graph SK8. Cumulative Performance of Pillar II pension funds



Source: Own calculations based on Manazeruspor data, 2019 (data as of 31 December 2018)

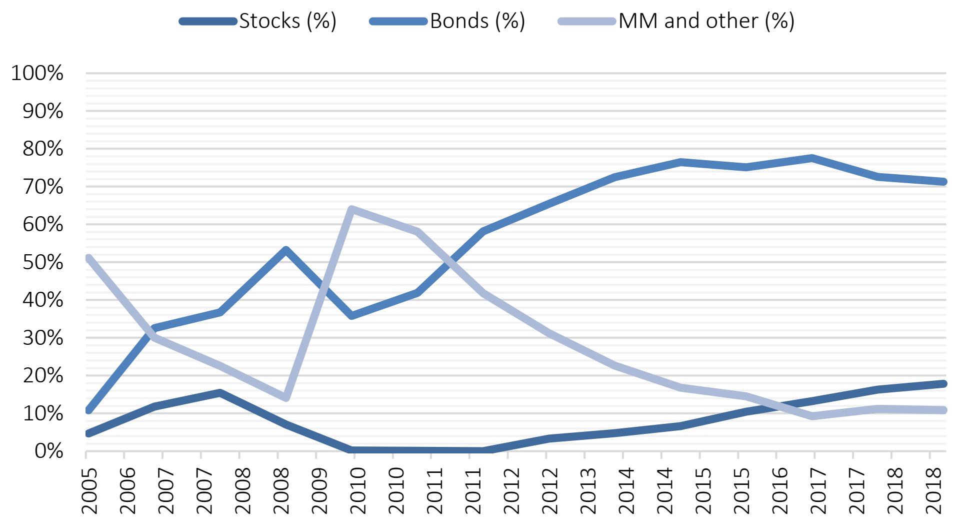
From the view of a saver, one could present the performance using various holding periods. The table below presents the AuM weighted performance of Pillar II pension funds net of fees in nominal as well as real terms.

Table SK9. Pillar II Pension funds Nominal and Real Performance according the holding period		
Holding Period	Net Nominal Annualized Performance	Real Net Annualized Performance
1 year	-1.65%	-3.52%
3 years	1.09%	0.15%
5 years	1.66%	1.17%
7 years	1.81%	0.72%
10 years	1.62%	0.28%
Since inception	1.49%	-0.41%

Source: Own calculations, 2019 (data as of 31 December 2018)

The portfolio structure of Pillar II pension funds according to the classes (bonds, equities, money market instruments) is presented in the graph below. According to our analysis, currently about 71% of all investments in Pillar II pension funds are bond investments. On the other hand, only 18% of all investments are equity investments. The portfolio structure does not correspond to the age profile of Pillar II savers, which causes overall low returns of Pillar II savings.

Graph SK10 Pillar II Pension funds´ Portfolio Structure



Source: Own calculations based on Manazeruspor data, 2019 (data as of 31 December 2018)

The portion of equities in Pillar II Pension funds´ portfolios is rising constantly, however the overall portfolio structure does not correspond the age profile of existing savers. On the other hand, younger savers who joined the Pillar II voluntarily after 2012 invest more aggresivelly in line with conventional knowledge.

Nominal as well as real returns of Pillar II pension funds in Slovakia weighted by AuM are presented in a summary table below.

Table SK11 Nominal and Real Returns of Pillar II Pension Funds in Slovakia						
2005	Nominal return after charges, before inflation and taxes	3.42%	1.49%	Real return after charges and inflation and before taxes	0.62%	-0.41%
2006		4.54%			0.24%	
2007		3.67%			1.77%	
2008		-6.65%			-10.55%	
2009		0.84%			-0.06%	
2010		1.26%			0.56%	
2011		1.48%			-2.62%	
2012		3.03%			-0.67%	
2013		1.34%			-0.16%	
2014		4.03%			4.13%	
2015		1.04%			1.34%	
2016		2.82%			3.32%	
2017		2.17%			0.77%	
2018		-1.65%			-3.52%	

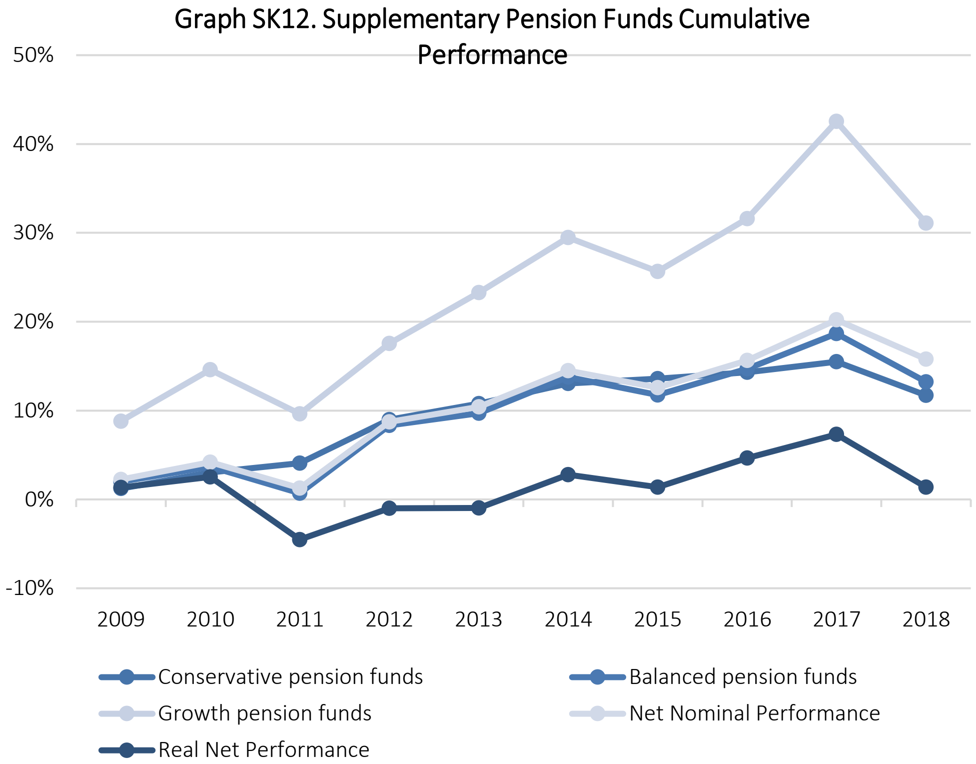
Source: Authors´ calculations, 2019 (data as of 31 December 2018)

Negative real returns between years 2008 and 2013 were caused by inappropriate legislative changes that came into effect in July 2009 after stock market turmoil. These changes forced portfolio managers to sell off all equities and hold cash in portfolios. Year 2018 brouhght overall decline on equity markets, which has negativelly influenced the performance of mixed, equity and index pension funds.

Pillar III – Supplementary pensions

Supplementary pension funds differ in strategy and portfolio structure. Conservative pension funds do not invest in equity investments. Balanced pension funds invest a small portion in equity investments (currently less than 20% of AuM in average) and growth pension funds invest a higher portion in equity investments (currently more than 40% of AuM in average).

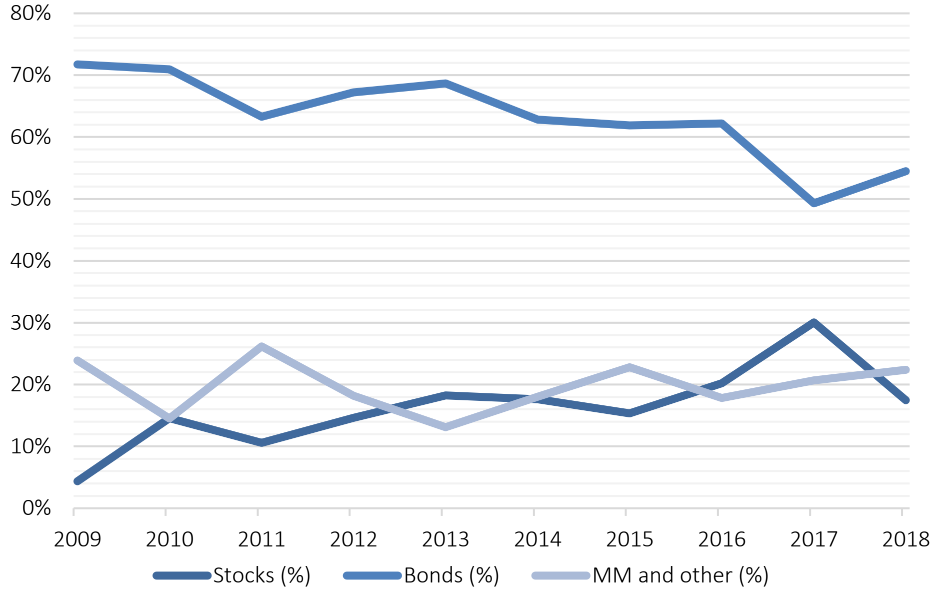
Supplementary pension funds' performance on a cumulative basis accompanied by the calculated net nominal as well as real cumulative performance is presented in the graphs below.



Source: Authors´ calculations, 2019 (data as of 31 December 2018).

Balanced and Conservative supplementary pension funds have achieved very similar returns over the analysed period. This could be explained by similar portfolio structure. The portfolio structure of Pillar III is presented in the graph below.

Graph SK13. Supplementary Pension Funds´ Portfolio Structure



Source: Own calculations based on www.manazeruspor.sk data, 2019 (data as of 31 December 2018)

Currently, more than 50% of all investments in Pillar III pension funds are bond investments. In 2018 we could have seen rather rapid portfolio changes in favour of bonds and sharp decrease of equity investments. However, this active intervention of fund managers came too late and did not help to protect positive returns of funds.

Looking at the performance from a saver´s point of view, where various holding periods are considered, we present the net of fees nominal as well as real returns.

Table SK14. Supplementary Pension funds Nominal and Real Performance according the holding period

Holding Period	Net Nominal Annualized Performance	Real Net Annualized Performance
1 year	-3.67%	-5.54%
3 years	0.94%	0.00%
5 years	0.95%	0.46%
7 years	1.93%	0.86%
10 years	1.48%	0.14%
Since inception	1.48%	0.14%

Source: Own calculations, 2019 (data as of 31 December 2018)

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

Table SK15. Nominal and Real Returns of Supplementary Pension Funds in Slovakia						
2009	Nominal return after charges, before inflation and taxes	2.25%	1.48%	Real return after charges and inflation and before taxes	1.35%	0.14%
2010		1.88%			1.18%	
2011		-2.78%			-6.88%	
2012		7.37%			3.67%	
2013		1.56%			0.06%	
2014		3.69%			3.79%	
2015		-1.68%			-1.38%	
2016		2.72%			3.22%	
2017		3.95%			2.55%	
2018		-3.67%			-5.54%	

Source: Authors´ calculations, 2019 (data as of 31 December 2018)

Supplementary pension funds have achieved negative returns in 2018 mainly due to the higher portion of equities in their portfolios. However, relatively high fees played their role and contributed negatively to the overall low performance.

Conclusions

The Slovak multi-pillar pension system is not quite favorable for savers. Pillar II suffers from constant changes and significant political risk therefore not only arises from diverging political opinions on the pension system. The new phenomena in Slovak pension system is the pension populism, where political parties tries into revert stabilization features and weaken the pension savings schemes in favour of PAYG scheme.

Even though there have been negative interventions in Pillar II from 2008 to 2012 (significant investment restrictions, a decrease in contributions from 9% to 4%), several positive features have been introduced in Pillar II. However, unprofessional move of transferring savers´ assets from equity-based pension funds into bond ones have had detrimental effect on savings, which could lead to low pension pots and further political pressures on decreasing importance of private pension savings in Slovakia.

Pillar III pension vehicles are generally poorly performing, costly and without significant tax benefits for employees´ contributions; Pillar III would never survive competition from Pillar II pension funds and typical investment funds. The debate on finding an appropriate regime for the Pillar III scheme is still ongoing, while there are several different views on how to make Pillar III more favorable for savers. Major governmental spending review in this area is expected to provide a clearer way forward.

Policy Recommendations

Slovak Pillar II suffers from the misalignment between the remaining saving horizon of savers (age profile) and applied investment strategy or allocation of savings. Most of the savers allocate their savings into the bond funds even if their remaining saving horizon is far longer than 15 years. Pension asset managers and regulators should therefore acknowledge inertia of savers and imply default investment strategy that would at least recognize the remaining saving horizon of savers and thus allocate the savings accordingly.

Pillar III faces two main limitations that are in fact deeply interconnected. The first problem is the small coverage of economically active population, which disqualifies the pillar from being recognized as universal pension pillar. This problem is however connected to the high fees that effectively refrain larger participation of employers and employees in this pillar. Regulators should scrutinize the possibilities to lower the management fees with rising assets under management, which would show the clear and transparent road map towards the development of supplementary pension schemes in Slovakia.

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