Long-Term and Pension Savings

The Real Return

2020 Edition

BETTER FINANCE

The European Federation of Investors and Financial Services Users

Fédération Européenne des Épargnants et Usagers des Services Financiers

Pension Savings: The Real Return

2020 Edition

A Research Report by BETTER FINANCE

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Acronyms

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

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

Pension Savings: The Real Return

2020 Edition

Country Case: Estonia

Kokkuvõte

Eesti pensionisüsteem on tüüpiline Maailmapanga mitmesambaline süsteem, mis põhineb personaalsetel pensionikontodel. Aastal 2019 oli mõlema samba tulem positiivne. Teise samba keskmine tootlus oli 9,67% ja kolmanda samba keskmine tootlus oli 19,70%. Peale inflatsioon arvesse võtmist, oli reaal-tootlus teise samba puhul 7,88% ja kolmanda samba puhul 17,90%. Tänu neile tootlusnumbritele tulid mõlemad sambad välja 2018 aasta kahjumitest ja pika-ajalised keskmised reaal-tootlused on jälle mõlema samba puhul positiivsed.

Alates 2017 aastast on Eesti turule lisandunud mitmeid madalate kuludega passiivse valitsemisega pensionfonde (nn. indeks fonde), mis on kiirelt võitnud kliente ja suurendanud turuosa. Madalate kuludega konkurentide lisandumine turule on sundinud fondivalitsejaid 2018 ja 2019 kulusid alandama ja aidanud tuua alla nii teise kui kolmanda samba fondide kulusid.

Aastal 2019 leidsid aset ka muudatused pensionfondide seaduslikule raamistikule, mis olid eriti laiaulatuslikud teise samba puhul. Täiendav teises samba pensionfondide reform oli selle rapordi kirjutamise hetkel ootel, kuniks Riigikohus otsustab selle põhiseaduspärasuse üle.

Summary

The Estonian Pension system is a typical World Bank multi-pillar (three pillar) system based on individual (personal) pension savings accounts. 2019 saw positivereturns across all pension pillars, with Pillar III recording average returns of 19.70% and Pillar II funds averaging returns of 9.67%. After adjusting for inflation, the real returns were: 7.88% for Pillar II funds and 17.90% for Pillar III funds. This more than offset the losses for both pillars in 2018 and pulled the long term (since 2003) real returns of Pillar II funds back to positive territory, after they had briefly dipped to negative, when adjusted with inflation.

Low-cost passively managed pension funds introduced in 2017 recorded increased assets under management as well as a higher number of savers despite negative reurns. In 2018 and 2019 the low-cost competitors have forced providers to further decrease the fees charged in Pillar II as well as Pillar III pension funds.

2019 also saw the implementation of legal changes significantly restructuring the legal framework surrounding pension funds, especially mandatory ones. Some further fundemental legal changes are currently pending before the supreme court.

Introduction

The Estonian old-age pension system is also based on the World Bank 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 a mandatory funded defined contribution (DC) based scheme;
- Pillar III – Supplementary pension organized as a voluntary individual pension scheme.

The Estonian multi-pillar pension reform began in 1998 with the introduction of the third (voluntary) pension pillar in legislation. The second or "mandatory" pension pillar, which funds individual private retirement accounts with worker and government matching contributions, was adopted in 2001 and became operational on 1 July 2002.

Table EE1. Multi-pillar pension system in Estonia		
Pillar I State Pension	**Pillar II** Funded pension	**Pillar III** Supplementary pension
Mandatory	Mandatory	Voluntary
PAYG	Funded	Funded
Financed by social tax	DC	DC
Benefits paid via State Pension Insurance Fund	Basic benefit	Complementary benefit
Minimum pension + employment related	Individual pension accounts	Individual pension contracts
Publicly managed by Social Insurance Board (government entity)	Privately managed pension funds	Two vehicles: 1. Privately managed pension funds 2. Pension insurance

Source: BETTER FINANCE own elaboration, 2020

The basic pension system generated an average replacement ratio in 2019 of 53.10% (gross, Men, 2018 data according to OECD), calculated by dividing the average old-age pension with the average salary in Estonia. The coverage ratio of Pillar I pensions comprises nearly 100% of the economically active population.

Table EE2. Summary returns table - Estonia				
	Pillar II		Pillar III	
	Nominal	Real	Nominal	Real
1-year (2019)	9.67%	7.88%	19.70%	17.90%
3-years (2017-2019)	3.53%	0.54%	5.87%	2.83%
7-year (2013-2019)	3.54%	1.64%	5.47%	3.55%
10-years (2010-2019)	3.88%	1.23%	5.48%	2.81%
Since inception (2003-2019)	3.91%	0.43%	5.22%	1.58%

Source: BETTER FINANCE own composition beased on Pnesionikeskus.ee data, 2020

Pillar I – State Pension

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

Legislatively, the state pension is governed by the State Pension Insurance Act. The act is part of the pension system reform which came into force on 1 January 2002. Since then, the act has been amended more than 30 times. Employers pay 33% of the salary of each employee as social tax, 13% of which is for health insurance and 20% (16% in case of participation in Pillar II) is for the pensions of today's pensioners.

There are two kinds of state pension: the pensions that depend on work contributions (the old-age pension, the pension for work-incapacity and the survivor's pension) and the national pension.[125] Estonians are entitled to the state old-age pension if they have been employed for at least 15 years in Estonia. If the period of employment is shorter, they are not entitled to the old-age state pension and might fall under the national pension system.

The **national pension** (also called National Pension Rate – NPR) provides a minimum pension for those who are not entitled to a pension that depends on work contributions, provided that they have lived in Estonia for at least five years before applying for a pension. The amount of the national pension as of 1 April 2020 (Pensionikeskus, 2020) is €221,63 (up from €205.21 on 1 April 2019). Generally, no additional benefits are provided via the state pension scheme.

The old-age pension, available for those who contributed for 15 years or longer, takes into account the solidarity part (national pension) plus the work and salary related part. The old-age pension financed through Pillar I is calculated as a sum of two components:

1. Basic amount (equaling to €215.52 – NPR);
2. Salary based amount calculated as a multiplication of two factors:
    - Pensionable service period;
    - Insurance contributions.

The basic amount, acting as a first component of the state pension, is aimed at achieving basic solidarity and a minimum pension. The solidarity state pension insurance is represented by the basic amount (base component) of a pension which is equal to all, irrespective of the person's salary.

The factor "pensionable service" period represents the part of state pension which depends on the length of employment (i.e. years of employment and years deemed equal to employment, e.g. raising of children, compulsory military service, full-time studies etc.) of the pensioner, which entitles him or her to the pension. Period of pensionable service is taken into account up until 31 December 1998. The monetary value of one year of employment in a monthly pension is €6,627 since 1 April 2019 and €7,104 since 1 April 2020 (Social Insurance Board of Estonia, 2020)[126]. This part of the state pension is deemed

[125] The difference is that both parts are financed by one social security contribution. However, the national pension is a minimum pension and this part depends on the number of working years (regardless the level of salary) and thus incorporates the solidarity principle. The second part depends on the level of salary and thus takes into account how much an individual has paid in contributions during his or her career compared to the average salary in the country.

[126] https://www.sotsiaalkindlustusamet.ee/en/pension-benefits/pension-calculation

to diminish in future years (temporary component) as the third component (insurance contributions) will account for a larger portion of the total state pension amount.

The factor "insurance contributions" depends on how much social tax has been paid on the salary of the pensioner since 1 January 1999. The amount of the insurance component is calculated on the basis of the sum of annual factors of pension insurance. An annual factor shows the ratio of the social tax paid on the person's salary during the calendar year to the social tax paid on the average salary of the state. If social tax is paid on the average salary, the annual factor is 1.0 and its monetary value in a monthly pension is €7,104 (since 1 April 2020), the same as the pensionable service period component.

The relative importance of the insurance component increases with every year, which means that the state old-age pension depends more and more on the amount of social tax paid for each specific person or the amount of his or her salary during his or her entire employment life. Thus, Pillar I limits solidarity among individuals.

Change in the formula from 2021.

As part of the overall reform of the pensions system reform, the insurance component is set to be replaced by a new "combined component" from the 1st of January 2021. The combined component will be calculate based on the previously described insurance component (which will make up 50% of the new combined component) and 50% will be based on a "solidarity component". The solidarity component is calculated based on an annual factor that is linked to the minimum wage. If a person earns at least the annual minimum salary in one year, this factor is 1.0. If they earn less than the annual minimum salary, the factor is reduced proportionally. After adding together, the two factors, they are divided by two to get the final value. This change is intended to increase solidarity in the system.

The solidarity part of the state pension insurance involves the redistribution mechanism of income from the persons with high salaries to the persons with low salaries. However, the base component of a pension is equal for all, irrespective of the person's salary, while the law also procures the minimum amount of the old-age pension irrespective of the paid social tax.

The **statutory retirement age** in 2020 is 63 years and 9 months for both men and women. On 7 April 2010, the Estonian Parliament adopted the Act to amend the State Pension Insurance Act[127] and related acts, establishing that the general pensionable age of 65 years is to be reached in 2026. The transition period (starting from 2017) applies for people who were born from 1954 to 1960. For the latter, the retirement age will be gradually increased by 3 months for every year of birth and will reach the age of 65 in 2026. The amendment came into effect on 1 January 2017. Further increases in the retirement age after 2026 will be by law[128] automatically tied to increases in life-expectancy. From 2027, any increses of life-expectancy at the age of 65 compared to the baseline period of 2018-2022[129] will result in an increase of retirement age. However, the increase is the statutory retirement age will be capped to a maximum of 3 months per year.**Indexation** of state pensions is performed by the Social Insurance Board with the aim to adjust the level of state pensions so they correspond to the development of the

[127] www.riigiteataja.ee/en/eli/ee/Riigikogu/act/530042020004/
[128] www.riigiteataja.ee/akt/103012019001
[129] Technically, the formula will compare the average life expectancy at 65 for the 5 year period that is 4-8 years before the year for which the pension age is being calculate with the life-expectancy at 65 for the five years between 2018-2022.

cost of living and receipt of social tax (growth of the salary fund). Once a year (1 April of each year), pensions are multiplied by an index that is dependent for 20% on the changes in the consumer price index (cost of living) and 80% on the yearly increase in received social tax (labor market conditions). The indexation introduced in 2002 was up until 2008 equally weighted (50% / 50%) on increases in consumers' price index and social tax contributions. It was changed in 2007 to today's 20% and 80%, respectively. According to the Pension Insurance Act, the Government of Estonia has to analyze the impact of the increase in pensions on financial and social sustainability and suggest any need of indexation changes to the parliament every five years.

In addition to the normal indexation, the "basic amount" component of pensions was increased by an additional 7 EUR as of 1 April 2020 as a political initiative. [130]

The average monthly old-age pension paid from Pillar I in 2019 was €475.9(€440.7 in 2018, in total the average pension has increase 30.17% in the previous 5 years)[131].

Pillar II – Funded pension

The funded pension and supplementary funded pension put a person in charge of his or her own future – the amount of his or her pension depends on how much he or she has put aside for retirement during their working life. The funded pension is legislated by the Funded Pensions Act, which came into force on 1 May 2004 and replaced the Funded Pension Act, effective 1 October 2001. The funded pension pillar (Pillar II) started its operation in July 2002.

The funded pension is based on accumulation of assets (savings) – a working person themselves saves for his or her pension, paying 2% of the gross salary to the selected pension fund. In addition to the 2% that is paid by the individual, the state adds 4% out of the current social tax that is paid by the employee and retains 29% (out of 33%). The state pension insurance component of a person who has subscribed to the funded pension is also respectively smaller (for the years when 16% is received for state pension instead of 20%).

Subscription to the funded pension is mandatory for persons presently entering the labor market, i.e. persons born in 1983 or later. The funded pension was voluntary for those born between 1942 and 1983. Subscription was possible in seven years from 1 May 2001 until 31 October 2010. By submitting a subscription application, a person assumes a binding obligation – a person who has once subscribed will never be able to give up the funded pension.

Each Pillar II participant has his/her own individual pension account that records contributions and accumulated savings. A pension account is a special type of securities account in which there are only units of mandatory pension funds and data related to these units, as well as data about the unitholder.

In response to the impact of the 2008-2009 financial crisis on the Estonian economy, a temporary change of contributions' regime has been adopted and lowered the amount of new contributions flowing into the mandatory pension funds. Through amendments to the Funded Pensions Act and the Social Tax Act (entered into force on 28 May 2009), temporary changes were adopted in connection

[130] https://www.sm.ee/et/uudised/tanasest-touseb-vanaduspension-keskmiselt-45-eurot
[131] https://www.stat.ee/58108?highlight=pension

with the contributions to pension Pillar II for the years 2009 to 2017. Contributions to a funded pension were suspended in the period from 1 June 2009 to 31 December 2010. Those interested could have continued making contributions to funded pension themselves from 2010 upon request. From 2011, contributions continued in half-volume, i.e. the state contributed 2% and the savers themselves 1%. Customary contributions to Pillar II (2% - 4%) were restored in 2012 and is fully valid since 2018. There was a special mechanism for Pillar II contributions between 2014 – 2017. To those who voluntarily continued their contributions in 2010 and 2011, the state shall pay an additional 6% during 2014 – 2017 in order to promote personal saving in Pillar II. However, if a saver did not contribute himself in 2010 and 2011 and submitted an application in 2013, they are required to pay voluntary contributions of 3% of their salary between 2014–2017. If savers do, the state will contribute an additional 6% during those 4 years. The prerequisite for these additional state contributions is at least 5% nominal economic growth of the Estonian economy. If this prerequisite is not fulfilled, the state is entitled to postpone the increasing of the contribution rate. In 2018, the contribution mechamis returned to2% - 4% in all cases.

A similar temporary measure was introduced in April 2020 as a result of the COVID-19 crisis and its' effects on the state budget as well as the overall economy[132]. The state contribution of 4% is set to be suspended for the period from 1st of July 2020, until the 31st of August 2021 for all Pillar II savers born after 1960. For those who voluntarily choose to continue with the personal 2% part to their Pillar II fund, additional 4% state contributions will be made after 1st of January 2023.

However, it's not immediately clear why the government chose to take such a radical step, which amounts to taking a forced, no-interest loan from future pensioners and that will have the effect of discouraging long-term savings and investment at a time when investment conditions are favourable, due to relatively low share prices. The arguments given by the ministers in charge, that it was necessary to support the budget balance, seem unconvincing, given that prior to the Covid-19 crisis, the State of Estonia had total government debt equal to only 8.4% of GDP, one of the lowest rates in the world, and high sovereign credit ratings. The low existing debt level and high credit rating would have permitted the government of Estonia to borrow the same amounts of money from the open market at very low interest rates, instead of effectively forcing a no-interest loan from future pensioners.

Indeed, in the same period that this measure was debated and adobted, the Treasury of Estonia was able to take long term loans at close to 0% nominal interest rates[133] and repeatedly sell short term (12 month) credit notes at negative interest rates[134]. Shortly after Estonia started de-confinement, in early June 2020, the Treasury successfully sold €1.5 billion of 10-year government bonds for a yield to maturity of 0.235% per annum[135]. This offer was highly oversubscribed, with investors placing €7.7

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[132] https://www.pensionikeskus.ee/uudis/ii-samba-maksete-peatamine-1-juulist-2020-a/

[133] The Treasury took a 750 MEUR, 15-year loan from the Nordic Investment Bank (NIB) on the 30th of March, with an interest rate of 0.32% + the 6-month Euribor (the corresponding Euribor rate was -0.287% on 30 March 2020): see https://www.rahandusministeerium.ee/sites/default/files/Riigikassa/voetud_laenud_30.04.2020.pdf; https://www.rahandusministeerium.ee/et/eesmargidtegevused/riigikassa/riigi-finantsvarad-ja-kohustused/riigi-volakohustused; https://www.euribor-rates.eu/en/current-euribor-rates/3/euribor-rate-6-months/

[134] Treasury had made several issuances of short-term (6-12 month) government bonds between March to early May 2020 for a total value of 475 MEUR with fixed interest rates ranging from -0.141% to -0,296%.

[135] https://www.rahandusministeerium.ee/en/news/high-demand-international-investors-estonias-government-bond-issue

billion worth of orders, which would have amounted to two-thirds of the entire initial state budget for 2020[136].

The above underlines the short-sightedness of the government's actions and the total lack of real justification for punishing future pesnioners at a time when many of them were anyway suffering large losses to their pensions savings due to the market turmoil. This un-voluntary loan taken from pension savers will likely mean that they partially miss out from the expected post-COVID market recovery, at least to the amount of the unreceived state contributions. The damage to future pensions seems particularly needless, given that Estonia suffered comparatively little from the COVID-19 crisis, both socially and economically.

These conditions are also markedly different form conditions during the implementation of the previous measure during the global financial crisis. In 2009, Estonia was not yet a member of the Eurozone and there was widespread fear of "contaigion" from the budding European Sovereign Debt Crisis and speculation in the foreign press regarding a potential devaluation of the Estonian kroon (which never came to pass, as the Estonian kroon kept the same fixed exchange rate to the Euro from 1 January 1991 until the adoption of the Euro on 1 January 2011). This would have likely meant hign interest-rates as well as breaching the Maastricht criteria for the then planned adoption of the Euro and possibly compromising the trustworthiness of the wider economy in the eyes of foreign investors, if the then government had decided to borrow large quantities of money in the market, rather than adobt austerity measures and budget cuts, including the aforementioned temporary stop to state pension contributions in 2009-2010.

Indeed, less than two weeks before the 2009-2010 payment suspension had entered into force, the Treasury of Estonia took a relatively small, €50 million, 6-month liquidity loan from commercial banks with the interest rate of 2.75% + the 6-month Euribor rate (the 6 month Euribor was 1.442% on the date of the loan and had at that point never been below 1% in it's history). What the interest rate would have, been if the government had committed to massive debt-fueled stimulus instead of austerity, is left to the imagination of the reader

Pillar III – Supplementary pension

The supplementary funded pensions scheme, or Pillar III, is a part of the Estonian pension system and is governed by the same act that governs Pillar II, the Funded Pension Act (Chapter 3 and following).

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

The supplementary pension participation is voluntary all persons, who can decide to save either by contributing to a voluntary pension fund or by entering into a respective supplementary pension insurance contract with a life insurance company. The amount of contributions is determined solely by

[136] https://www.rahandusministeerium.ee/en/news/government-approved-draft-state-budget-2020

the free choice of an individual and can be changed during the duration of accumulation phase. There is also a possibility to discontinue contributions (as well as to finish the contract).

The supplementary funded pension contracts can be made with life insurers as pension insurance or by acquiring pension fund units from fund managers. An individual can choose between three different pension products:

1. Pension insurance with guaranteed interest;
2. Pension insurance with investment risk (unit-linked); and
3. Pension fund.

Pension Vehicles

Pillar II – Funded pension

Up until September 2019, mandatory pension funds in Estonia were by law divided into one of four cathegories: conservative, balanced, progressive and aggressive. Every cathegory had its own legal limits for how large a percentage of a fund's assets could be invested into equities. With conservative fund allowed to invest 0%, balanced funds 25%, progressive funds 50% and aggressive funds 75% of their assets in equities, with the remaining part of the assets having to be invested in bonds, money market instruments, deposits, immovables and other assets. With the exception, that conservative funds were also not allowed to invest in immovables. For other funds, investment in immovables was limited to a maximum of 40% (changed from 10% in 2007), with further maximum limits set for investment in venture capital funds (50%,, up from 30% in 2007) and a maximum limit of 30% of all asset types allowed to be invested outside the EEA or OECD area.

After September 2019 however, all legal pension fund cathegories, except for conservative funds, were abolished and investment managers were given creater flexibility in setting investment strategies for their funds (as long as rules on disclosure are respected).

The new cathegory of conservative funds was similar to the previous incarnation, with the difference that 90% of assets needed to be invested in bank deposits, investment grade bonds, moneymarket instruments trading on regulated markets, other funds which invest the majority of their assets into the before mentioned cathegories as well as derivative instruments which are based on the cathegories of assets listed in this paragraph. In addition, conservative pension funds may not have an open net foreign exchange position worth more than 25% of total assets.

All other mandatory pension funds are free to set their investment strategies in their prospectus, with only the following global limits:

- Not more than 10% of assets can be provided as **driect loans**, with the additional requirement that the (legal) persons receiving the loans meet the same requirments as the issuers of bonds that the pension fund is allowed to buy ("investment grade")
- Not more than 5% of assets can be invested in **precious metals** and securities which underlying assets are precious metals or which price is dependent on precious metals
- Not more than 30% of assets can be invested in **index funds**

- Not more than 50% of assets can be invested into securities, money market instrments and funds that are **not traded on regulated markets**. Direct loans to non-listed entities also count toward this cap
- The **total open risk position of derivative instruments** may not exceed 50% of the assets of the fund, although derivative instruments designed to mitigate certain types of risks are exempt from this cap
- Not more than 40% of assets may be invested in **immovables**, either directly or through real estate investment funds or companies investing in real estate or securities directly tied to the price of immovables
- Not more than 10% of asset may be invested into a **single immovable property**, based on ascquisition price.

However, any asset manager wishing to undertake the management of mandatory pension funds, must by law manage at least one pension fund that conforms to the legal limits of a conservative pension fund, as described below.

Intrestingly, the above rules make all non-conservative pensions funds significantly more flexible in their investment choices than any other UCITS which is subject to Estonian law.
In Estonia, more than 691,000 people save under the Pillar II funds, which is almost equal to the economically active population. Only slightly over 5% of those have opted for conservative pension funds

Wealthier individuals and those with higher earnings tend toprefer conservative funds with less equity exposure. Lower income groups on the other hand tend to prefer riskier pension funds with more equity exposure and more market risk.

This is possibly due to the age-distribution of pension fund stratagies, with the large majority of investors in the most aggressive cathegory of pension funds being under 40 years of age, whereas the proportion of pension savers investing in relatively conservative pension funds (those where equity exposure is capped at under 50% of assets) goes up dramatically with people over 50 years of age. Generally, younger people at the start of their careers would be expected to earn less on average and have accumulated fewer assets on average than those in the last decades of their working lives.

Comparing the Pillar II market share development in 2019, more contribution in-flows could be seen in aggressive funds (especially of the index fund variety) and less into conservative and balanced funds.

Pillar III – Supplementary pension

According to the law, two types of pension vehicles for supplementary pension (Pillar III) are allowed:

1. Voluntary pension funds;
2. Supplementary pension insurance contracts.

For the supplementary pension insurance vehicle, two product options are available:

- Pension insurance at a guaranteed interest rate;
- Pension insurance with investment risk (unit-linked).

Considering the size of Pillar III based on the coverage of economically active population, the Estonian Pillar III amounts only about 15% of the economically active population. The investment restrictions for supplementary pension funds are broadly the same as for non-conservative, mandatory pension funds, with the exception that pension funds are able to invest **up to 70% of assets into immovables** (as opposed to 40% for mandatory funds).

In addition, certain conflicts of interest provisions are laxer for voluntary pension funds. For example, by law, fees charged from a mandatory pension fund for investments made into UCITS managed by the same fund manager that manages the pension fund, or another fund manager belonging to the same consolidation group, need to be repaid into the pension fund, then no such provision exists for voluntary pension funds. No such provision exists for voluntary pension funds, leaving them more open to conflicts of interest from the pension fund manager.

Table EE4. Supplementary Pension vehicles market share		
Supplementary pension vehicles	Assets under management / Reserves *(in €)*	Market share based on AuM / Reserves *(in %)*
Voluntary pension funds	199,531,080	47.50%
Supplementary pension insurance contract	220,533,000	52.50%
TOTAL	420,064,080	100.00%

Source: Own calculations based on pensionikeskus.ee data, 2020 (data as of 31.12.2019)

Charges

Pillar II – Funded pension

Pension funds are offered by asset management companies, which are managed under the Investment Funds Act and, as such, the funds are considered typical UCITS funds with special regulation via the Funded Pension Act.

A saver contributing into the pension fund receives the fund units, which represent the unit-holder's share in the fund's assets. Each pension fund can have only one class of units. The nominal value of a unit at the beginning of the fund operation is €0.64. The rights and obligations attached to a unit with respect to a unitholder will enter into force upon issuing a unit and will terminate upon redeeming a unit. A unit is deemed issued upon registration and is considered redeemed upon cancellation with the register. Ownership of a unit is proved by an entry in the register.

As the pension funds are considered typical UCITS funds, fees and charges typical for UCITS funds are applied to the pension funds with some legislative restrictions.

According to the paragraph 58 and 65of the Investment Funds Act, the following charges can be applied to the expense of a mandatory pension fund:

- management fee,
- exit fee (unit redemption fee),
- transactions costs,
- success fee

Considering the individual saver, additional charges are paid from the individual value of pension savings:

- unit redemption fee,
- entry fee (unit issuance fee, resp. contribution fee).

As of the 2nd of September 2019, the management fees of mandatory pension funds were legally capped at 1.2% for conservative pension funds and 2% for all other mandatory pension funds. Redemption fees were capped at 0.05% for conservative pension funds and 0.1% for all other mandatory pension funds. No subscription fee may be charged by a mandatory pension fund.

Redemption fees are types of charges that are applied on a one-off basis, when a contribution to the fund is recorded respectively when the saver sells the pension units to the issuer. The effect of these charges is limited to the transaction, so there is only a cumulative effect that can be calculated as a simple summation. Redemption fees are also tied to the ability of savers to switch among the pension funds during the saving period. A fund can be replaced only with another fund of the mandatory funded pension. The choice of the pension fund can be changed in two ways:

1. Directing contributions to a new fund – the units of the current fund will be retained and will continue earning in the former fund. After choosing a new fund, your future contributions will be transferred to it, i.e. units of different funds will appear side by side in your pension account.
2. Changing the pension fund units – the units of one pension fund will be replaced with the units of a new pension fund selected.

From 1 January 2011 onward, there is no minimum limit for units upon changing a fund (before 1 January 2011 the minimum requirement was 500 units). Since 1 August 2011, it is possible to transfer to a new pension fund all or only a part (e.g. 25%, 50% or 75%) of the assets collected in the former pension fund.

The investment funds act provides an obligatory reduction in the management fees of investment funds, in line with the growth of assets under management of the fund. Namely, after a mandatory pension fund reaches 100 million euros of assets under management, the fund manager is oblidged by law to reduce the base management fee for each additional 100 million euros of assets under management by at least 15 per cent compared to the rate of the base management fee applicable to the previous 100 million euros. Funds are no longer required to enforce this reduction, when the yearly base management fee for the mandatory pension fund in question reahes 0.4% of assets under management.

The idea of the maximum management fee caps and obligatory management fee reduction for mandatory pension funds were to ensure sufficient competition in the mandatory pension funds market at the time of it's launch, despite the initial lack of economies of scale (given the initially low number of mandatory participants, the low level of salaries in Estonia at the time as well as the small population of Estonia), while guaranteeing that the overall level of fees and charges would decrease when economies of scale are achieved.

The option of applying a success fee became possible as of the 1st of January 2019 and is unique to mandatory pension funds in Estonia. No other UCITS listed in Estonia have the right to apply a success fee.

According to paragraph 65[2] of the Investment Funds Act, the fund manager of a mandatory pension fund has the right to charge a success fee if the cumulative increase in the net asset value of a unit of the fund exceeds the cumulative increase in receipt of the pension insurance part of social tax as of 31 December of the year of registration of the pension fund (hereafter “reference index”). The success fee for a given year is limited by law to a maximum of 20% of the excess of the increase in net asset values over the reference index and to 2% of the asset value of this pension fund, whichever limit is lower.

Conservative mandatory pension funds do not have the right to apply a success fee.

The introduction of the success fee concept and other changes to the way pension fund fees need to be disclosed, brought changes to the way Estonian pension funds disclose their fees and to how regulators and statistics agencies collect data on the fees. Given the backwards-looking nature of the success fee, mandatory pension funds are required to report on their “Total Expense Ratio” (hereafter referred to as TER) for the previous year.

The TER includes:

1) the fee paid to the fund manager for the management of the fund or the fees, charges and expenses directly related to the management of a public limited fund (management fee);

2) the fee paid to the depositary for the services provided (depositary’s charge);

3) the transfer fees and service charges directly related to transactions performed for the account of the fund and other fees and charges and expenses related to the management of the fund and specified in the basic documents of the fund;

4) success fees

The funded pension register (Pensionikeskus AS), which is the main provider of statistics for pension funds in Estonia, also stopped gathering statistics for separate classes of fees or charges and has moved to collecting statistics on the TER of mandatory pension funds. While this offers a more complete overview of the costs of pension funds, it unfortunately also has the side-effect, from the point of view of this report, of limiting long-term comparability of cost levels, since TER statistics are currently only provided going back to 2017.

The below table shows the TER for all mandatory pension funds registered in Estonia between 2017-2019, divided into different different risk cathegories following the Synthetic Risk and Reward Indicator (hereafter SRRI) methodology. Low-Risk Funds are those with a SRRI of 1-2, Medium-Risk Funds have a SRRI of 3-4 and High-Risk Funds have a SRRI of 5-7. Mandatory pension funds designated as “conservative” are marked with an asterix.

Table EE5. Mandatory Pension Funds´ Fees				
	Pension fund	2017	2018	2019
High-Risk Funds	LHV Pensionifond Roheline	n/a	n/a	0.85%
	Luminor A Pluss Pension Fund	1.57%	1.50%	1.62%
	Pension Fund LHV Index	0.86%	0.69%	0.63%
	SEB Pension Fund 100	n/a	n/a	0.96%
	SEB Pension Fund Index 100	0.49%	0.43%	0.40%
	Swedbank Pension Fund K100	1.13%	0.99%	0.70%
	Swedbank Pension Fund K1990-1999 indeks	0.89%	0.72%	0.47%
	Tuleva World Stocks Pension Fund	0.47%	0.47%	0.45%
	LHV Pensionifond Eesti	1.34%	1.61%	1.26%
Medium-Risk Funds	Luminor A Pension Fund	1.48%	1.40%	1.58%
	Luminor B Pension Fund	1.38%	1.33%	1.55%
	Luminor C Pension Fund*	0.78%	0.75%	0.97%
	Pension Fund LHV L	1.34%	1.58%	1.01%
	Pension Fund LHV M	1.08%	1.20%	0.84%
	Pension Fund LHV XL	1.35%	1.62%	0.98%
	SEB Energetic Pension Fund	1.41%	1.30%	0.92%
	SEB Optimal Pension Fund	1.11%	1.07%	0.94%
	SEB Progressive Pension Fund	1.33%	1.27%	0.94%
	Swedbank Pension Fund K30	1.04%	0.92%	0.65%
	Swedbank Pension Fund K60	1.10%	0.97%	0.67%
	Tuleva World Bonds Pension Fund*	0.50%	0.50%	0.47%
Low-Risk Funds	Pension Fund LHV S	0.82%	0.70%	0.69%
	Pension Fund LHV XS*	0.65%	0.60%	0.61%
	Swedbank Pension Fund K10*	0.39%	0.35%	0.37%
	SEB Conservative Pension Fund*	0.57%	0.57%	0.49%
	Average (not weighted)	**1.00%**	**0.98%**	**0.84%**

**Conservative pension funds*
Source: Pensionikeskus.ee, 2020 (data as of 31.12.2019)

As can be seen from the table, the average fees have been declining in the last three years. This is consistent with the historical downward trend in management fees that was noted in the BETTER FINANCE "Pensions Savings: The Real Return 2019 Edition" and is consistent with the objectives of the 2019 reform to mandatory pension funds rules.

Pillar III – Supplementary pension

The supplementary pension is organized in two ways: as an insurance contract or as a supplementary pension fund. The way in which charges are disclosed to the client is significantly different for both.

For insurance contracts, no charges are publicly disclosed. The terms and conditions of an insurance contract cover the topic of charges, however, no charges are disclosed. Even if the charges are disclosed, the structure of fees is not transparent enough to allow the calculation of the total cost ratio. In most cases, the insurer is entitled to change contract fees and risk payments unilaterally during the insurance contract validity, with the obligation to inform the policyholder of the changes at least 30 days before such changes become effective. If the policyholder does not agree with the changes, he is entitled to terminate the contract.

The situation is different for a supplementary pension fund. All funds disclose most actual charges, which are presented in the table below.

Table EE6. Supplementary Pension Funds´ Fees			
Fund	2017	2018	2019
LHV Pension Fund Index Plus	0.99%	0.85%	0.75%
LHV Supplementary Pension Fund	1.11%	1.08%	1.36%
Luminor Aktsiad 100 Pension Fund	1.64%	1.66%	2.12%
Luminor Intress Pluss Pension Fund	1.41%	1.53%	1.84%
SEB Active Pension Fund	1.97%	1.83%	1.78%
SEB Balanced Pension Fund	1.40%	1.31%	1.27%
Swedbank Pension Fund V30	1.55%	1.48%	1.21%
Swedbank Pension Fund V60	1.64%	1.60%	1.31%
Swedbank Pension Fund V100	1.77%	1.75%	1.43%
Swedbank V100 Index Pension Fund (exit restricted)	-	-	0.90%
Tuleva III Pillar Pension Fund	-	-	0.49%
AVERAGE	**1.50%**	**1.45%**	**1.31%**

Source: Pensionikeskus.ee data, 2020 (data as of 31.12.2019)

Comparing to the previous years, the relative stagnation of charges can be observed for traditional funds, with charges actually increasing in many cases. However, the introduction of low-cost index funds helped to lower fees on average.

Taxation

Both funded pillars use the "EET" regime for taxation, which basically means that the contributions paid towards the pension schemes are tax-exempt. Returns achieved by respective pension funds are also tax-exempt and the benefits paid out during the retirement are subject to the income tax taxation.

Pillar II – Funded pension

Estonia is applying an EET taxation regime for Pillar II with some specifications (deductions) to the payout taxation regime, where generally the "T" regime is applied.

Taxation of the Fund

Income or profits of the Fund are not subject to taxes at the fund level.

Taxation of unitholders

Contributions to the Fund usually consist of two parts:

1. 2% withheld from the wages and other remuneration of a resident natural person participating in the mandatory funded pension system; in certain cases from the remuneration paid to a member of the management or supervisory body of a legal person; from the business income of sole proprietors after deductions relating to business and permitted in the Income Tax Act have been made, but annually from an amount not more than 15 times the sum of the minimum monthly wages for the taxable period; in certain cases from the remuneration or fees

paid to a natural person on the basis of a contract for services, authorization agreement or another contract under the law of obligations entered into for the provision of services, and

2. the amount added by the state, which equals 4% of the sum of the resident natural person's wages and other remuneration.

The abovementioned 2% withheld from wages and other remuneration is tax deductible, i.e. not subject to income tax. Specifications apply to the procedure of contributions in the years 2014 to 2017.

Exchange of a fund's unit for another unit of a mandatory pension fund and redemption of a unit to enter into an insurance contract for funded pension (pension contract) is not taxed. Insurance contract for funded pension (pension contract) and pension fund units are not treated as financial assets for the purposes of income taxation and taxation of income on these cannot be postponed.

During the payout phase, income tax is charged on payments made from the mandatory pension fund to the unit holder, the successor of the unit-holder as well as on payments made to the policyholder, an insured person or a beneficiary pursuant to a pension contract provided for in the Funded Pensions Act. Thus, if a unitholder reaches retirement age, mandatory funded pension payments will be taxed together with the state (NDC PAYG pillar) pension. Estonian income tax rate since 2015 is 20%.

The taxation period for natural persons is a calendar year. In Estonia, the annual basic exemption (non-taxable amount) per year depends on the person's income, ranging from 6000 EUR for those earning up to 14 400 EUR per annum and 0 EUR for those earning above 25 200 EUR per annum. The same rate applies also to pension payments.

Taxation of successors

Payments to a successor upon redemption of units are taxed with the income tax rate established by law. Transfer of units into a successor's pension account is not taxable.

Pillar III – Supplementary pension

The effective Income Tax Act stipulates EET regime (similar to Pillar II) where:

I. Resident natural persons have the right to subtract the amounts paid to acquire supplementary fund units from their taxable income. The amount that is deducted may be up to 15% of the income earned in the taxation period, but no more than € 6,000.

II. Income or profits of the Fund are not subject to taxes at the fund level.

III. Payouts from a supplementary pension fund are subject to income tax as follows:

   a) 10% income tax if they are made under any of the following circumstances:

      (i) after the unit holder reaches the age of 55, but not before five years have passed from acquisition of the units;

      (ii) in the event of the unit holder's full and permanent incapacity for work;

      (iii) when the fund is liquidated.

   b) In all other cases, payouts from the fund are subject to income tax valid at the time the payout is made.

IV. Payouts made by an insurance company to the policyholder from the assets saved in the fund as lifelong pension payments after the policyholder turns 55 years of age are exempt from income tax.

Pension Returns

Pillar II – Funded pension

2019 can be described as a bullish year "going back to black" as both nominal and real returns were strongly positive, as opposed to the significantly negative returns in 2018. The Scandinavian Banks – Swedbank, SEB and Luminor – held close to 69% of the market between them, with Swedbank being the uncontestable market leader, holding a 41% marketshare. The biggest local bank, LHV, has the second largest pillar II market-share, with 28%. The only pension fund manager in Estonia that is not owned by a bank is the relatively new mutual fund Tuleva, which enterd the market in 2017, branding itself as a "social startup" and advocating for passively managed, low-fee funds. Although by the end of 2019 it held only 2.8% of the second pillar market, its entry pushed all the other pension fund managers to offer passively managed funds as part of their range. This in turn has had a significant contribution to lowering of pension fund fees in the Estonian market.

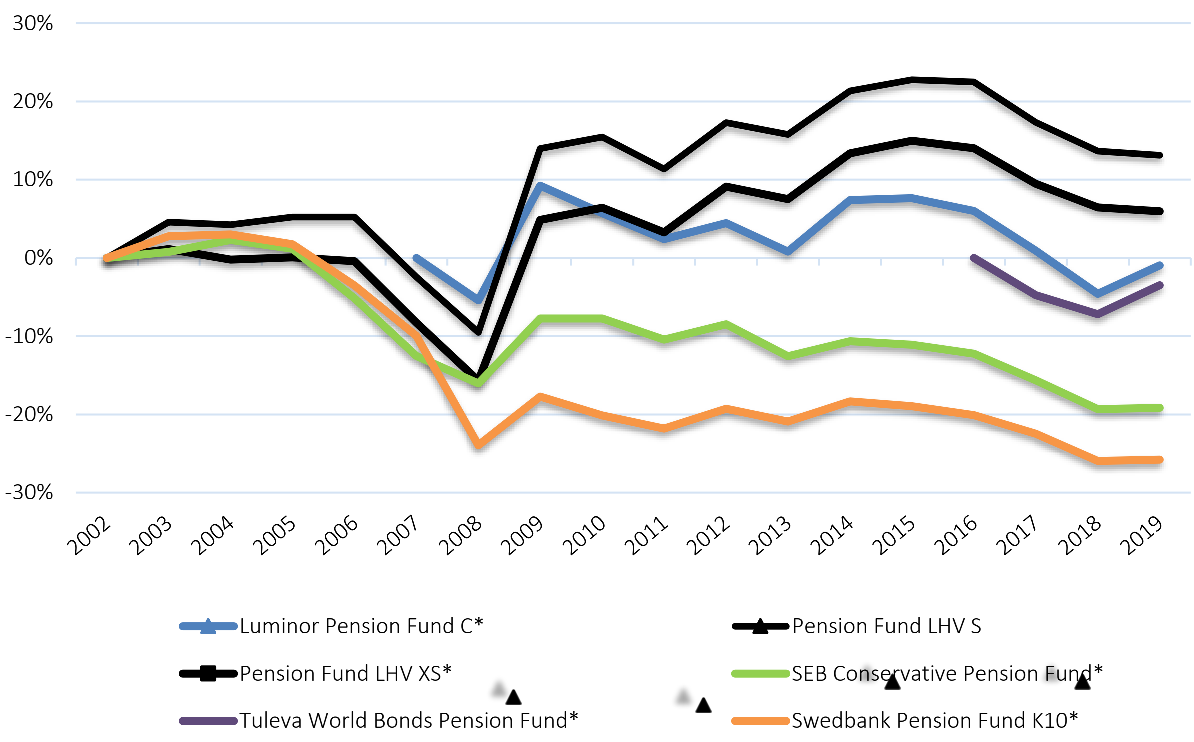
Five asset managers offered 24 pension plans in Estonia in 2019, with the number set to stay the same in 2020, but with the change that LHV announced the winding down of their domestic-focussed fund "LHV Estonia", which will be merged into the bigger "LHV L" while also launcing "LHV Green", the first pension fund in the Estonian market to have a stated sustainability focus. The pension plans (funds) can be divided into four groups in accordance with the investment strategy they use:

1. conservative (not investing in stocks);
2. balanced or small equity funds;
3. active or medium equity funds;
4. aggressive active and passive (investing in stocks mainly).

It should be noted that volatility and performance is closely tied to the structure of the portfolio and the degree of deviation from the benchmark. Active asset management, while being riskier, emphasises "stock picking skills" to optimise returns and deliver overperformance to the market by the maturity (recommended holding period) of the product. To which extent this is happening in Estonian mandatory pension funds can be seen in the below graphs presenting the cumulative, inflation adjusted returns. Time series are shown for funds for which at least two full years of returns data is available.

Conservative and low-risk (based on SRRI) Pension Funds´ cumulative inflation-adjusted returns are presented in the graph below. As can be seen, only a minority of conservative and "low-risk" funds have managed to outperform inflation in the long term. The majority have decresed in real value. Funds that currently qualify for the legal designation of "conservative" are marked with an asterix.

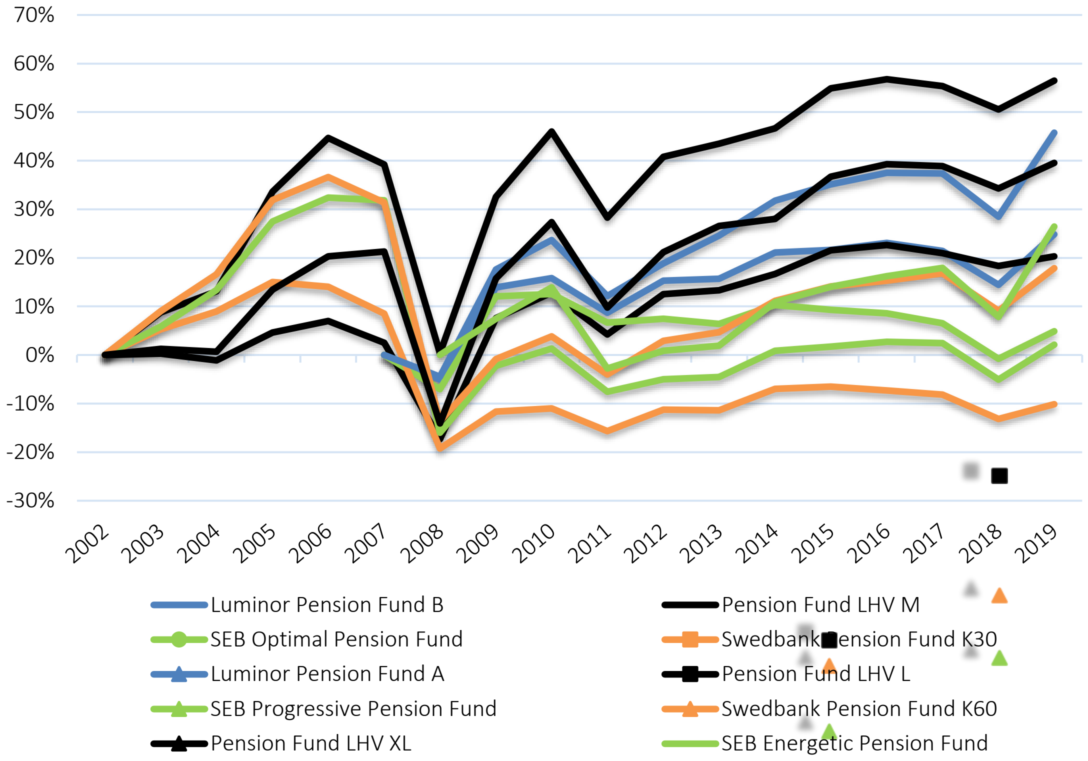
Graph EE7. Conservative and Low-Risk Pension Funds´ cumulative inflation-adjusted returns



Source: *Own composition based on Pensionikeskus and Statistikaamet data*

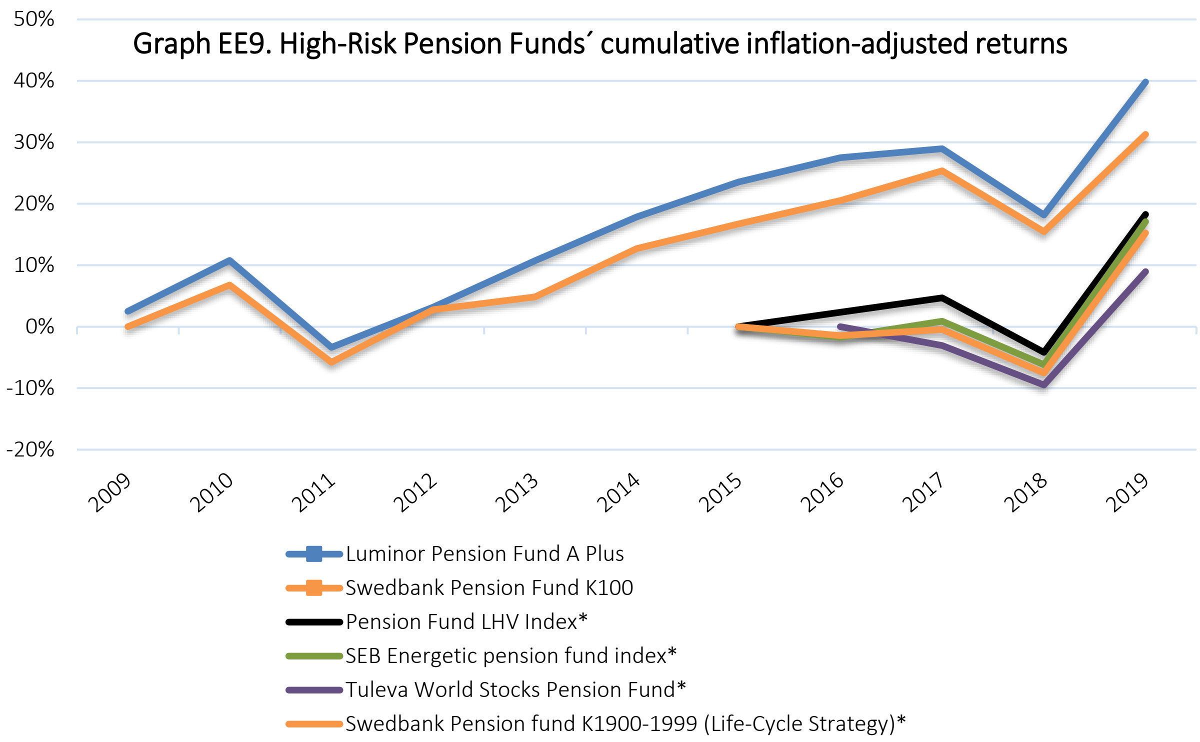
Medium-risk (based on SRRI) Pension Funds´ cumulative inflation-adjusted returns are presented in the graph below. Contrary to the conservative and low-risk funds, only one medium-risk fund has significantly lost real value and even that one has outperformed the worst "conservative" funds, demonstrating why pension savers who are 15+ years away from retirement age are usually recommended to prefer "riskier" investment. In the very long run, there is a higher risk to the real value of one's savings in investing in products that carry less short-term risks.

Graph EE8. Medium-Risk Pension Funds´ cumulative inflation-adjusted returns



Source: Own composition based on Pensionikeskus and Statistikaamet data

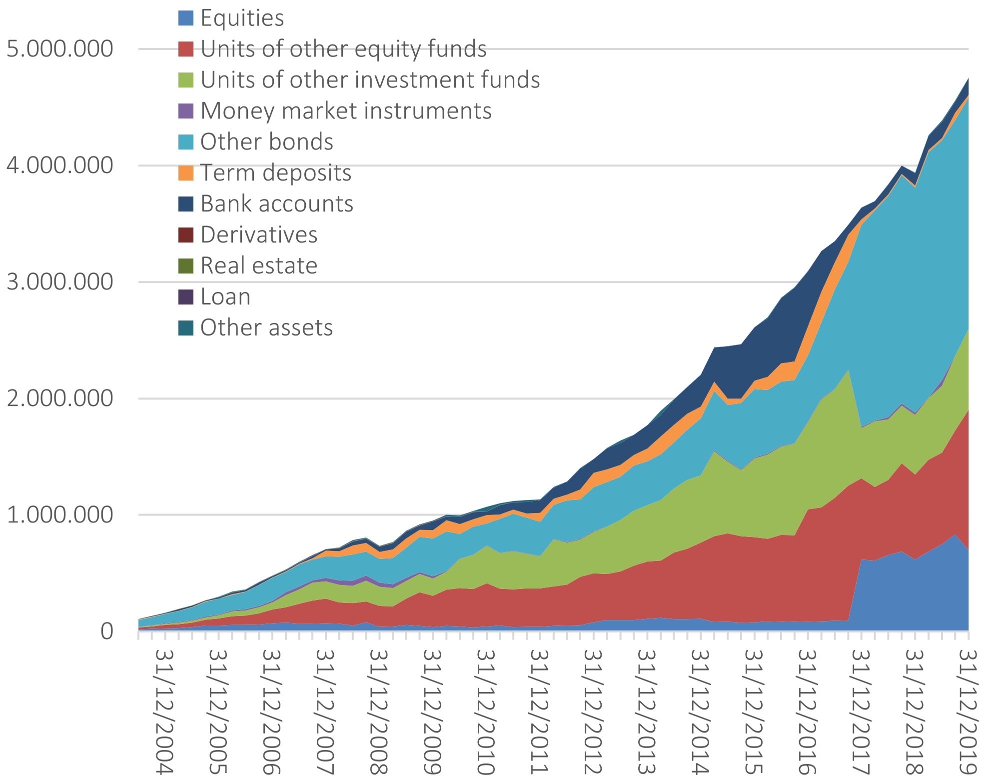
High-risk (based on SRRI) Pension Funds´ cumulative inflation-adjusted returns are presented in the graph below. All high-risk funds have significantly outperformed inflation during their existence. However, it’s difficult to draw comparisons with the data in above graphs, since all the high-risk funds were established 2009 or later, so not only is tha dataset considerably shorter, but all of hese funds also “missed” the stock-market crash that coincided with the financial crisis of 2008-2009.



Source: Own composition based on Pensionikeskus and Statistikaamet data

The below graph shows the portfolio structure of mandatory mandatory pension funds. Pension supervisor should pay closer attention to the potential risk of closet indexing, considering the large proportion of assets that were invested into other UCITS, especially in the period when all funds were officially actively managed.

Graph EE10. Portfolio structure of mandatory pension funds (in thousands €)



<u>Source:</u> Own composition based on Finantsintspektsioon data (fi.ee), 2020 (data 31.12.2019)

The trend of growing investment into other UCITS was abruptly reversed in 2017 and direct bond (as well as equity investments) rapidly rose to dominate in the portfolio structure of mandatory pension funds. These sudden changes can be at least partially associated with regulatory changes. However, since mid-2018 investments into UCITS, especially equity funds, started to gradually grow again. This can ba associated with the entry and increasing importance of passively managed index funds, since at the time of writing of this report, all index funds in Estonia invest exclusively into larger foreign index funds, rather than trying to replicate any index themselves.

Nominal as well as real returns of mandatory pension funds in Estonia using weighted average by AuM are presented in a summary table below.

Table EE11. Nominal and Real Returns of Mandatory Pension Funds in Estonia						
2003	Nominal return after charges, before inflation and taxes	6.84%	3.91%	Real return after charges and inflation and before taxes	5.65%	0.43%
2004		10.07%			5.27%	
2005		13.43%			9.77%	
2006		7.40%			2.30%	
2007		6.25%			-3.48%	
2008		-23.43%			-30.97%	
2009		12.53%			14.40%	
2010		9.42%			4.00%	
2011		-4.44%			-8.53%	
2012		9.70%			6.06%	
2013		3.28%			1.23%	
2014		5.10%			5.04%	
2015		2.49%			2.66%	
2016		3.35%			1.00%	
2017		3.76%			0.00%	
2018		-2.47%			-5.79%	
2019		9.67%			7.88%	

Source: Own calculations based on Pensionikeskus data, 2020 (data 31.12.2019)

Considering the fact, that the taxation in Estonia's mandatory (as well as supplementary) pension scheme is applied to the pay-out phase only and the income of each individual is tested, calculating the after-tax annual pension fund performance would lead to misleading results and only general assumptions of tax implications during the accumulation phase. Therefore, the after-income tax performance calculations have not been made in this study.

Additionally, we present the performance according to the selected periods of 1, 3, 5, 7 and 10 years and since inception of the II pension pillar.

Table EE12. Performance of the Pillar II pension funds in Estonia		
Holding Period	Net Nominal Annualized Performance	Real Net Annualized Performance
1-year	9.67%	7.88%
3-years	3.53%	0.54%
5-years	3.29%	1.05%
7-year	3.54%	1.64%
10-years	3.88%	1.23%
Since inception	3.91%	0.43%

Source: Own calculations based on Pensionikeskus data, 2020 (data 31.12.2019)

Pillar III – Supplementary pension

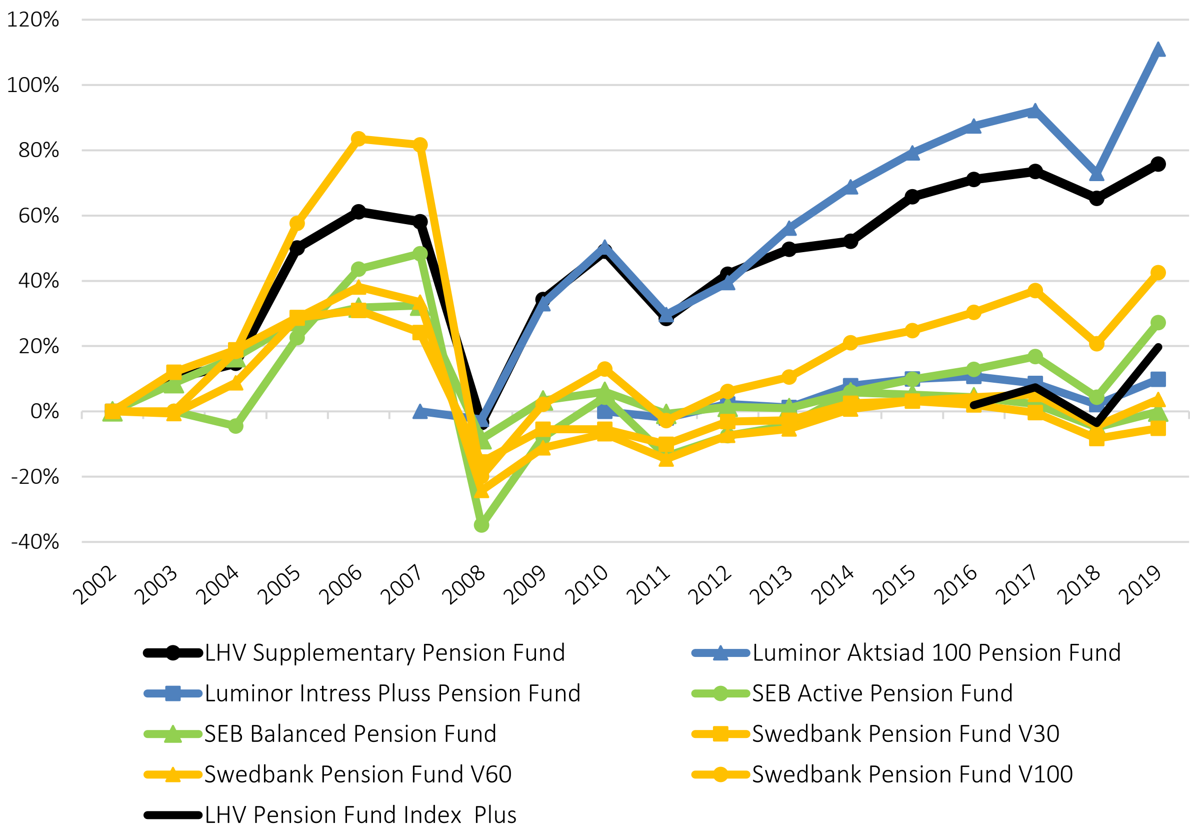
When analyzing the performance of supplementary pension vehicles, only the funds should be considered. Insurance based vehicles do not disclose this information on a periodical basis, as the market risk is shifted onto the insurer.

Supplementary pension funds do differ in their strategy, mostly based on the volatility of their portfolios. In most cases and compared to mandatory pension funds, the investment strategies of supplementary pension funds´ portfolio managers are far more aggressive. By large, the investment strategies do allow having up to 100% of assets allocated into equities and equity based structured products. Some asset management companies have reacted to this and started to also offer supplementary pension funds with conservative strategy.

LHV ceased two actively managed funds in 2017 (LHV Pension Fund 100 Plus; LHV Pension Fund Interest Plus) and has continued to offer more competitive (from the fee structure perspective) passively managed fund (LHV Pension Fund Index Plus). In 2019, two additional supplementary pension funds entered the market, Tuleva Pillar III Fund and Swedbank V100 Index (Exit Restricted) fund, both of which are passively managed low-fee funds.

The performance of supplementary pension funds on a cumulative basis is presented in the graph below.

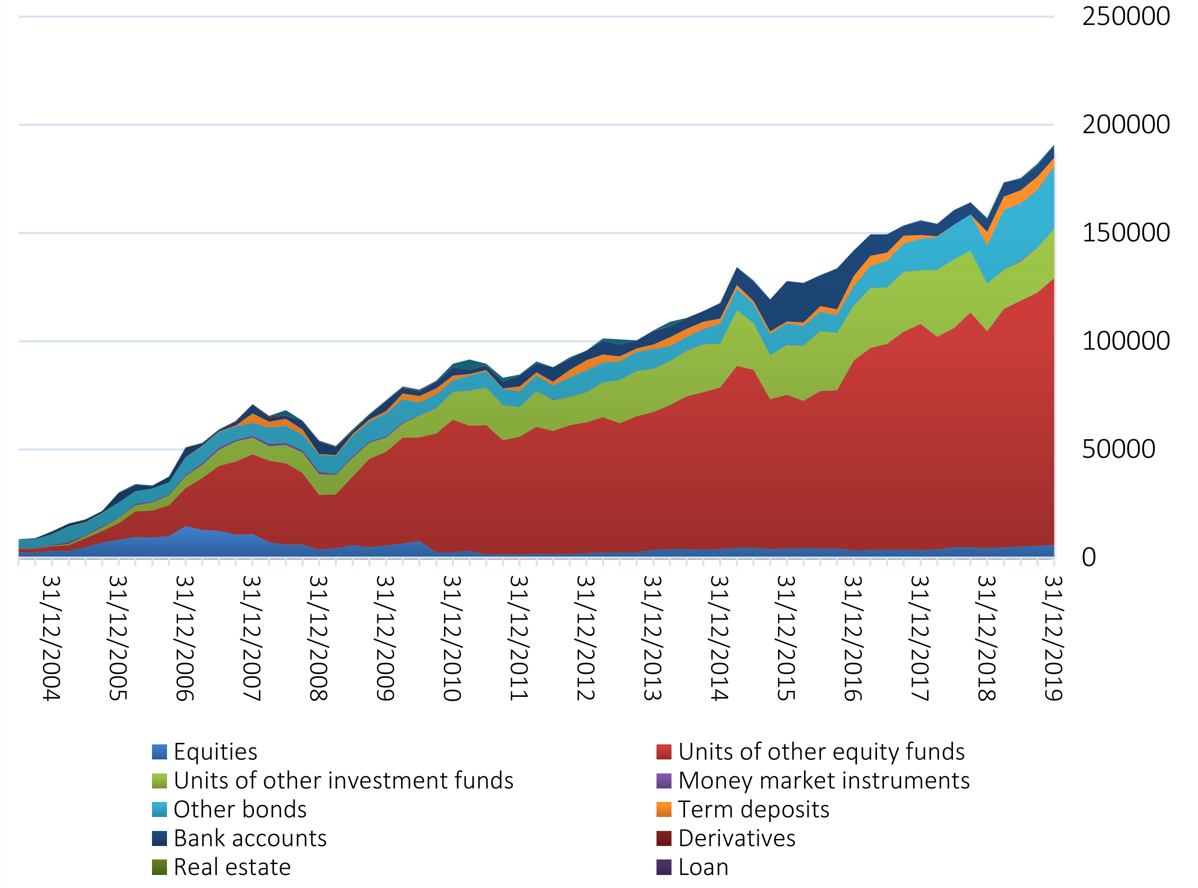
Graph EE13. Supplementary pension funds´ cumulative inflation-adjusted performance



<u>Source:</u> *Own composition based on Pensionikeskus data, 2020 (data 31.12.2019)*

The structure of supplementary pension funds´ portfolios differ significantly and a larger proportion is invested in equity and/or equity based structured financial products (mainly equity based UCITS funds).

Graph EE14.Supplementary pension funds´ portfolio structure (in thousands €)



Source: Own composition based on Finantsintspektsioon data (fi.ee), 2020 (data 31.12.2019)

Similar to the mandatory pension funds, portfolio structure of supplementary pension funds tends to change in favor of packaged products (UCITS funds, ETFs), confirming the trends of investing via financial intermediaries. Again, given that index funds appeared only in the last few years in the Estonian market and given the high fees traditionally charged by supplementary pension funds, this data points toward significant "closet indexing". The case in the supplementary pension fund market appears even worse than in the mandatory pension fund market, given that the dominance of investments into other funds is even stronger, while management fees are even higher. The ratio of direct investments (equities and bonds) to investments in other UCITS has not been higher than 1 to 4 since the end of any quarter since mid-2010, with some quarters closing with a ratio as low as 1 to 9.

Table EE15. Nominal and Real Returns of Supplementary Pension Funds in Estonia						
2003	Nominal return after charges, before inflation and taxes	9.40%	5.22%	Real return after charges and inflation and before taxes	8.21%	1.58%
2004		13.03%			8.23%	
2005		23.78%			20.12%	
2006		15.57%			10.47%	
2007		8.37%			-1.36%	
2008		-40.40%			-47.93%	
2009		21.99%			23.87%	
2010		14.21%			8.79%	
2011		-8.00%			-12.08%	
2012		11.76%			8.12%	
2013		5.41%			3.36%	
2014		7.69%			7.62%	
2015		2.93%			3.10%	
2016		4.68%			2.33%	
2017		6.05%			2.29%	
2018		-6.51%			-9.83%	
2019		19.70%			17.90%	

Source: Own calculations based on Pensionikeskus data, 2019

Another view on the performance allowing the comparison across the EU countries and over time is presenting the nominal as well as real net performance according the different periods.

Table EE16 Performance of Pillar III Pension funds in Estonia

Holding Period	Net Nominal Annualized Performance	Real Net Annualized Performance
1-year	19.70%	17.90%
3-years	5.87%	2.83%
5-years	5.04%	2.79%
7-year	5.47%	3.55%
10-years	5.48%	2.81%
Since inception	5.22%	1.58%

Source: Own calculations based on Pensionikeskus data, 2019

Conclusions

Estonia, as an early pension system reformer, has introduced a typical multi-pillar pension system that combines state unfunded schemes, as well as mandatory and voluntary fully funded pillars. Different types of pension vehicles in Pillar II (as well as Pillar III) allow savers to choose from a wide variety of investment strategies. Lower transparency in fee history contrasts with the high transparency of performance disclosed on a daily basis. The exception is Pillar III insurance contracts, where no information about performance or fees is publicly disclosed. This resulted in an inability to confront the nominal as well as real returns of insurance contracts with other options available to Estonian savers.

Performance volatility of most pension vehicles is relatively high. However, Estonian savers tend to accept higher risk with regards to their savings. Pillar III vehicles are a typical example of high volatile pension vehicles. But after the financial crisis, pension asset management companies also started to offer more conservative funds for Pillar III savers.

Concerning the pension funds´ portfolio structure, one trend is clear. Portfolio managers are steadily replacing direct investments into bonds and equities with the structured financial products. Thus, the question of potential future returns when using financial intermediaries should be raised. Most of the pension funds can be seen as passively managed, which raises the question of high fees. A new trend arising in 2016 and continuing in 2019 is the introduction of low-cost index pension funds for both pension schemes, which could bring higher value to the savers due to lower fees compared to the peers.

Even if in most cases the net performance (adjusted for fees) is disclosed by pension funds, the overall level of fees is questionable. Comparing the level of fees, there is a significant risk undermining the ability to deliver above-benchmark performance in future years.

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