Long-Term and Pension Savings

The Real Return

2020 Edition

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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

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Country Case: Slovakia

Zhrnutie

Slovenský dôchodkový systém je typickým modelom Svetovej banky založenom na viac-pilierovom (troj-pilierovom) systéme s individuálnymi (osobnými) účtami sporiteľov. V roku 2019 došlo výrazným zmenám v I. pilieri, ktoré boli motivované politickým populizmom pred voľbami. Do dôchodkového systému bol ústavným zákonom zapracovaný dvojpilierový systém a zároveň strop dôchodkového veku. V závere roka 2019 bol výrazne zvýšený minimálny dôchodok s napojením valorizácie na priemernú mzdu a na začiatku roka 2020 schválené 13. dôchodky vo výške priemerného starobného dôchodku. Všetky tieto zmeny odklonili priebežne financovaný pilier od dlhodobej udržateľnosti a znížili dôveru v stabilitu štátom garantovaného piliera.

Summary

The Slovak Pension system is a typical World Bank multi-pillar (three pillar) system based on individual (personal) pension savings accounts. The year 2019 brought significant changes in the I. pillar that were motivated by political populism before the elections. Pension system has been changed by constitutional legal act that confirmed two-pillar basic pension system but introduced constitutional ceiling on retirement age. The end of the year 2019 brought the increase in minimum pension with the valorization mechanism tied to the average wage increase. At the beginning of the 2020, the government introduced the 13. pension which value should be paid to each pension beneficiary. All changes have shifted the state pension pillar away from fiscal balance and decreased the trust in the state organized pillar.

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%		

Source: 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 13.25% (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 6 months in 2019, valid for both men and women. However, the automatic mechanism of retirement age adjustment has been abandoned in 2019 and replaced with the constitutional ceiling of retirement age at 64 years for men. For women, the retirement age is lower and depends on the number of raised children. For each raised child the retirement age is lowered by 6 months up to 3 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) = €12.6657 (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 €12.6657 = €532.

If an individual has earned on average 100% of an average salary during his entire working career and the average salary in 2019 was €1,068, then the individual replacement ratio of such an individual would be: €532 / (1 x €1,068) = 49.81%.

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.

The year 2019 brought an introduction of Pension Benefit Statement with pension benefits projections also into the II. pillar. The providers are obliged to send the pension benefit statements to all savers since January 2021.

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 five providers - Pension Asset Management Companies (PFMCs) - operating on the market. In 2019, the NN bought the Aegon. 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 SK 1. Pension Asset Management Companies market share (pillar II)

Pension Fund Management Company	Assets under management (in millions €)	Market share based on AuM
Allianz – Slovenska	2,904.06	31.14%
AXA	2,544.36	27.29%
DSS Postovej banky	493.27	5.29%
NN (ING before 2015)	1,723.15	18.48%
VUB - Generali	1,659.63	17.80%
TOTAL	**9,324.47**	**100.00%**

Source: Own calculations based on ManazerUspor.sk data, 2020 (data as of 31 December 2019)

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 SK 2. Pillar II Pension vehicles market share

Scheme	Type of voluntary pension fund	Assets under management (in millions €)	Market share based on AuM
Guaranteed PFs	Bond guaranteed pension funds (5) - *obligatory*	6,729.56	72.17%
Nonguaranteed PFs	Mixed nonguaranteed pension funds (2) - *optional*	100.97	1.08%
	Equity nonguaranteed pension funds (5) - *obligatory*	1,241.18	13.31%
	Index nonguaranteed pension funds (5) - *optional*	1,252.76	13.44%
TOTAL	**17 Pension funds**	**9,324.47**	**100.00%**

Source: Own calculations based on ManazerUspor.sk data, 2020 (data as of 31 December 2019)

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 72% 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.

Obligatory - Bond guaranteed pension funds 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.

Obligatory - Equity non-guaranteed pension funds 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 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 SK 3. Pillar III Supplementary Pension Companies market share

Supplementary Pension Company	Assets under management (in millions €)	Market share based on AuM
DDS Tatra banky	727.80	30.67%
AXA	351.66	14.82%
NN	928.17	39.11%
STABILITA	365.58	15.40%
TOTAL	**2,373.22**	**100.00%**

Source: Own calculations based on ManazerUspor.sk data, 2020 (data as of 31 December 2019)

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 SK 4. Supplementary Pension vehicles market share

Type	Supplementary pension vehicles	Assets under management *(in millions €)*	Market share based on AuM
Contributory	Conservative supplementary pension funds (4)	780.66	32.89%
	Balanced supplementary pension funds (2)	1,004.57	42.33%
	Growth supplementary pension funds (7)	503.68	21.22%
PAY-OUT	Pay-out supplementary pension funds (4)	84.31	3.55%
TOTAL	**17 Pension funds**	**2,373.22**	**100.00%**

Source: Own calculations based on ManazerUspor.sk data, 2020 (data as of 31 December 2019)

In general, the Pillar III scheme covers less than 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[245] '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 SK 5. Pillar II Pension Funds´ Fees

Fee type	Since 2005	as of 31 December 2019
Management fee (for PFMC)	max 0.8% p.a., NAV	max 0.3% p.a., NAV *(since 1 April 2012)*
Success Fee (for PFMC)	max 5.6%, HWM	max 10%, HWM (*since 1 July 2013)*
Administration of Personal pension account (for PFMC)	1% of new contribution	1% of new contribution
Administration fee (for Social Insurance Agency)	0.50% of new contribution	0.25% of new contribution *(since 1 January 2013)*

<u>Source</u>: Own research, data as of 31 December 2019

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),

[245] 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.

- 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%** NAV (2010) => max **1,98%** (2019+)	max **1,2%** NAV (2019 = 1,3% and each following year -0,1%)
2. payout SPF	max **0,996%** NAV	max **0,6%** NAV (2019 = 0,65% and each following year -0,05%)
Success 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%**

Source: Own research based on Supplementary pension saving Act, data as of 31 December 2019

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 2019 was higher than €3,021 (around 6% of working population in 2019).

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 (4.75% in 2019) 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 4.75% 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 (€1,068 in 2019), employee contributions up to 1.4% 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 €64.08 per employee per month are considered as tax expenses for contributing employers in 2019. 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 five asset managers offer 17 pension funds in Slovakia (see table below). Pension funds are divided into 2 main groups:

1. obligatory pension funds
   a) bond guaranteed pension funds (5 offered)
   b) equity nonguaranteed pension funds (5 offered)
2. optional pension funds
   c) mixed nonguaranteed pension funds (2 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	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 nonguaranteed pension funds (optional)	NN d.s.s. – MNGPF (Harmónia)	*22 March 2005*
	VUB Generali d.s.s. – MNGPF (Mix)	*22 March 2005*
Equity nonguaranteed pension funds (obligatory)	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 nonguaranteed pension funds (optional)	NN d.s.s. – INGPF (Index Global)	*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 Euro)	*2 April 2012*
	VUB Generali d.s.s. – INGPF (Index)	*2 April 2012*

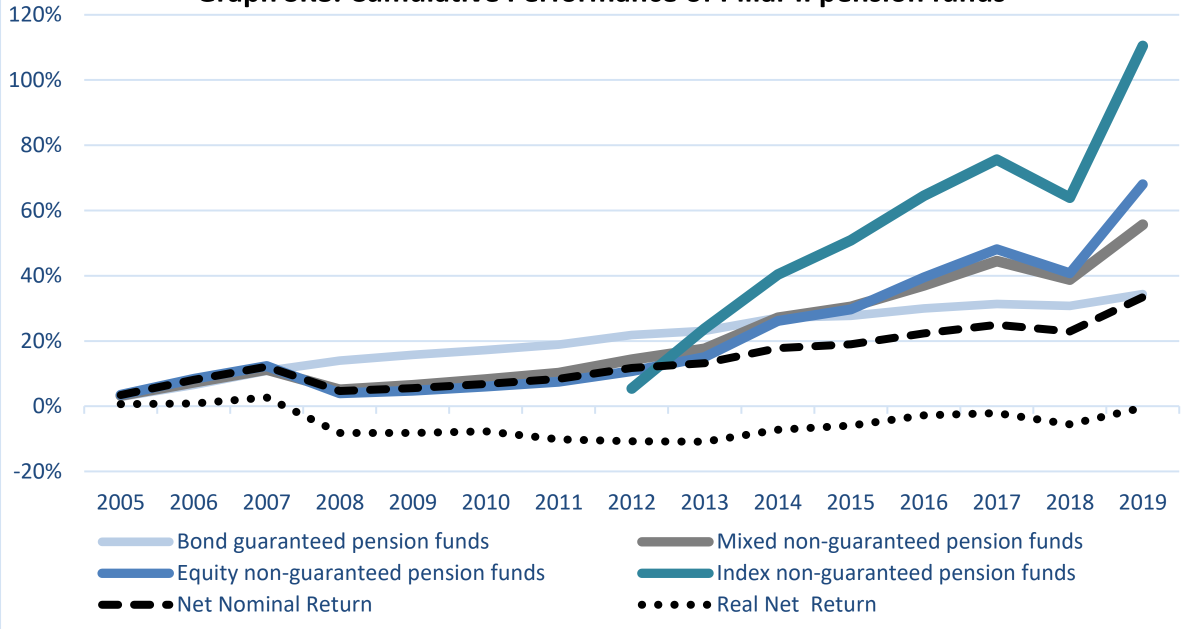
Source: Own elaboration based on www.manazeruspor.sk data, 2019

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.sk data

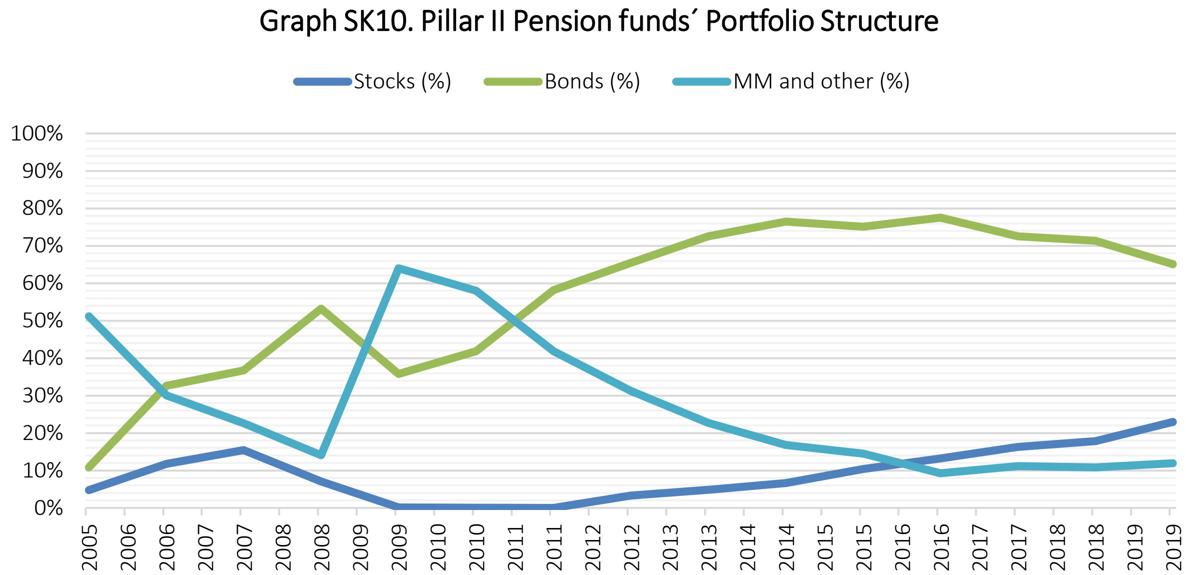
From the view of a saver, one could present the performance using various holding periods. The table below presents the AuM weighted performance of Pillar II pension funds net of fees in nominal as well as real terms.

Table SK 9. Nominal and Real Returns of Pillar II Pension Funds in Slovakia

2005		3.42%			0.62%	
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	**Nominal return after charges, before inflation and taxes**	3.03%	**1.94%**	**Real return after charges and inflation and before taxes**	-0.67%	**-0.03%**
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%	
2019		8.53%			5.36%	

Source: BETTER FINANCE calculations based on www.manazeruspor.sk data, 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 65% of all investments in Pillar II pension funds are bond investments. On the other hand, only 23% 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.



Source: Own composition based on Manazeruspor data

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. Pillar II Pension funds annualized returns

Holding Period	Net Nominal Annualized Performance	Real Net Annualized Performance
1 year	8.53%	5.36%
3 years	2.93%	0.81%
5 years	2.53%	1.41%
7 years	2.57%	1.57%
10 years	2.37%	0.81%
Since inception	1.94%	-0.03%

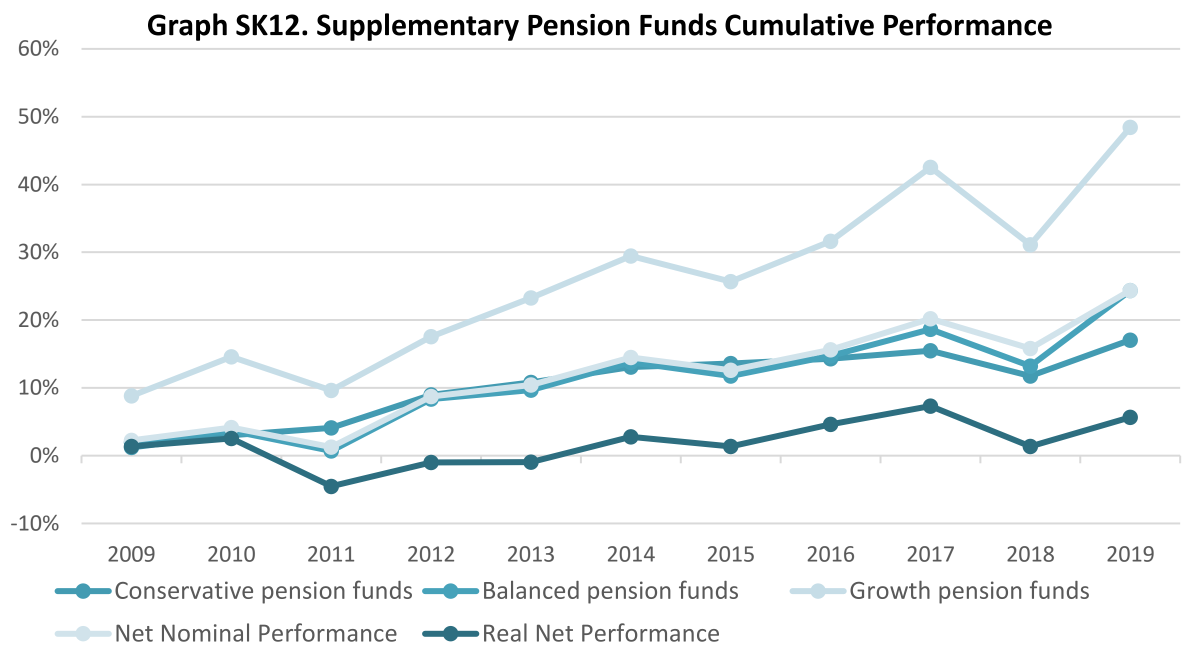
Source: BETTER FINANCE calculations based on www.manazeruspor.sk data, 2020 (as of 31 December 2019)

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 2019 brouhght solid returns on equity markets, which has positivelly influenced the performance of mixed, equity and index pension funds.

Pillar III – Supplementary pensions

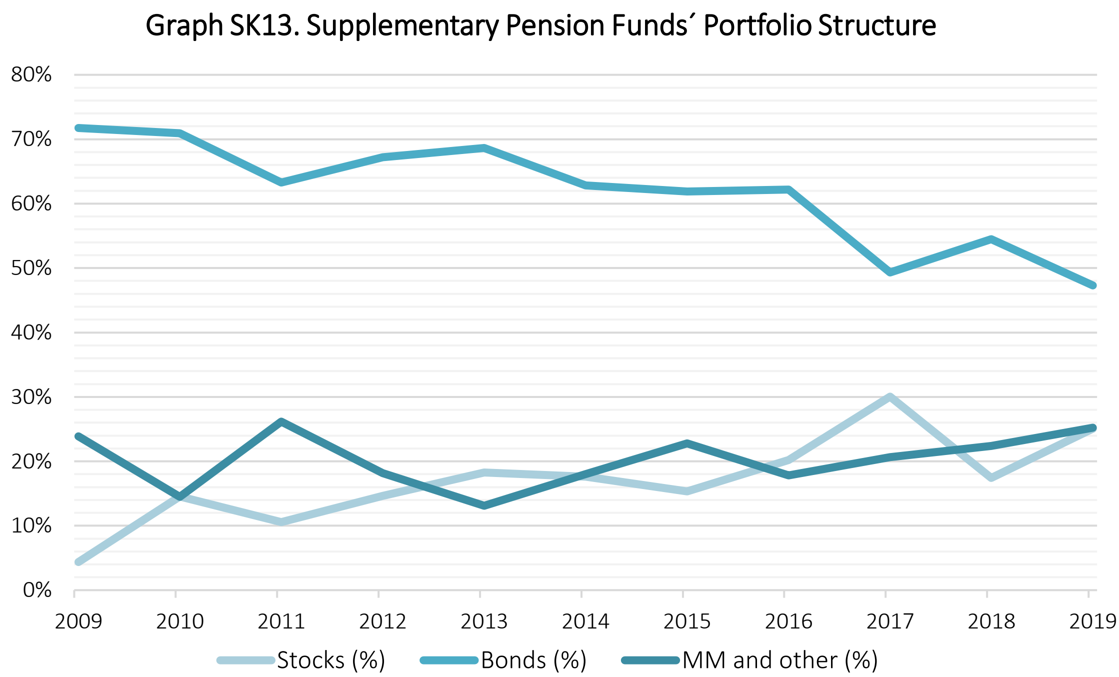
Supplementary pension funds differ in strategy and portfolio structure. Conservative pension funds do not invest in equity investments. Balanced pension funds invest a small portion in equity investments (currently less than 20% of AuM in average) and growth pension funds invest a higher portion in equity 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: Own composition based on Manazeruspor data

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.



Source: Own composition based on Manazeruspor data

Currently, more than 47% of all investments in Pillar III pension funds are bond investments. In 2019 we could have seen portfolio changes in favour of equities and rather sharp decrease of bond investments.

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. Nominal and Real Returns of Supplementary Pension Funds in Slovakia

2009		2.25%			1.35%	
2010		1.88%			1.18%	
2011		-2.78%			-6.88%	
2012		7.37%			3.67%	
2013		1.56%			0.06%	
2014	Nominal return after charges, before inflation and taxes	3.69%	2.00%	Real return after charges and inflation and before taxes	3.79%	0.50%
2015		-1.68%			-1.38%	
2016		2.72%			3.22%	
2017		3.95%			2.55%	
2018		-3.67%			-5.54%	
2019		7.40%			4.23%	

Source: BETTER FINANCE calculations based on www.manazeruspor.sk data, 2020 (as of 31 December 2019)

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

Table SK15. Supplementary Pension funds Nominal and Real Performance according the holding period

Holding Period	Net Nominal Annualized Performance	Real Net Annualized Performance
1 year	7.40%	4.23%
3 years	2.46%	0.32%
5 years	1.67%	0.55%
7 years	1.94%	0.94%
10 years	1.98%	0.42%
Since inception	2.00%	0.50%

Source: BETTER FINANCE calculations based on Manazeruspor data 2020 (data as of 31 December 2019)

Supplementary pension funds have achieved positive returns in 2019 mainly due to the increased 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 reverted stabilization features and decreased the financial stability and trustworthiness of the PAYG scheme. The year 2019 could therefore be viewed as a year of pension system destabiliation.

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.

However, the key issue of the pension system in Slovakia is the I. pillar managed by state-owned Social Insurance Company. Pension populism has financially destabilized the I. pillar and decreased the trustworthiness of the I. pillar, while the private forms of pension savings have increased on importance. The government should immediately start taking actions to increase the financial stability of the I. pillar and remove the populist features introduced in 2019 as soon as possible.

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