
Current Issues and Challenges in Supplementary Pension System: The Slovenian Case

Aleš Berk
June 09 2007

Slovenian Case: Background

- Inclusion percentage
- Coverage percentage
- Individual-to-employer contribution ratio
- Split supervision
- Isolation from a financial system with different treatment of individuals under different schemes
- *One-fits-all* mandatory guarantees
- Inefficient benchmark
- Competition focused on management fees but not products
- Board-friendly and not employee-friendly fund selection

Slovenian Case: Solutions

- Stimulate supplementary pension system compared to PAYG by following internationally recognised best practices
 - Reconsider redistribution rate
- Promote transparent financial product competition in all respects (yield, risk, costs, guarantees)
- Allow flexible types for affluent individuals (IPRAs UIPPs)
- Set favorable tax treatment – what is a goal of stimulating pension savings?
-

Fully-funded Pension Scheme Framework

- Pension funds should be managed to an exclusive benefit of beneficiaries.
- They should:
 - manage widely diversified (umbrella) funds with valuation of assets according to market values,
 - operate in a sound and competitive portfolio management environment with a full discretion about asset classes according to UCITS directive,
 - provide fair and timely information to beneficiaries,
 - provide more flexible product-design with high level of transparency and safety, cost efficient management based on *prudent investor principle*, and
 - be portable.
- UIPPs (*managed individual pension portfolios*) and IPRAAs (*individual pension accounts*)

The Critical Issue

- Financial education and awareness of an average Slovenian employee about the need to co-finance her/his own pension, even after almost two decades of “modern era”, still rather low.
- The need for continuous awareness-raising campaign about:
 - the financial freedom of each individual, and
 - reasonable options available to gain it.

Pension System Risk Transfer

Types of risk in a pension system

- poverty risk
- fiscal instability risk
- longevity risk
- mortality risk
- economic growth rate risk
- financial (market) risk

Pension System as a Sum of Parts

- The ultimate goal should be the system with:
 - a strong capital-based system with an mandatory occupational (II.) pillar that at least matches the PAYG demographic-driven gap
 - portability of pension products (employer provides funds, employee makes an allocation decision upon the preselected pension products)
 - some absorption capacity for privatization
 - moderate and non-competition-dragging first *PAYGO* pillar which would alleviate poverty
 - Financed via contributions, general taxes and professionally managed funds dedicated for pensions
 - Full indexation to wages or to a growth rate of the economy.
- Transition (for at least some decades) calls for an introduction of a pension mechanism based on NDC.
 - “bridge” or transition financing
 - good for diversification reasons
- Pension insurance or pension savings?

Issues to be Cautious About

- The mandatory occupational pillar can cause dissatisfaction if pension funds are not integrated into the financial system
 - Labor unions
 - *One-fits-all-like* guarantees (social security)

- Benefits of alternative asset classes (i.e. non-UCITS funds - PE, real estate funds, hedge funds and CTAs) vs. governance mechanisms

- Life-time annuity
 - Stimulation? For whom?
 - Fair annuity pricing

- Inefficient benchmark

Current Benchmark

- Questionable issues about current benchmark:
 - YTM vs. HPR
 - Measurement lag
 - Allocation bias and security selection
 - Benchmarking horizons (*deters active approach to asset management*)
 - Arbitrarily set *guarantee-threshold*

Reasonable Future Benchmark

- Transparent, known *ex-ante* benchmark that is:
 - unambiguous
 - marketable and liquid
 - tractable
 - with two explicitly required characteristics:
 - *Modified duration* up to 3 years, and
 - Inflation-linked sovereign securities.