

# Designing regulatory framework for pension reform and development of financial markets: Estonian experience

Tõnu Lillelaid, Veiko Tali, Thomas Auväärt

## **1. Overview of mandatory funded pension scheme reform in Estonia**

### **1.1 Reformed pension system**

In June 1997 the Government of Estonia approved the pension reform concept paper, which set up the basis of the present three-pillar pension system.

Reformed pension system consists of three pillars:

- ⌘ First or public pension pillar, based on PAYG financing, was reformed in 1998. Main changes were related to individual account of contributions and introduction of benefit formula partly based on contributions. At the same time the gradual raise of pension age to 63 for both men and women, continued;
- ⌘ Second or mandatory individual funded pillar was legislated in 2001 and it started operating in 2002 (see p. 1.2);
- ⌘ Third or voluntary funded pension pillar was also legislated in 1998, allowing investments to both – special III pillar insurance contracts or voluntary pension funds. III pillar is based mainly on very favorable tax treatment of contributions and also benefits.

All pillars together aim at providing people optimum pension as they neutralize risks that jeopardize pillars individually (demographic, investment, political risks etc.) The main aims of introducing the second pension pillar were:

- ⌘ to increase individual interest and responsibility in the pension system;
- ⌘ to secure to adequacy level of old age protection and avoid the reduction in the average replacement rate due to unfavorable demographic developments;
- ⌘ to protect the political and financial sustainability of pension system by diversification of risks endangering the pension system.

### **1.2. Main features of second pillar**

Estonian second pillar is mandatory DC based funded individual scheme. During accumulation phase contributions are collected to the special second pillar pension funds chosen by individuals. At retirement pensions are paid as a rule in the form of annuities (provided by life-insurance companies), but there are also options for payments from pension funds in case the annuity is too small or exceeds certain limit.

The term “mandatory” is used to describe the second pillar, though it is mandatory only for new labor market entrants – individuals born 1983 or later after they have become 18 years old. Individuals born 1942-1982 have been able to join the II pillar on voluntary basis. It is important to emphasize that once person has chosen to join the second pillar, he cannot reverse the decision.

Contribution rate to second pillar is 6 % of payroll. 4 % is allocated from social tax payments (which total rate is 33 %) paid by employer. Additional 2 % is paid by employee from its own salary. Contributions are collected by Tax and Customs Board. Collections can be allocated to only one pension fund at a time. Still once during a year a person can start to make contributions to another fund or switch funds changing all units of one fund to units of another. Units of a pension funds

are inheritable and can only be bequeathed to natural persons. In case of II pillar the EET type of income taxation is used.

Scheme is administrated by a central agency - Estonian Central Depository for Securities (ECSD). ECSD keeps account of individual's subscription to a funded pension. The agency will register the funded pension applications submitted, the funds chosen, the contributions paid, the pension fund units acquired, payments made, funds replaced and other procedures related to the funded pension schemes.

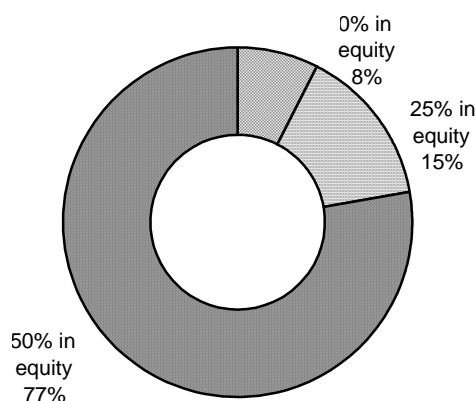
Pension funds in Estonia are legally designed as specialized type of contractual investment fund. Management companies who manage second pillar pension funds can also manage third pillar pension funds, as well as other investment funds (incl UCITS) and private portfolios. Assets of pension funds are hold by depository banks. All main service providers (incl. ECSD) of second pillar are supervised by Financial Supervisory Authority, who also register pension funds and approve fund rules.

There is also a moderate guarantee scheme established for protection of pension fund unit holders. It is triggered in case of insolvency of management company and when there was damage caused by breaches of rules of management of pension fund. The guarantee scheme is not providing protection against investment risk, but a person can choose between pension funds with different types of investment strategy.

### 1.3. Second pillar in action

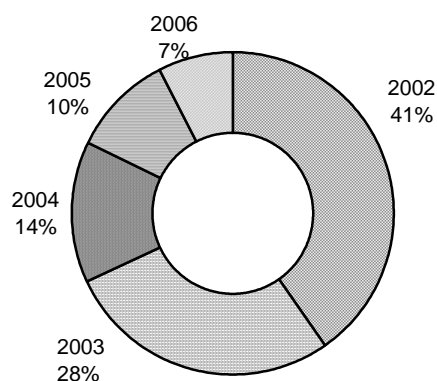
Funded Pensions Act was passed by the Parliament in September 12, 2001. The first round of switching to II pillar scheme started in May 3 2002. Six fund management companies got licenses to manage second pillar pension funds and 15 funds were registered (6 conservative, 3 balanced and 6 progressive funds). According to law, every FMC (fund management company) has to manage a fund that is not allowed to invest into equity, thus it invests only to fixed income instruments (conservative fund). In addition they can operate funds, which invest up to 25% (balanced fund) or up to 50% to equity (progressive fund). 50 % is the maximum limit of equity investment allowed by law. Progressive fund has proved to be the most popular type of fund among second pillar members, as also seen on the figure 1 below.

**Figure 1: Number of switchers to II pillar by type of fund in 2006**



Source: Ministry of Finance of Estonia

**Figure 2: Switchers to II pillar by switching time.**



Source: Ministry of Finance of Estonia

After the first round of switching to second pillar, that ended with May 31, number of members of the second pillar was unexpectedly high – 40,000 people. Second round of joining in 2002 lasted till November 1. Total number came as a surprise for most, being 207,200. When projections were made on switching behavior, it was believed that at least 50,000 people would join the new system on the first year. It was also wished, that the number of fund members would raise to 250,000 (half of current tax payers) by 2007 or 5 years after the start. By the end of 2006 the number of switchers was 520,000.

An individual (unit-holder) has right to exchange units of a pension fund for units of another pension fund and can begin to make contributions to a new pension fund once a year for which he or she has submitted an application. In past year's ca 10% of persons have used this option and mostly they started to contribute to the new fund and left the existing units to old fund. Over 96% of individuals, who changed their pension fund, chose a progressive fund as a new fund. This can be first of all explained by highest investment returns of these types of funds.

**Table 1: Number of switchers who changed their pension fund 2003-2006**

	2003	2004	2005	2006
<b>Started contributing to new fund</b>	8119	31965	40056	35129
<b>Changed pension fund</b>		2186	7043	8152

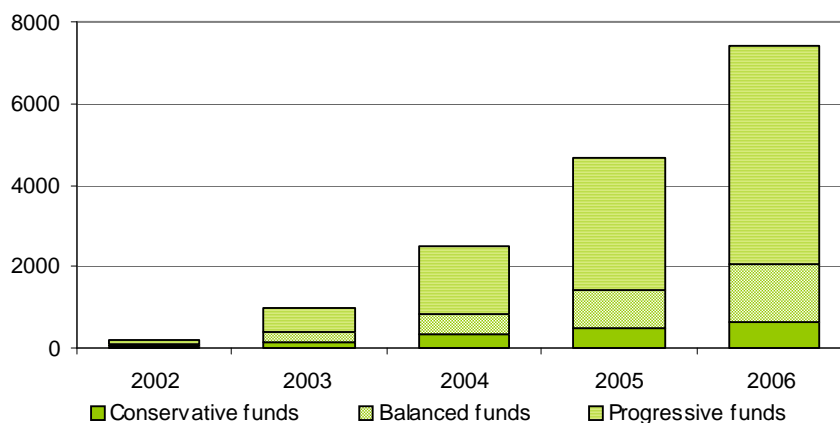
Source: Ministry of Finance of Estonia

**Table 2: Movement between different types of pension funds in 2006**

	Old fund					
	Started contributing to new fund			Changed pension fund		
New fund	Conservative	Balanced	Progressive	Conservative	Balanced	Progressive
Conservative	113	109	157	44	43	27
Balances	236	140	388	123	51	81
Progressive	2489	3804	27693	1354	1624	4805

II pillar assets are growing very fast. At the end of 2006 II pillar assets amounted 7,4 billion EEK (0,5 billion EUR, 3,6% of GDP). II pillar market is heavily concentrated. The largest fund management company Hansa Asset Management owns 53% of II pillar market (by assets and investors), while market share of two smallest management companies is only 7%. There have been no big changes in structure of pension fund market since 2002. In 2005 two small management companies merged in order to reduce costs and increase reliability. Both fund management companies had 3 pension funds under management and after merger all 6 were retained. Market share of this management company is currently ca 5%.

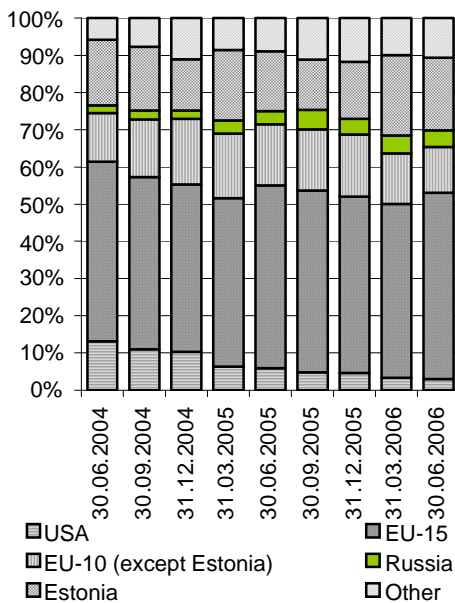
**Figure 3: II pillar assets by investment strategy in 2002-2006 (million EEK)**



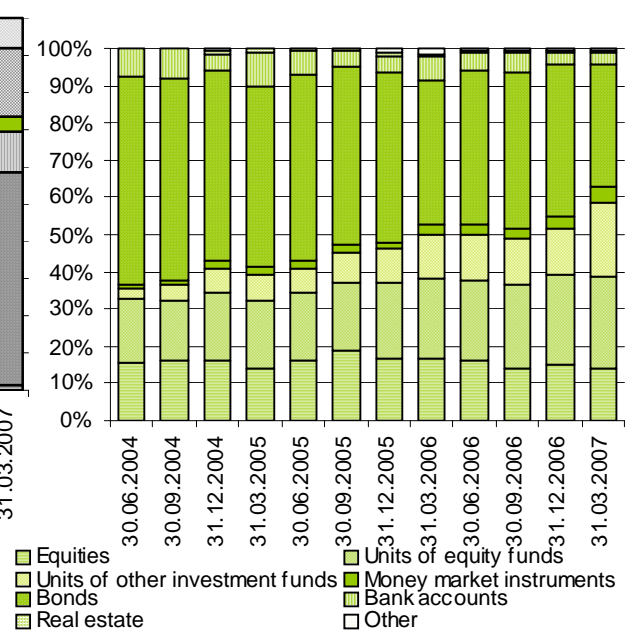
Source: Ministry of Finance of Estonia

Majority of assets of II pillar pension funds are invested into bonds and other low-risk fixed assets (mainly due to limits set by law). The importance of investment into other investment funds is slightly increasing. You can see from figure 6 that the units of the other investment funds (except equity funds) are replacing the investments into bonds and the units of the equity funds are replacing investments into equity. Regarding regional allocation (see figure 4), most of the fund assets are invested into "old" European Union countries (EU - 15). There is no obvious trend when you look investments into Estonia, but the proportion of investments into Estonia should decrease in future due to small size of the local financial market.

**Figure 4: II pillar investments by region**



**Figure 5: II pillar investments by asset type**

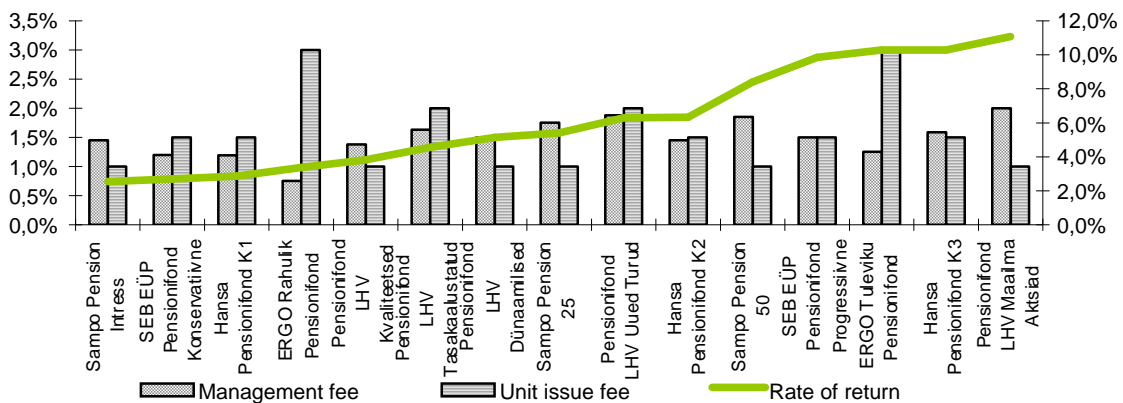


Source: Ministry of Finance of Estonia

Source: Ministry of Finance of Estonia

There are three types of fees that pension funds can charge from investors: a unit issue fee, a unit redemption fee and a management fee. Unit redemption and management fees have upper limits set by law (1% and 2%). There is no limit for unit issue fee since the beginning of 2007 (before that it was 3%). Actual pension fund fees are usually lower than limits (see figure 6).

**Figure 6: Fees and nominal investment returns of pension funds**

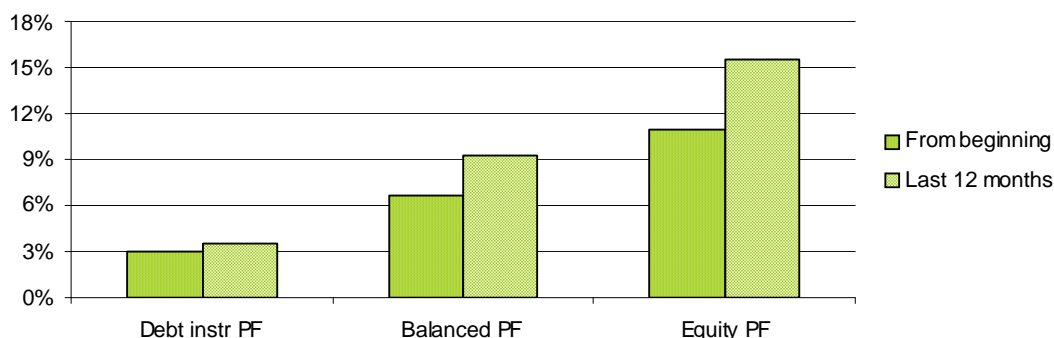


Source: Ministry of Finance of Estonia

Actual unit redemption fee is for all funds 1%. For the purpose of higher transparency all other fees like depositary fees, fees to FSA, ECSD fees and contributions to guarantee scheme should be paid by pension fund management companies. Only transaction expenses can be deducted from the assets of the fund.

Investment returns of pension funds depends on the investment strategy of the fund. Real rate of return for conservative funds is around 0%, but for progressive funds 6-8% (annual basis, from 2002).

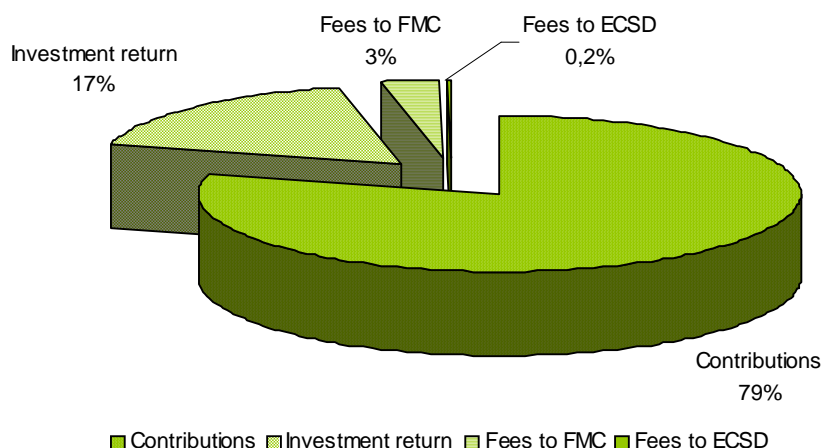
**Figure 7: Investment return of different types of pension funds**



Source: Ministry of Finance of Estonia

The accumulated cost of the II pillar system is currently ca 3% of total assets (see figure 8); this includes revenues of the FMC (includes fees to depositary, supervision etc) and ECSD. Unavailable is data about cost to Tax Board (collecting contributions and transferring to ECSD) and administrative cost for employers.

**Figure 8: II pillar system costs (accumulated in 2002-2006)**



Source: Ministry of Finance of Estonia

#### 1.4. Changes in regulatory framework since 2002

The regulatory framework for II pillar pension scheme has remained basically the same. Some changes introduced since 2002 are described below. In 2004, the new Funded Pensions Act was passed. It was mainly renewed because new Investment Funds Act was passed and the contents of both these laws were restructured. New law made following main changes in II pillar rules:

- ⌘ Initially there it was possible to join with II pillar on voluntary basis until 2022. Due to very high switching activity in the beginning, the decision was made to shorten this date to 2010. So after 2010 it is no longer possible to join II pillar for persons born before 1983.
- ⌘ Self-employed persons can contribute to the II pillar. Initially there was no possibility for that.
- ⌘ Contribution to the II pillar is also made from parental benefits (paid until 1,5 years after birth of child). Contribution rate in such case is 1%.

Investment restrictions of pension funds to the venture capital funds and real estate funds were released starting from beginning of 2007. Investment limits for real estate and real estate funds were increased from 10% to 40% and for venture capital funds from 30% to 50%. Amendment was done to stir the activity of these type of funds in Estonia and to encourage longer-term investment behavior of management companies. Currently only ca 0,3% of II pillar pension fund assets are invested into real estate.

## **2. Pension reform impact to financial markets**

### **2.1. Financial market development in Estonia**

Estonian financial market is characterized by dominant position of banking sector, high level of foreign-ownership and concentration, as well by relatively advanced level of services (internet banking etc.) (see table 3 for main indicators)

Last decade of 20th century has been a period of dramatic economic restructuring and turbulence for financial markets. For example, in banking, the number of institutions has been reduced six times in seven years – from 42 to 7 (excluding foreign branches), with two institutions now accounting for nearly 78 per cent of the market share by assets. The same degree of consolidation has taken place in insurance that is today – like banking – predominantly foreign-owned by Scandinavian (Swedish) financial market participants. The assets of branches of foreign credit institutions and credit institutions controlled by non-resident financial groups comprised 98% of the total assets of banks operating in Estonia.

The growth of Estonian financial sector's consolidated assets accelerated considerably since the beginning of the new century, exceeding nominal economic growth several times. Following Estonia's accession to the EU, increase in the provisions of financial services was significant, which have tightened competition.

**Table 3. Main indicators of Estonian financial market**

	2000	2001	2002	2003	2004	2005	2006
Number of private banks (incl. foreign branches)	7	7	7	7	9	13	<b>14</b>
Concentration C2, %	83,5	83,3	82,8	81,8	81,3	80,1	<b>77,6</b>
Banks ROE, %	8,4	20,9	20,3	20,0	22,8	23,5	<b>25,5</b>
Banks capital adequacy, %	13,2	14,4	13,4	12,5	11,5	10,7	<b>10,8</b>
Foreign ownership in bank's share capital, %	84,0	85,0	86,7	85,7	89,8	93,1	<b>94,4</b>
Real sector debt/GDP	34,7	38,3	42,9	50,6	57,6	73,3	<b>94,1</b>
Housing loans interest rate (end of period), %	11,0	7,7	6,8	5,0	3,6	3,4	<b>4,7</b>
Insurance premiums/GDP, %	1,6	1,8	1,9	2,3	2,2	2,3	<b>2,2</b>
Investment funds assets/GDP, %	1,7	3,1	4,1	6,3	7,5	10,6	<b>13,3</b>
Stock market capitalization/GDP, %	34,4	26,6	33,5	40,5	50,8	28,5	<b>34,6</b>
Change of stock exchange index, %	10,1	4,7	46,8	34,4	57,1	48,0	<b>28,9</b>

Source: Ministry of Finance of Estonia

As mentioned above, the financial sector in Estonia is very much dominated by the banking sector, while the securities market have been remained small in the past. However today, both pension reform and EU enlargement is definitely brightened up the market. In investment services sector a trend is also noticeable that previously investment funds and insurance products now replace more and more deposited savings (see table 4).

Despite of the high concentration of the banking market the competition is still very intense and the number of market participants has even slightly increased during the last years. At the end of 2006, there were seven locally licensed credit institutions and seven branches of foreign credit institutions operating in Estonia. The active operation of the branches of foreign credit institutions in the loan market has certainly had an effect on the distribution of market shares in recent years.

**Table 4. Private persons debt and investments (to GDP)**

Ratio to GDP (%)	1999	2000	2001	2002	2003	2004	2005	2006
Private persons loan stock	6,6%	7,2%	8,5%	10,7%	14,5%	20,0%	28,8%	39,7%
<b>Private persons savings deposits</b>	5,9%	7,1%	7,5%	7,2%	6,6%	7,3%	7,9%	9,0%
Investment funds assets (excl. pension funds)	1,4%	1,5%	2,8%	3,4%	4,6%	5,7%	7,7%	9,2%
<b>Pension funds assets</b>	0,0%	0,0%	0,0%	0,2%	0,8%	1,8%	3,0%	4,1%
Individual portfolios	0,5%	0,7%	1,1%	1,4%	2,2%	3,5%	6,1%	8,1%
Unit linked life-insurance	0,0%	0,1%	0,0%	0,0%	0,1%	0,2%	0,4%	0,5%

Source: Ministry of Finance of Estonia

The Tallinn Stock Exchange (TSE) is the only regulated securities secondary market in Estonia. It was founded on 31 May 1996. After ten years of operation, the TSE index has grown to 615 points. The TSE and the Estonian Central Register of Securities belong to the international OMX Group and since 2004 the TSE has been a member of NOREX, the Nordic and Baltic stock exchange alliance.

**Table 5. Investments by countries to Tallinn Stock Exchange**

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Estonia	66,9%	65,0%	34,9%	27,0%	23,6%	22,5%	19,4%	19,7%	17,2%	45,3%	52,6%
Sweden	5,6%	3,9%	29,7%	38,6%	45,4%	45,4%	48,8%	52,8%	54,3%	26,5%	19,9%
UK	1,3%	3,2%	2,1%	3,8%	5,4%	7,7%	7,1%	7,5%	8,3%	3,3%	5,2%
Luxembourg	0,0%	0,4%	3,1%	1,5%	0,2%	1,1%	1,7%	1,8%	4,3%	5,5%	5,5%
Latvia	0,1%	0,6%	0,5%	0,2%	0,1%	1,0%	0,8%	0,9%	0,3%	0,5%	3,6%
USA	2,3%	1,8%	3,4%	12,5%	8,4%	7,5%	8,4%	6,6%	6,3%	4,7%	3,3%
Finland	11,7%	12,4%	12,8%	5,5%	5,1%	7,0%	6,8%	7,1%	5,7%	7,5%	3,2%
Other countries	12,1%	12,7%	13,5%	10,9%	11,8%	7,8%	7,0%	3,6%	3,6%	6,7%	6,7%

In general the foreign ownership and co-operation arrangements with other stock exchanges have had a positive impact on the liquidity and fostered the integration of the Estonian securities market into the European markets. However, unlike in other countries, government debt securities have not been one of the driving forces of capital markets development, which is a mainly result of conservative fiscal policies (central government debt level is currently around 1,7 % of GDP). Therefore, the securities market in Estonia consists primarily of an equity market, and the debt market has developed only due to the issuance of corporate debt instruments. However, the corporate debt market volumes are modest and it is mainly a primary market with private placements. Secondary market is weak and not liquid.

## **2.2. Preconditions for reform**

When designing the pension reform one should take into account the existing level of development and structure of financial services industry and markets. Important preconditions for successful implementation of (mandatory) funded pension reform are comprehensive regulatory framework, sufficiently capable supervisory structures and functioning market infrastructure. Market participants themselves should also be capable and ready to execute their mission. It is also crucial to take into account the level of experience and financial education of persons who will be the members of the mandatory scheme and should make critical decisions including these related to their personal investment risk.

From institutional point of view it is very critical to have strong supervisory authority capable to protect the interests of pension scheme members. In Estonia in 2001, just before implementation of II pillar, three separate financial supervisory inspectorates (banking, securities and insurance) were merged to one Financial Supervision Authority (FSA). Creation of integrated financial supervisory authority was a fundamental and successful reform, which provided a prerequisite for enhancing the effectiveness of supervision and procuring its consistent quality in all parts of the financial sector. The reform included major changes in financing of supervisory activities – FSA-s budget is fully financed by financial industry. The integration of all supervisory functions into FSA allowed systematically and without the risk of supervisory arbitrage or dispersion of responsibility to control all participants of II pillar scheme including management companies, ECDS, depository banks, stock exchanges, life insurance companies and public issuers.

Minimum critical market infrastructure (central depository and stock exchange) was formed in the middle of 1990-s – ECSD in 1994 and TSE in 1996. In 1998 the Deposit Guarantee Fund was established. Estonian financial sector has undergone a significant transformation since the end of the “bubble” in 1996-97 and strengthened considerably since the Asian and Russian crises. Mainly during the end of 1990-s the banking and insurance sector was consolidated and restructured. Weaker players disappeared and financial sector became dominated by subsidiaries of big and experienced Scandinavian financial groups (banks). First management companies and investment funds were established in 1994-5, pension funds in 1998.

## **2.3. Impact of pension reform to development of financial sector**

Implementation of funded pension schemes can have an important impact for development of financial sector as well as for real economy. It is possible to strongly influence the future structure of financial services industry and development of capital markets when designing the key features of regulatory framework for pension reform. Having regard primarily Estonian experience some following rather obvious propositions can be made:

- ⌘ The earlier funded pension reform will be implemented comparing to the relative level of development of financial sector – the higher should be the impact of pension reform for further development of financial sector.
- ⌘ The bigger the relative level of potential financial flows “mobilized” by new pension scheme – the higher the impact to the financial sector. This aspect is especially influential during the first phase of pension reform and depends mainly on the level of contribution rate and the extent of compulsiveness of the scheme.
- ⌘ In connections with first two propositions it seems obvious that the impact of the implementation of pension reform is higher in smaller countries. This can be the case, but mainly in relation of providers of financial services and even in such a

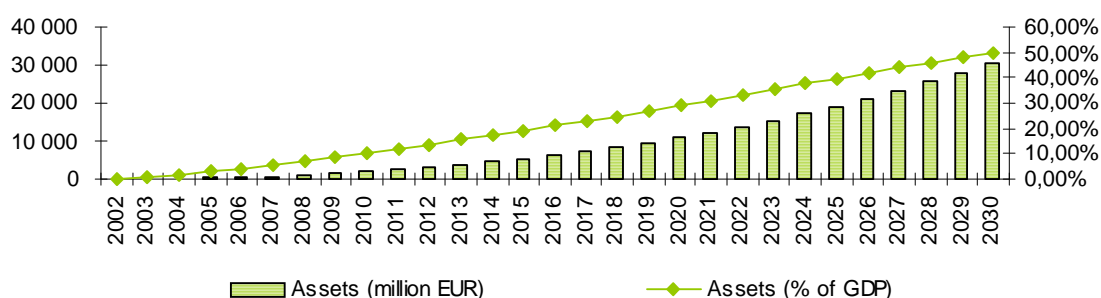
case only if the magnitudes of pension funds exceed the critical mass. If to restrict the investments of pension funds to local markets then of course the impact can be also significant for development of capital markets. But such a solution is not reasonable and sustainable first of all for smaller countries.

When designing the regulatory framework for mandatory funded pension scheme it is more important to keep in mind the longer-term impact of pension reform to development of financial sector and markets. Ideally the pension reform should be designed in a way, which enhances the further development of financial markets and positive restructuring of financial sector. Such design of reform should reproduce the favorable conditions for realization of aims of pension reform itself. Taking into account the critical importance of long-term impact of pension reform it is essential that the regulatory framework is designed in such a way that it can be timely redesigned if the mismatches have appeared or conditions have changed. Estonian experience has shown that redesigning possibilities can be seriously restricted because of optional character of switching to II pillar (see p.1.2.). Voluntary switchers to II pillar (in our case 75 % of total) have (legally) justified expectations that all key conditions of the scheme remain unchanged or if not, then they get the possibility to switch back.

Estonian experience about pension reform impact to development of financial services industry and capital markets is discussed below.

Estonian II pillar is characterized by medium-sized level of contributions (6%) and high level of voluntary switching to the system. Second pillar was introduced in 2002 after the main restructuring of Estonian financial sector in the end of 1990-s. Consequently, the impact of II pillar to development of financial markets can be significant mainly in longer-term and in case of high level of switching. As it is described above (see p.1.3) the switching to the II pillar have been very popular – approximately 54% of eligible voluntary switchers have taken this option. It allows to expect that II pillar pension fund assets will continue increasing rapidly and reach 50 % (from 3,9 % in 2006) of GDP around 2030 (see Figure 8). At the same time the existing level of banking assets to GDP is already 126 % of GDP and is growing. This means that II pillar impact to financial sector in future will increase considerably but will be not very strong compared to the banking sector.

**Figure 8: Assets of mandatory pension funds (2002-2030)**



Source: Projections of Ministry of Finance of Estonia

Other main features of II pillar regulatory framework are following:

- ⌘ Differentiation of solutions for accumulation (pension funds) and payment phase (mainly annuity contract). During reform preparations several alternatives were discussed including parallel provision of insurance and fund products during both phases.
- ⌘ There is no requirement to have specialized service providers designated only for provision of II pillar products. Pension fund managers can also manage all type of investment funds and private portfolios. Same principal is applicable also for life-insurance companies. This open approach was chosen with the purpose of

creation of critical mass of volumes attractive for capable and reliable service providers under conditions of the small market size.

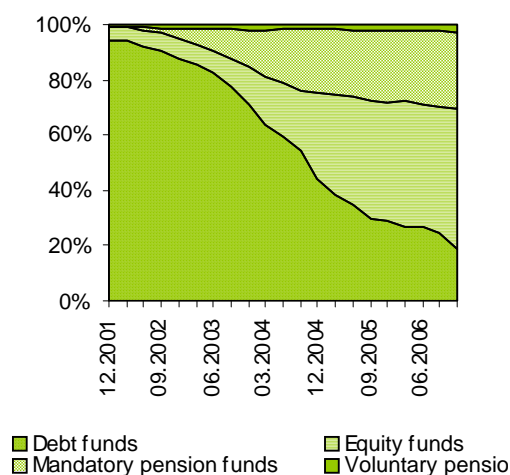
- ⌘ II pillar pension funds are specially designed collective investment schemes – contractual investment funds managed by licensed management companies. Assets of pension funds are kept separately by depository bank with certain fiduciary responsibilities. Net asset value of pension funds is calculated and published on daily basis and all transactions are taken place according to NAV.
- ⌘ Investment regulations are based on quantitative limits including diversification rules, self-investment restrictions, instrument based restrictions (50 % max to equity, 10 % to non-listed securities) and country-based restrictions. There are no country-based limits for investing into EEA or OECD instruments. Currency matching rule is 70 % but it is not applicable for euro. It was assumed that it is not reasonable and sustainable to create artificial regulatory advantages for (small) Estonian market. Local instruments should be attractive themselves.
- ⌘ Absolute or relative return guarantee mechanisms are not applied as it is the case in several other CEE countries. At the same time every management company is obliged to manage at least one conservative pension fund. One management company can manage several II pillar pension funds, but the investment policy of each fund should be different. Switching is allowed as described in 1.2. Guarantee scheme covers only operational risk (see also p.1.2).

After five years of experience we can imagine first preliminary results and lessons of II pillar reform from the point of view of development of financial services sector and capital markets.

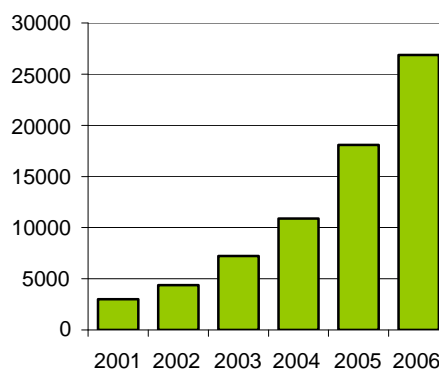
One of the main positive and “planned” results of reform is the real boom of asset management and investment funds industry. Prospects of regular fresh inflows and rapid increase of II pillar assets created a stable basis for forming of capable and competitive asset management sector. As one can see from figures 9 and 10 the investment fund assets have increased almost 10 times during last 6 years. The growth is mainly fostered by the rapid increase of equity funds and mandatory (II pillar) pension funds. By the end of 2006, there were eight fund management companies in Estonia. In 2006, the number of investment funds registered in Estonia increased to 46, including 18 equity funds (14 in 2005), 15 mandatory pension funds (15), 7 voluntary pension funds (7) and 6 debt funds (8). Total assets managed by fund management companies increased rapidly, reaching 2 billion EUR by the end of 2006, of which 1,7 billion EUR originated from managed investment funds and 0,3 billion EUR from client securities portfolios.

Developing of strong and qualified asset management industry has made Estonian financial services sector more diversified. We also can see clear signs of forming of regional asset management competence center in Tallinn (specializing mainly in investing Scandinavian money into CEEC instruments). Concentration in asset management sector remains high, but we can see positive trends towards increase of competition. Recently a new (independent from big financial institutions) management company was established and two new ones are likely to be prepared.

**Figure 9: Investment fund market shares**



**Figure 10: Investment fund assets (million EEK, 1EEK=15,6466EUR)**



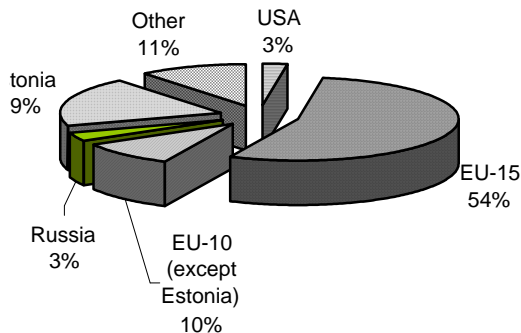
Source: Ministry of Finance of Estonia

Some other preliminary results/lessons related to the impact of II pillar regulatory framework

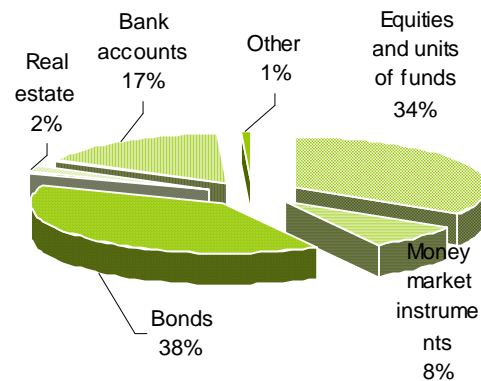
to the development of financial markets are following:

- ⌘ Quantitative investment limits applied are likely to be too restrictive and not adequate to the aims of the II pillar. Especially some instrument-based limits (e.g. equity limit) need to be reconsidered and modified.
- ⌘ Investment strategy of II pillar asset managers is not sufficiently oriented to long-term results. It is partly stimulated by daily comparison of results of funds.
- ⌘ There are certain concerns about the level of competition in II pillar pension fund sector. The number of II pillar pension funds as remained the same (15) as it was already in 2002. The number of II pillar asset managers decreased from 6 to 5. Fees paid to managers have not almost changed from the beginning.
- ⌘ II pillar impact to the development of domestic capital market has been moderate. Corporate bond market has not flourished as expected in certain extent (this trend can be changed). There is lack of new long-term instruments and new issuers. As one can see from Figure 11 investments into Estonia form ca 19 % of II pillar pension fund assets. This level is rather significant, but approximately 1/3 of this amount is indirectly invested outside of Estonia (see Figure 12).

**Figure 11: II pillar investments by region**



**Figure 12: II pillar investments into Estonia**



Source: Ministry of Finance of Estonia

### **3. Current issues and further developments of II pillar**

During 2008 it is planned to amend and correct the regulatory framework for II pillar. Topics under discussion are mainly related to payment phase, investment restrictions of pension funds and fee structures.

The biggest challenge is definitely the completing of regulatory framework for payment phase, which will start from 2009. Basic features of payment phase were stipulated in law already in 2001. According to the existing law the main solution for payment phase is compulsory lifetime annuity. Insurers shall apply a unisex mortality table for both men and women. It has been in a discussion whether all the insurers should use the same table or it could be partially competitive with certain restrictions. Insurers are allowed to offer only base (insurance) products for the policyholders. Joint product is also allowed but it has to meet the requirements of the base product. In both occasions a guaranteed period may be entered into including so that the beneficiary or beneficiaries specified in a contract shall be entitled to payments made pursuant to the contract if the insured dies during the guaranteed period. Other hotly debated issues related to payment phase are:

- 1) possibility of recalculating benefits in case of renewal of mortality tables
- 2) possibility and conditions of switching between insurers or among different products;
- 3) transparency of expenses and fee structure (exit, entry etc.) of insurers
- 4) whether to use guarantee schemes and what will be the scope of such scheme
- 5) conditions for using programmed withdrawal option instead of lifetime annuity

What concern accumulation phase and investment regulations the proposals to increase equity investment limit (from 50 to 70 or higher %) and remove some other restrictions are under discussion. For voluntary pension funds (III pillar) it is currently already 100%. The main reason for that is equity's higher long-term rate of return. Current statistics (although short-term) is also proving (see figure 7), that all 6 pension funds with highest return are progressive pension funds. Around ¾ of investors also prefer progressive pension funds (see figure 2).

Another hot debate is around the structure of fees of pension funds. Currently there are three types of fees – entry, exit and management fee. As you see from figure 7, taking account both fees it is very difficult to compare which fund have the

lowest fees. To improve the transparency of fees, the proposal, which is under consideration, is to keep only two fees instead of three and to remove entry fee at all. In certain cases (close to retirement) the exit fee also can be removed. Additionally pension funds must use regressive management fees depending on the volume of assets. Investors should get then the advantage of scale effect of the pension fund like fund managers.