ESTONIA

REVIEW OF THE PRIVATE PENSIONS SYSTEMS

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FOREWORD

This review of Estonia by the Working Party on Private Pensions is part of a series of reviews of national policies undertaken for the OECD Insurance and Private Pensions Committee (IPPC). It was prepared as part of the process of Estonia's accession to OECD membership.

The OECD Council decided to open accession discussions with Estonia on 16 May 2007 and an Accession Roadmap, setting out the terms, conditions and process for accession, was adopted on 30 November 2007. In the Roadmap, the Council requested a number of OECD Committees to provide it with a formal opinion. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council decided to invite Estonia to become a Member of the Organisation on 10 May 2010. After completion of its internal procedures, Estonia became an OECD Member on 9 December 2010.

The IPPC was requested to examine Estonia's position with respect to core principles related to insurance and private pensions systems. The examinations were carried out by the Working Party of Governmental Experts on Insurance (WPGEI) and Working Party on Private Pensions (WPPP). The present report was finalised on the basis of information available in December 2009. It is released on the responsibility of the Secretary General of the OECD.

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INTRODUCTION

This document has been prepared as part of the OECD's work in relation to Estonia's application for accession to the OECD. The purpose of this document is to assist the Working Party on Private Pensions (WPPP) form an opinion on Estonia's ability and willingness to meet the requirements of OECD membership in the field of private pensions as set out in Appendix A.VIII of the Accession Roadmap for Estonia adopted by the Council [C(2007)101/Final] Accordingly, Estonia will be assessed against the two core principles referred to in the Roadmap:

- ensuring sound prudential regulation of private pension systems and protecting the rights of members and beneficiaries; and

- relaxation of restrictions on cross border trade, investment and establishment of pension services as required under the OECD Codes of Liberalisation.

The WPPP reviewed the first core principle of the Roadmap (except supervisory matters) at its meeting on 6 July 2009. Following that meeting, the Chair sent a letter to the Estonian Delegation (dated 14 September 2009) including a set of questions for clarification. Estonia responded in written (letter dated 13 October 2009 included in DAF/AS/PEN/ACS(2009)1/REV3/ADD4), providing detailed answers to all the questions.

A report on private pension supervision was prepared to support the discussion at the WPPP meeting held on 30 November 2009 [DAF/AS/PEN/ACS(2009)3/REV1/ADD3], including draft recommendations on supervision. The Estonian Delegation provided comments on supervision during this meeting [DAF/AS/PEN/ACS(2008)1/REV1/ADD5].

In this revised report, particular attention has been paid as to how regulations, supervision, and market-practice in Estonia measure up in relation to the OECD Recommendation on Core Principles of Occupational Pension Regulation [C(2009)57)], using the Methodology developed for this purpose (DAF/AS/PEN/WD(2008)1/REV2). The detailed assessment and the main recommendations made by the Working Party are contained in the executive summary.

The report also addresses compliance with the "OECD Recommendation on Good Practices for Financial Education relating to Private Pensions" [C(2008)23]. Market access issues and the Codes of Liberalisation are addressed by the Working Party of Governmental Experts (WPGEI) which assists the Investment Committee in these matters.

The document contains two main sections: the executive summary contains a summary of the assessment of the implementation of the OECD Recommendation on Core Principles of Occupational Pension Regulation in Estonia. It highlights the main points of convergence and divergence of the Estonian private pension system with the OECD Recommendation. Any differences with the OECD Recommendation, outstanding questions and areas for further discussion have been categorized and described under the appropriate OECD Core Principle. A reference is also made to the OECD

Recommendation on Good Practices for Financial Education relating to Private Pensions. The second section of this document contains a brief description of the Estonian pension system.

Five additional documents support the analysis and recommendations contained:

- A detailed assessment of the Estonian Private Pension System in relation to the OECD Consolidated Core Principles of Occupational Pension Regulation (DAF/AS/PEN/ACS(2009)3/ADD1). The format for this assessment follows that prescribed in the "Methodology for Assessing the Implementation of the OECD Consolidated Core Principles of Occupational Pension Regulation" (DAF/AS/PEN/WD(2008)1/REV2).

- A detailed assessment of the Estonian private pension supervisory framework against the IOPS Principles of Private Pension Supervision (DAF/AS/PEN/ACS(2009)3/REV1/ADD3), included as Principle 7 of the OECD Recommendation on Occupation Pension Regulation;

- The original submission by the Estonian authorities in response to the Questionnaire prepared by the Working Party on Private Pensions (DAF/AS/PEN/ACS(2009)3/ADD2);

- The response by the Estonian Delegation to the WPPP's chair containing various questions for clarification (DAF/AS/PEN/ACS(2009)3/REV1/ADD4).

- The Estonian Delegation's presentation at the second WPPP accession review meeting on 30 November 2009 (DAF/AS/PEN/ACS(2009)3/REV1/ADD5).

EXECUTIVE SUMMARY

Overview of the Estonian private pension system

The Estonian private pension system is based on individual savings accounts, and composed of two components, a mandatory and a voluntary one. Members have investment choice in both the mandatory and the voluntary system. There are no occupational pension schemes in Estonia. Although they are not prohibited, there is no legal framework for this type of schemes.

The mandatory funded pension scheme was launched in 2002 and is based on pension funds administered by private asset management companies. It is a defined contribution system where the amount of pension benefits depends on the total contributions over the working career and the yields of the pension funds. It is based on full-funding and covers only the risk of old age. However, to some extent it also serves as a survivors' pension, as the accumulated assets can be inherited.

Possibilities for voluntary supplementary funded pension schemes were introduced already in 1998. The supplementary pension is also based on the full-funding principle and is offered through voluntary pension funds and personal pension plans offered by life insurance companies. In addition to pension insurance with investment risk, insurance companies offer policies with guaranteed interest rates and different combinations of insurance products.

The voluntary plans cover two social risks: old age and long-term disability. Regarding pay out of pension benefits the available options are lifetime annuity, temporary annuity, lump sum payments and other irregular payments from pensions.

The creation of an integrated Financial Supervision Authority (FSA) in 2001 was a prerequisite for enhancing the effectiveness of supervision and ensuring its consistent quality in all parts of the financial sector. The reform included major changes in the financing of supervisory activities; The FSA's budget is fully financed by the financial industry.

The integration of all supervisory functions into one allowed the FSA to systematically, and without risk of supervisory arbitrage or dispersion of responsibility, control all actors in the private pension system, including management companies, ECDS (Estonian Central Depository for Securities), depository banks, stock exchanges, life insurance companies and public issuers. The FSA is responsible for both the licensing and supervision of all types of funds, including pension funds.

Position of Estonia with regards to the OECD Legal Instruments

In its Initial Memorandum and its presentation to the Working Party on Private Pensions, Estonia formally stated that it accepted all six OECD legal instruments in the field of private pensions.

The Working Party finds that Estonia is largely compliant with the OECD Core Principles of Occupational Pension Regulation and the related Guidelines. Regulation is comprehensive and generally well designed. The country also has all the main features of a sound supervisory framework as stated in the Core Principles.

At the same time, the Working Party finds that there are some areas where further initiatives by policymakers would be appropriate to improve the operation of the private pension system. These initiatives include:

- Considering the necessary preconditions for the establishment of occupational pension arrangements as a complement to existing arrangements and establishing an appropriate regulatory, supervisory and tax framework for these plans to develop *[Core Principle 1]*;

- Monitoring the impact of recent regulatory reforms on the competition and efficiency of the pension fund industry and evaluating options to further reduce the management fees paid by plan members, which remain high by international standards *[Core Principle 1]*;

- Assessing the suitability of different life-cycle investment strategies as default options for pension funds. The current default strategy (fixed income fund) may be too conservative for younger members *[Core Principle 4]*;

- Consider strengthening the protection of the rights of members and beneficiaries by (i) disclosing a single, comparable measure of the different management fees charged by pension fund managers, including the fees charged by mutual funds in which pension funds invest, (ii) communicating changes in benefits under the reformed system, such as the inclusion of benefit projections in the annual reports, (iii) offering greater flexibility in the timing of fund switches, particularly if a member wishes to move to a better performing or lower cost pension fund. [*Core Principle 5]*;

- Reviewing the implementation and effectiveness of the new regulation on conflicts of interest and considering other mechanisms in order to strengthen accountability to the fund members. One policy option that may be considered is requiring the appointment of independent directors to the board of supervisors of pension fund managers. The management board of the pension fund management companies may also need to be subject to stricter fit and proper criteria. *[Core Principle 6]*;

- Considering strengthening regulations to avoid unwarrantedly high exposures to mutual funds operated by the same financial group to which the pension fund management company belongs. The implementation of the new risk management guidance should also be closely monitored, so that it leads to an improvement in the way management companies assess and control the various risks to which pension funds are exposed. *[Core Principle 6]*;

- Reviewing the legislation under which the Financial Supervision Authority operates in order to strengthen its powers and transparency, and enhance its resources. Consideration should also be given to enhancing the risk-based on-site inspection regime and specifically introducing some risk-scoring for individual pension fund managers so that the intensity of supervision can be made proportionate to assessed risk *[Core Principle 7]*.

The Estonian delegation has stated its general agreement with these recommendations and briefed the group on their planned implementation at the meeting held on 30 November 2009 [DAF/AS/PEN/ACS(2009)3/REV1/ADD5].

The Working Party also finds that Estonia is aware of the importance of financial education in the field of pensions. Various efforts are made, most notably by governmental organisations, in order to improve financial literacy. In particular, the Estonian Government's decree of September 1, 2002 required that the curriculum for basic and secondary schools covers basic economic issues, including financial matters. In 2002, during the introduction of the statutory, private pension system, a public information campaign was organised by the government.

Internet is also commonly used as a channel to communicate to the population. A website, www.minuraha.ee (In English: My Money) has been created by the Estonian Financial Supervision Authority. The website includes comprehensive and independent information on financial issues in general, while a special section is dedicated to the issues concerning private pensions. A special website, www.pensionikeskus.ee (In English: Pension Centre), has also been created by the Estonian Central Register of Securities. The latter website provides comprehensive and neutral consumer information about the pension system in general and about private pensions in particular. The websites are also available in the Russian language.

The Working Party recommends furthering the implementation of the "OECD Recommendation on Good Practices for Financial Education relating to Private Pensions" [C(2008)23] via appropriate financial education programmes relating to private pensions.

Implementation of the OECD Core Principles of Occupational Pension Regulation

The following section provides a summary assessment of the Estonian private pension system against the OECD Recommendation on Core Principles for Occupational Pension Regulation [C(2009(57)], using the methodology developed for this purpose. This section highlights the main points of convergence and divergence of the Estonian private pension system with the OECD Recommendation. Any differences with the OECD Recommendation, outstanding questions and areas for further discussion have been categorized and described under the appropriate Core Principle.

Core Principle 1: Conditions for effective regulation and supervision

The Estonian private pension system is an individual savings vehicle, based on defined contribution principles, without any return or benefit guarantee. No occupational pension plans so far exist, though they are not prohibited by law. There are no plans to establish a regulatory framework for occupational plans.

The operation of the funded pension system is governed by a comprehensive regulatory system and the supervision of private pension providers, as well as their licensing, is since the merger of various agencies in 2001, performed by one single authority, the Estonian Financial Supervision Authority (FSA). The private pension system is subject to the Funded Pensions Act. In addition, the provisions of the Investment Funds Act apply to pension funds, management companies and depositaries of pension funds.

Estonia's mandatory private pension system is relatively new, having been launched in 2002. Therefore the significance of the pension institutions is still limited, but is growing fast. Investments are to a large extent directed abroad due to insufficient capacity in the local financial market. Voluntary pension plans were introduced in 1998, but so far the total assets are less than 10% of the total private pension savings.

The absence of occupational pension arrangements, and in particular the lack of a regulatory and tax framework for employers' involvement in retirement provision may be reviewed at a future date. There are already plans to make employers' contributions to voluntary pension plans on behalf of employees more tax favourable than is currently the case. Some areas where employers' involvement may be beneficial are the negotiation of fees with pension providers and the provision of financial education and advice to plan members.

The relatively high fees charged by pension fund managers have received much public attention in recent years. Individual choice between competing providers was expected to bring costs down over time. However, fees paid to managers were virtually unchanged until recently. To improve transparency, the government recently proposed new legislation that would eliminate the entry fee, keeping only the exit and management fees, as well as lower fee ceilings for the larger asset managers. Since this announcement was made, pension funds have started to lower their fees. Currently, ten pension funds have no issue fees, even though the respective amendments only come into force from 2011. Some pension funds have also reduced their management fees.

Core Principle 2: Establishment of pension plans, funds and fund managing companies

Estonia has a comprehensive licensing framework for pension plans and providers including most of the requirements of the Core Principle. The Financial Supervision Authority (FSA) is the licensing authority for basically all types of financial institutions, and the criteria, standards and requirements are stipulated in the Investment Funds Act. The required governing documents for a pension plan are comprehensive and clearly defined.

Only defined contribution plans are allowed in Estonia, and they are all individual schemes, with the possibility to self-direct the investments. As a result, there are only requirements for the licensing of fund management companies during the savings accumulation phase. The license for managing pension funds is the same as for investment (mutual) funds.

Basic risk control mechanisms are in place for investments, as well as a requirement for internal audit, and an actuary in the case of insurance companies that pay annuities. New risk management guidelines were introduced in 2009, calling for the establishment of written internal procedures by the management board.

There are minimum capital requirements for pension fund managers, which are greater for the mandatory system than for the voluntary one.

Managers of the pension entity (the fund management company), individual fund managers and members of the management board (elected from among the entity's main managers) and the supervisory board are subject to fit and proper requirements, including a requirement to have completed higher education. Fund managers are required to have at least three years of experience in asset management.

Pension entities are required to submit a detailed business plan covering at least three years. The business plan of a management company shall set out a forecast and analysis of all the important economic indicators of the management company and the funds managed thereby, and a description of the management structure of the management company and of the rights, obligations and liability of persons involved in management of the funds, and also a description, forecast and analysis of various other factors.

There are no regulations or instructions regarding giving the licensing authority the possibility to show flexibility in the requirements according to size or complexity. There are no regulations concerning the licensing authority's power to change the conditions on a license already granted, only the possibility of revocation.

Core Principle 3: Pension plan liabilities, funding rules, winding up, and insurance

The Estonian pension system is an individual defined contribution system and no defined benefit plans are allowed. Therefore, most of the rules under Core Principle 3 are not applicable.

Pension funds are the only authorised financing vehicles during the accumulation stage in the mandatory pension system. Annuities are permitted as a form of benefit pay-out. In the voluntary pension system, guaranteed insurance policies are also permitted as a form of saving.

In case of insolvency of pension entities there is a guarantee scheme against operational risk. Pension fund management companies pay contributions in the level of 0.01% of the net asset value of all pension funds managed.

The winding up of a pension fund may be decided only if the transfer of the management of a pension fund has been impossible. In order to liquidate a fund, a management company must apply for a corresponding authorisation from the FSA, who will analyze the application and submitted information.

Core Principle 4: Asset Management

Estonia has a detailed investment regulation for pension funds, based on key investment principles such as diversification and liquidity. There are few investment regulations in place and the government is planning further liberalisation and aims to implement the prudent person principle. The limit on equities will be raised to 75% in 2010. Investment in mutual funds operated by the pension fund management company are currently limited to 10% while those of the same financial group or holding company are capped at 50%.

Pension fund management companies must establish an investment policy for each fund they manage and review it every three years. The management companies must offer three different investment options, varying by their equity allocation. The default option for those who do not choose a fund is the fixed income fund. There is therefore no age-based or life-cycle profile for the default option, which may be a more suitable investment strategy.

The asset class quantitative portfolio limits including planned changes generally do not inhibit the diversification of the investment portfolio, given the high ceilings set for the main asset classes (50% for equities, raised to 75% in 2009) and the possibility to invest freely in regulated markets within the euro area.

Core Principle 5: Rights of members and beneficiaries and adequacy of benefits

There are no company-sponsored pension plans in Estonia. Both the compulsory funded pension and the voluntary funded pension plans are individual plans and therefore there is no exclusion of groups based on non-economic criteria.

In relation to the compulsory funded pension there are some different rules depending on age – for older employees participation is voluntary and from a certain age the participation is not possible as it was felt that older workers would be better off under the old social security system. Life assurance undertakings are not allowed to use different mortality rates for men and women when calculating pension payments.

Estonia's reformed pension system is likely to deliver lower replacement rates than the old system, though this will depend on the extent to which individuals take up the opportunity to save voluntarily in the pension funds or otherwise. Another venue for raising benefits would be to raise the official retirement age, which equalised at 63 for men and women is still low by international standards and in relation with the life expectancy of its population.

Pension fund members must be informed of all fees charged by the providers. However, there is no possibility currently for comparing the different fees charged in a standardised manner. Three different kinds of fees are currently permitted, an entry fee, and exit fee and an asset management fee. The government is planning to eliminate the entry fee and to lower the fee ceiling. Fees charged by mutual funds in which pension funds invest are not reported separately (they are deducted from Net Asset Values).

Self-directed investments are possible in the Estonian system. In the mandatory pension fund system the default fund is a compulsory fixed instrument fund. Given the general widespread disinterest in pension investment choices, some kind of life-style approach could be considered, in order to raise expected pension benefits for members who do not make an active choice of investment.

It is also only possible to change mandatory pension fund once a year, which means that members must stay with the same investment choice and provider for at least one year. Such a policy may be justified in order to control costs but also restricts good reasons to move, such as seeking a better performing or lower cost pension fund. Members must submit a switching request before October while the switch itself is implemented in January of the next year. This restriction may limit the ability of individuals to make timely switching decisions, although it may facilitate communication to members and reduce the administrative costs of switches.

There are no legal requirements for the right to timely and fair execution of investment decisions and to written confirmation of these transactions.

The Estonian government is aware of the need to improve financial literacy and is taking necessary actions. Since 2002, primary and secondary schools must provide lessons in economics, including financial matters. The supervisory authority and the securities depository institution also have websites to provide comprehensive and independent information about the pension system.

Core Principle 6: Governance

The governance requirements for pension plan providers in Estonia are set out in the law, with clearly defined responsibilities for the supervisory and management boards, as well as requirements regarding suitability. Pension fund management companies are applied the governance requirements of investment management companies.

With a private individual pension system where all investment risk falls on the individual and with the possibility to self-directed pension plans, there are limitations to the extent of accountability to plan members and the possibility of member representation on the governing body. The demand on the Financial Supervision Authority might therefore be higher in this respect, than in countries with occupational pension plans where employer and employees organisations may have a greater role.

While there are detailed "fit-and-proper" requirements on fund managers and members of the governing and supervisory boards, there is no requirement for independent board review or member representation in, for instance, oversight committees. Given that the pension fund managing companies are commercial companies, board members have primarily a fiduciary duty to their shareholders, to the possible detriment of pension fund members.

It is also unclear how effectively the potential and actual conflicts of interest faced by fund managers and other staff of the pension entity are addressed by the internal auditor. There are also no self-regulatory procedures in place, such as a code of conduct for the staff and board members of the pension entity that aim at protecting the interest of pension fund members. New guidance on risk management and regulation on conflicts of interests (including personal transactions of fund managers) were approved in 2009 but are yet to be implemented.

Core Principle 7: Supervision

Estonia has a fundamentally sound system of pension supervision, which fully or broadly complies with all the International Organisation of Pension Supervisors (IOPS) Principles of Private Pension Supervision, except Principle 5, on risk orientation, with which it is only partially compliant.

The FSA has high level and appropriate objectives set out in legislation, including objectives covering pensions supervision, which are translated into its published four-year strategy and annual working programme. It also has clear duties and responsibilities.

Legislation provides robustly for the independence of the FSA as an institution. While the Supervisory Board is not independent from the Government, this should not matter as it is limited to a strategic, budgetary and oversight role.

Legislation provides the FSA with extensive powers over all aspects of the way pension funds are run and generally provides a robust regulatory regime for the funds themselves. The FSA have identified gaps relating to pension fund conflicts of interest and risk management, which have been filled by new legislation and an advisory code of practice respectively.

Although the statutory objectives relating to pension funds are compliance orientated and there is no formal risk scoring system, many pre-requisites for risk-based supervision are in place. The FSA has analysed risks and this analysis underpins a four-year strategy and the annual working programmes, which also change to reflect major external developments. The FSA has been proactive in addressing identified risks in relation to pension fund conflicts of interest and risk management and has a good appreciation of the risk environment at the macro and fund level.

The FSA is required to be transparent in its operations and publishes an annual report and extensive industry data. It also publishes advisory guidelines which help interpret legislation and its four-year strategy. There is accountability to the Supervisory Board and to Parliament. The FSA does not, however, publish information on its internal procedures nor material, including circulars, intended to assist supervisory entities meet the FSA's expectations, although serious consideration is being given to publishing Frequently Asked Questions.

Legislation prescribes the governance rules for the FSA's Supervisory and Management Board's and is supported by a Code of Ethics, which inter alia covers staff conflicts of interest and compliance with which is checked and reported on by internal audit. There are also documented internal controls, checked by internal audit, and risk management procedures.

DESCRIPTION OF THE ESTONIAN PENSION SYSTEM

I. The Estonian State Pension System

In 1990 the Estonian Pension System was financially separated from the Soviet Pension System, followed by a benefit separation in 1991. In the 90s a number of reforms were initiated, such as introducing differentiation on the basis of length of service, increase of pension age and new determination of pension rights. After the year 2000 contribution related elements in the pension formula, equalization of pension age for men and women, and indexation of state pensions were introduced.

The state pension is run on a pay-as-you-go basis and has two components:

- A fixed rate national pension for all residents of Estonia with at least 5 years of residence and no requirements of prior work history

- Retirement, disability and survivor's pension based on former work input (social tax paid), and with a qualification period of 15 years of pensionable service in Estonia

The state pension coverage for Estonian retirees is around 97% of men and 99% of women. The majority of the remaining citizens receive pensions from some other country (mainly from the Russian Federation). Currently the retirement age for men is 63 and for women 60 years and 6 months. The retirement age for women will increase gradually, and reach 63 years in 2016.

The average annual retirement pension was 54,400 EEK (3,477 EUR) in 2008. The ratio of the average net pension to average net wage in the whole economy has in the last years been slightly over 40%. The average old age pension for women reaches nearly 95% of the average old age pension for men.

The pension/wage ratios with 40 years of contributions are presented in Table 1 below. In the future the differences ought to increase, as the pension levels gradually will depend more on salary level.

Table 1. Expected pension benefit (2008)

Wage	Annual pension (EUR)*	Net pension to individual net wage	Net pension to average net wage of the economy
50% average wage	3,278	78%	41%
Average wage	3,478	43%	43%
200% average wage	3,876	25%	48%

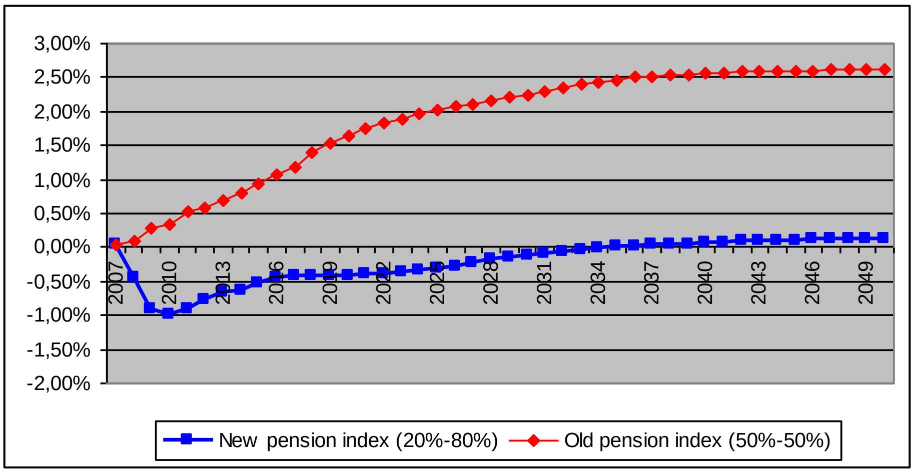
*Gross annual pension, but the tax threshold for pensions is rather high (in 2008 4,026 EUR per year) and currently less than 10% of pensioners pay income tax. Therefore these pensions basically equal to net pensions.

The State pension is financed mainly from the state pension part of social tax. The total social tax (paid by employers, self-employed or in some cases the state) is 33%, of which the state pension part is 20%. For those who have joined the mandatory funded system, 16% goes to the PAYG system and 4% to the funded pension. The expenses for national pensions and pension supplements are also, if necessary, covered by other revenues of the state budget.

The indexation introduced in 2002 was up until 2008 based on social tax and the increase in consumers price index with equal weights (50% and 50%) but was changed in 2007 to 80% and 20% respectively. According to the Pension Insurance Act, the Government of Estonia has to analyse the impact of the increase in pensions on financial and social sustainability, and every 5 years suggest any need of indexation changes to the parliament.

The new pension indexation and the slowdown of the economy have had a rather big impact on the state pension budget with more than 1% of GDP deficit in a short term. Although there are some reserves to cover it, there is a need for a supplementary funding to finance the deficit after 2-3 years. Concerning projections of the future development of the finances of the State pension system in Estonia, Figure 1 shows an unofficial budget balance graph made in 2008 and submitted by the Estonian delegation;

Figure 1. Budget balance graph (2008)



Source: Estonian response to the WPPP questionnaire on private pensions

Pension expenditure in Estonia was 5.4% of GDP in 2006 (EU25: 10.4%). Projections for public pension expenditure is that they are to decrease from 6.7% in 2004 to 4.2% in 2050, due to the shifting of part of the social security pension contributions into privately funded schemes. The total pension expenditure is projected to decrease from 6.7% of GDP in 2004 to 6.6% in 2050.

The main challenge for the state pension system is the financial sustainability and ensuring the adequacy of pensions. The replacement ratio from the state pension scheme will fall, mainly due to implementation of a mandatory privately managed system and the increasing proportion of retirees in the population. The funded pension is estimated to partly offset the decrease in the PAYG pension. However, the long term estimates for the combined benefits translate into a decrease in replacement ratios.

II. The Estonian Private Pension System

There were no private pension plans in Estonia prior to the start up of the current system. In 1997, a conceptual framework of pension reform was put in place. The main objectives of the new system were: ease of understanding, universality, equal treatment of different social groups, improving sustainability and adequacy, decreasing the shadow economy and lifting some frictions in the labour market. Given these goals, the government decided in favour of an individual account based, fully-funded scheme managed by competing private providers.

The Estonian private pension system is based on individual savings accounts, and composed of two components, a mandatory and a voluntary one.

Members have investment choice in both the mandatory and the voluntary system. Other than the obligation to contribute to the mandatory system, the other main difference between the two arrangements is that insurance contracts are also an option as a voluntary means for retirement savings.

The paid out pension benefits from the combined mandatory system (PAYG and funded) added together are taxed with the normal income tax rate, but start at a higher tax threshold 5,250 EEK (normal level is 2,250 EEK). Currently, the income tax rate is 21%. Regarding voluntary pension schemes, benefits are taxed with a reduced tax rate, currently 10%, and life annuities are tax-free.

For the voluntary arrangements there are also certain conditions in order to be eligible for income tax credits. The payment of benefits shall not commence before 55 years of age and the minimum period for participating at the pension scheme is 5 years. Contributions to voluntary pension funds and premiums paid under pension insurance policies of life insurance companies can be deducted from taxable income to the extent of 15% of the annual income. There are plans to make employer contributions to voluntary plans on behalf of employees more tax favourable than is the case today.

There are no occupational pension schemes in Estonia. Though they are not directly prohibited, there is no legal framework for this type of schemes.

III. The mandatory funded pension scheme

The mandatory funded pension scheme was launched in 2002 and is based on pension funds administered by private asset management companies. It is a defined contribution system where the amount of pension benefits depends on the total contributions over the working career and the yields of the pension funds. It is based on full-funding and covers only the risk of old age. However, to some extent it also serves as a survivors' pension, as the accumulated assets can be inherited.

The default portfolio in the mandatory funded system is a fixed income fund. If a pension fund manager is not chosen it will be determined by the registrar (Estonian Central Register of Securities) through the drawing of lots. The main administrators of mandatory pension funds are fund management companies.

Participation is mandatory for persons born in 1983 or later. Persons born prior to 1983 and participating in the labour market can join it on voluntary basis (possible until the end of 2010). The mandatory contribution rate is 6% of wages. The employee pays 2% from the gross wage (withheld by the employer) and the employer another 4% as a part of the social tax 20% pension contribution.[1]

With 40 years of service the expected net benefit-salary ratio is estimated to roughly 15-20% from the mandatory funded system. The available pay out options are lifetime annuity offered by insurance companies, programmed withdrawals and lump sum payments. The main payment form in the long run is expected to be a lifetime annuity, but with small fund assets due to a short accumulation period, lump sum payments and programmed withdrawals are the main types of benefit for the near future.

IV. The voluntary supplementary pension scheme

Possibilities for voluntary supplementary funded pension schemes were introduced already in 1998. The supplementary pension is also based on the full-funding principle and is offered through voluntary pension funds and personal pension plans offered by life insurance companies. In addition to pension insurance with investment risk, insurance companies offer policies with guaranteed interest rates and different combinations of insurance products.

The voluntary plans cover two social risks: old age and long-term disability. Regarding pay out of pension benefits the available options are lifetime annuity, temporary annuity, lump sum payments and other irregular payments from pensions. The voluntary pension funds cover approximately 8% of the workforce (53,000 members), while another 13% are covered by life insurers (85,000 members). Members can switch life insurer every three years.

V. Regulatory and Supervisory Framework

In Estonia in 2001, just before implementation of the mandatory funded system, three separate financial supervisory inspectorates (banking, securities and insurance) were merged into one Financial Supervision Authority (FSA).

The creation of an integrated financial supervisory authority provided a prerequisite for enhancing the effectiveness of supervision and ensuring its consistent quality in all parts of the financial sector. The reform included major changes in the financing of supervisory activities; The FSA's budget is fully financed by the financial industry.

The integration of all supervisory functions into one allowed the FSA to systematically, and without risk of supervisory arbitrage or dispersion of responsibility, control all actors in the private pension system, including management companies, ECDS (Estonian Central Depository for Securities), depository banks, stock exchanges, life insurance companies and public issuers.

The FSA is responsible for both the licensing and supervision of all types of funds, including pension funds. The Financial Supervision Authority shall supervise whether the activities comply with the requirements provided for, and legislation issued on the basis thereof, in the:

- Funded Pensions Act (main legislation)

[1] As a result of the crisis and in order to contain the deficit of the public pension system, the mandatory contributions to the funded pillar have been stopped as of 1 June 2009. They are expected to resume in 2011 and the lost contributions of the interim years may be made up with higher contributions (beyond the mandatory level) in later years.

- Securities Market Act and the Guarantee Fund Act
- Money Laundering Act, Terrorist Financing Prevention Act and the International Sanctions Act

The purpose of supervision is to ensure that the foundation or establishment, activities and dissolution of funds and management companies comply with Acts and other legislation, with particular attention to protection of the interests and rights of the shareholders or unit-holders of funds.

According to the latest IMF Financial Sector Assessment Programme country report on Estonia (No. 09/89, March 2009), there is some concern regarding current approach to supervision being insufficient to ensure that asset managers are acting in the best interest of the contributors. As the FSA has carried out some reforms since the IMF FSAP mission, these issues will be addressed in a separate report to be discussed at the December 2009 meeting.

VI. Main Indicators of the Private Pension System

Assets

Estonia has been able to develop a growing pension fund industry despite the relatively small size of the economy. Pension funds are likely to be one of the fastest growing segments of the financial sector in the future. The prospects of regular fresh inflows and rapid increase of private pension assets have created the basis for forming a capable and competitive asset management sector.

Institutional fund assets have increased almost 10 times during the last 6 years. The growth is mainly fostered by the rapid increase of equity funds and mandatory pension funds. By the end of 2008, there were 13 fund management companies in Estonia. In 2008, the number of investment funds registered in Estonia increased to 47. Currently, there are 19 mandatory pension funds operated by 6 management companies, 12 voluntary pension funds and 5 insurance companies that offer voluntary pension plans. In the voluntary pension system, about two third of assets are administrated by insurance companies and one third by fund management companies.

The total amount of assets accumulated in the Estonian private pension system is just slightly over 13,250 M EEK in 2008 (approximately 800 M € May 2009 exchange rate), with over 90% in the mandatory system. Table 2 below shows the development of the total assets in both mandatory and voluntary funds, as well as debt and equity mutual funds (excluding pension funds). By June 2008, the mandatory pension funds had overtaken equity mutual funds in assets under management. Pension fund assets represent more than 5% of GDP (EEK 248.1 billion in 2008).

Table 2. Net Assets of mutual funds and pension funds

(millions EEK)

Type of funds/Date	31.12.2004	31.12.2005	31.12.2006	31.12.2007	31.03.2008	30.06.2008
Debt funds	4.818	5.300	5 .096	4.835	5.079	5.169
Equity funds	3.390	7.668	13.569	17.345	12.914	11.914
Mandatory pension	2.484	4.655	7.436	10.994	11.254	12.188
Voluntary pension *	187	453	763	1.106	1.018	1.064
Total	10.879	18.076	26.864	34.280	30.266	30.335

*The voluntary pension assets above are through pension funds. Assets through insurance companies are not included. At www.pensionikeskus.ee the statistics for June 2009 shows total pension insurance reserves at just above EEK 2 bn.

Asset Allocation

The current quantitative investment limitations for mandatory pension funds are;

- 75% equity (changed from 50% in 2009), of which only 50% may be directly in shares (up to 75% in the case of equity funds);
- 40% real estate and real estate funds (changed from 10% in 2007);
- 50% venture capital funds (changed from 30% in 2007);
- 30% outside the EEA or OECD area.

There are currently three main types of mandatory pension funds that members can choose from, distinguished by their equity exposure. A new fund with a maximum 75% equity exposure will be introduced in 2010. The current three investment options are the following:

- Fixed income funds ("Conservative")
- Mixed pension funds, with a maximum of 25% of assets in equity ("Balanced")
- Equity pension funds, with a maximum of 50% of assets in equity ("Progressive")

In voluntary pension funds there are no investment restrictions regarding asset classes.

In June 2009 (source www.pensionikeskus.ee, statistics) 76% of the total assets in the mandatory pension system were invested in the Equity pension funds, 17% in Mixed pension funds and 8% in Fixed income funds. Two Swedish and a Danish bank are the largest fund managers:

Swedbank Investment funds (brand "Hansa") with 51% market share

SEB Investment funds, with close to 28% market share

Danske Capital AS (Brand "Sampo Pank"), with 13% market share

In the voluntary system the market leaders are Swedbank, with over 65% market share, and SEB, with 26% market share (source www.pensionikeskus.ee, statistics June 2009). Over 50% was invested in 100% equity funds, close to 25% in mixed funds with over 50% in equities, and the remaining 25% in mixed funds with 35% or less in equities.

Regarding voluntary pensions offered by insurance companies, there are five providers available, and the market leader is Swedbank with 40% of total assets (reserves), followed by SEB and Seesam Life (owned by Vienna Insurance Group), with around 20% market share each. Total insurance assets were just above EEK 2 bn, and the number of insurance contracts close to 85,500 (source www.pensionikeskus.ee, statistics June 2009).

In Table 3 below the geographical allocation of mandatory pension fund assets is presented. Approximately 88% of the total assets are invested in Europe (Russia excluded). Investments in Estonia are around 28% of total assets. There are no such statistics regarding voluntary pension assets, but they are so far relatively small (see table 3 above).

Table 3. Geographical breakdown of mandatory pension funds

(by country, percentage of total assets)

	30.09.2008	31.12.2007	31.12.2006	31.12.2005	31.12.2004
United States	3%	1%	3%	4%	10%
Austria	5%	4%	4%	2%	2%
Belgium	0%	0%	1%	1%	3%
Estonia	28%	24%	19%	15%	14%
Netherlands	2%	1%	3%	2%	3%
Croatia	0%	0%	1%	2%	5%
Ireland	3%	2%	0%	1%	4%
Italy	0%	0%	2%	2%	1%
Cayman Islands	2%	0%	0%	0%	0%
Lithuania	1%	1%	1%	5%	5%
Luxembourg	18%	24%	17%	11%	8%
Latvia	4%	3%	2%	3%	2%
Poland	2%	2%	4%	5%	5%
France	8%	9%	11%	11%	6%
Sweden	3%	1%	1%	2%	2%
Germany	3%	2%	5%	5%	5%
Finland	5%	9%	7%	5%	5%
United Kingdom	2%	3%	2%	1%	1%
Switzerland	0%	1%	1%	3%	2%
Denmark	1%	1%	1%	2%	3%
Hungary	1%	1%	3%	4%	6%
Russia	3%	4%	3%	4%	2%
Not specified	3%	3%	3%	4%	1%
Total	100%	100%	100%	100%	100%

In Table 4 below the allocation between asset categories in the mandatory system is presented. The relatively recent lifting of the investment limitations mentioned above may result in a change of asset allocation in the future, and different types of funds.

Table 4. Total assets of mandatory pension funds

(by asset category, percentage of total assets)

Pension fund/date	30.09.2008	31.12.2007	31.12.2006
Equities	10%	10%	15%
Units of other equity funds	22%	30%	25%
Units of other investment funds	22%	21%	12%
Money market instruments	5%	4%	3%
Other bonds	26%	26%	41%
Term deposits	9%	7%	1%
Bank accounts	5%	1%	2%
Derivatives	0%	0%	0%
Real estate	0%	0%	0%
Other assets	1%	0%	1%
Total	**100%**	**100%**	**100%**

Investment returns

Table 5 below shows the nominal pension fund investment returns "from beginning", which means average yearly return from the establishment of the fund. For most mandatory pension funds the starting date is 2002. At the end of 2008, four new mandatory pension funds (Nordea and SEB Optimaalne funds) were established.

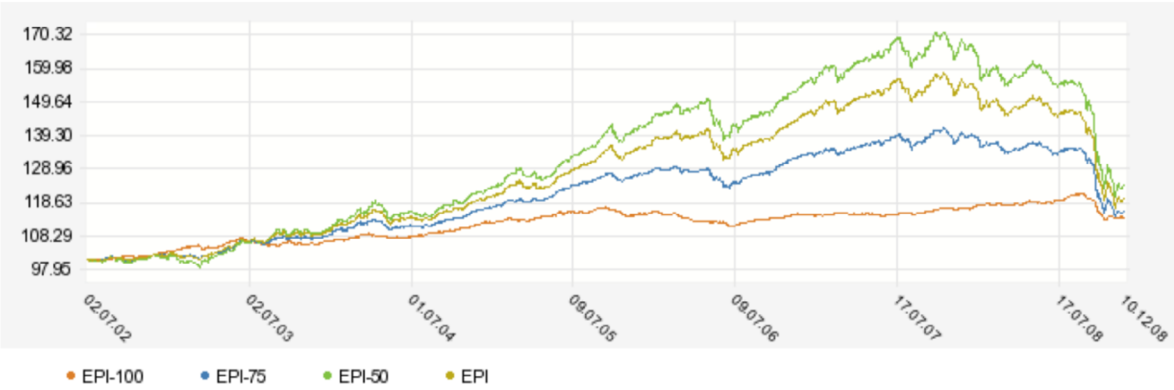
Table 5. Investment performance of mandatory pension funds (until December 2008)

	Annualised, nominal rate of return %				
Pension fund	**3m**	**6m**	**12m**	**36m**	**From beginning**
ERGO Rahulik Pensionifond	-1.47%	0.82%	1.37%	0.8%	2.61%
ERGO Tuleviku Pensionifond	-19.96%	-24.28%	-28.72%	-5.84%	2.92%
Hansa Pensionifond K1	-11.5%	-9.57%	-8.26%	-2.13%	1.17%
Hansa Pensionifond K2	-14.78%	-15.83%	-18.27%	-3.57%	2.25%
Hansa Pensionifond K3	-19.85%	-23.16%	-27.6%	-5.39%	3.45%
Kohustuslik Pensionifond Sampo Pension 25	-3.23%	-4.73%	-8.35%	0.44%	3.5%
Kohustuslik Pensionifond Sampo Pension 50	-5.4%	-8.3%	-14.54%	0.44%	5.2%
Kohustuslik Pensionifond Sampo Pension Intress	-0.08%	1.14%	1.05%	2.14%	2.46%

	Annualised, nominal rate of return %				
Pensionifond LHV Dünaamilised Võlakirjad	-4.31%	-3.79%	-2,00%	1.63%	3.51%
Pensionifond LHV Kvaliteetsed Võlakirjad	-4.63%	-3.86%	-2.61%	1.02%	2.4%
Pensionifond LHV Maailma Aktsiad	-15.61%	-18.86%	-22.13%	-1.07%	5.18%
Pensionifond LHV Tasakaalustatud Strateegia	-10.05%	-10.59%	-13.09%	-0.35%	2,00%
Pensionifond LHV Uued Turud	-16.45%	-20.18%	-23.23%	-1.02%	2.5%
SEB Konservatiivne Pensionifond	-2.88%	-0.07%	1.97%	0.59%	2.32%
SEB Optimaalne Pensionifond	0.00%	0.00%	0.00%	0.00%	0.18%
SEB Progressiivne Pensionifond	-23.08%	-26.92%	-30.88%	-5.8%	2.79%
Nordea Pensionifond A	0.00%	0.00%	0.00%	0.00%	5.04%
Nordea Pensionifond B	0.00%	0.00%	0.00%	0.00%	2.53%
Nordea Pensionifond C	0.00%	0.00%	0.00%	0.00%	0.22%

The funds shown in Table 6 have a different asset allocation and some have different starting dates. Therefore it is difficult to comment on the overall performance of the mandatory pension fund system. Figure 2 shows the cumulative performance of the different fund types presented as an index. The index is set at 100 in July 2002.

Figure 2. Performance index for mandatory pension funds (July 2002 = 100)



EPI-100: 0% equity pension funds *EPI-75: 25% equity pension funds*
EPI-50: 50% equity funds *EPI: total pension funds*

The voluntary pension funds were established on different dates, so the column "from beginning" in table 6 is with reference to different starting points, as presented below in Figure 3:

Figure 3. Year of establishment of voluntary pension funds

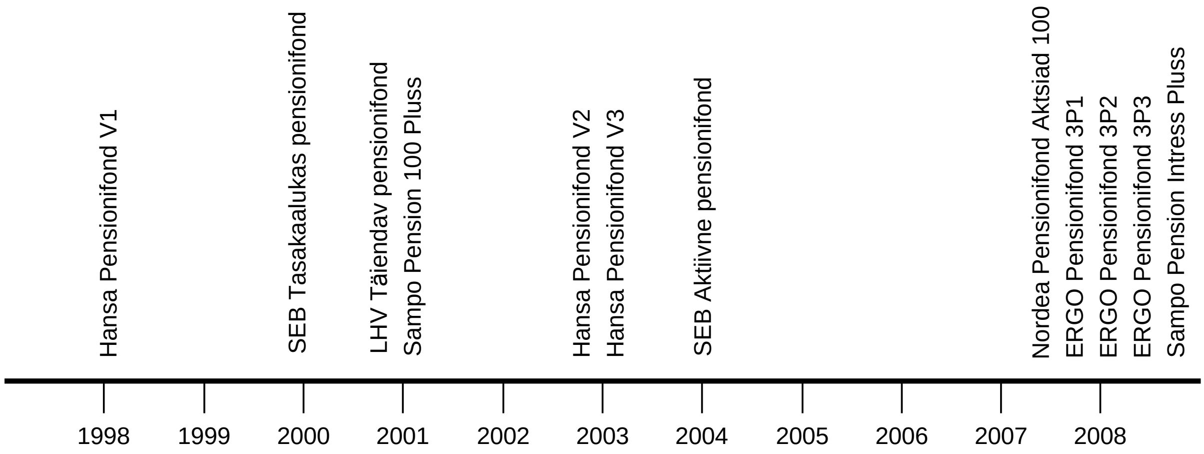


Table 6. Investment performance of voluntary pension funds (December 2008)

Pension fund	Rate of return %				
	3m	6m	12m	36m	From beginning
Nordea pensionifond Equity 100	-	-	-	-	10.51
Hansa Pension V3	-33.4	-42.68	-51.6	-12.56	2.61
Hansa Pension V2	-25.47	-31.81	-37.8	-8.71	1.24
ERGO pensionifond 3P1	-	-	-	-	1.43
ERGO pensionifond 3P3	-	-	-	-	1.23
LHV Täiendav pensionifond	-23.83	-30.49	-35.27	-6.53	2.71
Sampo Pensionifond	-8.41	-13.43	-21	-0.74	6.1
SEB Ühispanga Aktiivne Pensionifond	-35.83	-43.78	-50.24	-10.59	-1.57
SEB Ühispanga Tasakaalukas Pensionifond	-16.86	-20.69	-23.94	-2.64	4.93
ERGO pensionifond 3P2	-	-	-	-	1.22
Hansa Pension V1	-19.95	-22.52	-25.3	-5.71	4.16

Fees

There are four types of fees a pension funds can charge:

- The unit issue fee, which is calculated as percentage of the net asset value of issued units. There is a limit of 2%;

- The unit redemption fee is calculated as percentage of the net asset value of redeemed units and it is limited to 1%. For members of mandatory pension funds who are close to retirement (retirement age less than 5 years away) there is no redemption fee;

- The annual management fee is determined as a proportion of the market value of the assets of the pension fund. For the mandatory funds there is a 2% limit (1.5% for funds with no equities)

- Custodian's charges are only charged in the voluntary system. In the mandatory system they are covered by the pension fund management company. Depositary's charges are calculated daily as percentage of net asset value (units' net asset value will decrease). The average charge is 0.2%.

Costs that are related to transactions and loans are deducted from pension fund's net asset values. Usually there is a limit that the management fee, costs related to transactions and loans cannot be higher than 3% of net asset values of the fund. The custody charges in the voluntary system are also included in this limit.

There are some planned changes in the fee charges in the years to come which are now written into law. Starting with the year 2010, mandatory pension funds must use a regressive scale for the management fee. For every 100 million EUR of assets, the management fee must be reduced with at least 10%. If the management fee is 0.5% or lower there is no demand for regression of the management fee. For funds with no equities the limit of the management fee will be 1.2%. From 2011 pension funds will not be able to charge the unit issue fee.

There are concerns about the level of competition in the mandatory pension fund sector. Fees paid to managers have been virtually unchanged since the outset. It can also be noted that the administration costs in relation to the total fund assets for the mandatory system are higher than for the (significantly smaller) voluntary system. However, it should be pointed out that the possible differences in asset allocation also could have an impact on the overall administration costs. As of 31 December 2007 the administration (operating) costs were:

- 148.6 million EEK or 1.34% of their asset volume for the mandatory system

- 14.6 million EEK or 1.32% of their asset volume for the voluntary system

Table 7. Fees for mandatory and voluntary pension funds

Mandatory pension funds	Unit issue fee	Management fee	Unit redemption fee
Swedbank Pensionifond K1	1.50%	1.19%	1%
Swedbank Pensionifond K2	1.50%	1.49%	1%
Swedbank Pensionifond K3	1.50%	1.59%	1%
SEB Konservatiivne Pensionifond	1%	1.20%	1%
SEB Optimaalne Pensionifond	1%	1.30%	1%
SEB Progressiivne Pensionifond	1%	1.50%	1%
ERGO Pensionifond 2P1	0%	0.75%	1%
ERGO Pensionifond 2P2	0%	1.25%	1%
Kohustuslik Pensionifond Sampo Pension Intress	1%	1.20%	1%
Kohustuslik Pensionifond Sampo Pension 25	1%	1.75%	1%
Kohustuslik Pensionifond Sampo Pension 50	1%	1.85%	1%

Mandatory pension funds	Unit issue fee	Management fee	Unit redemption fee
Pensionifond LHV Maailma Aktisad	1%	2%	1%
Pensionifond LHV Uued Turud	2%	1.88%	1%
Pensionifond LHV Tasakaalustatud Strateegia	2%	1.63%	1%
Pensionifond LHV Dünaamilised Võlakirjad	1%	1.20%	1%
Pensionifond LHV Kvaliteetsed Võlakirjad	1%	1.20%	1%
Nordea Pensionifond A	0%	1.60%	1%
Nordea Pensionifond B	0%	1.50%	1%
Nordea Pensionifond C	0%	1.10%	1%
Voluntary pension funds			
Swedbank Pensionifond V1	1.50%	1.20%	1%
Swedbank Pensionifond V2	1.50%	1.30%	1%
Swedbank Pensionifond V3	1.50%	1.40%	1%
SEB Aktiivne Pensionifond	1%	1.50%	1%
SEB Tasakaalukas Pensionifond	1%	1%	1%
Vabatahtlik Pensionifond Sampo Pension 100 Pluss	1%	1%	1%
Vabatahtlik Pensionifond Sampo Pension Intress Pluss	1.50%	0.95%	1%
LHV Täiendav Pensionifond	1%	1%	1%
Nordea Pensionifond Aktsiad 100	1%	1.50%	1%
Ergo Pensionifond 3P1	1%	1%	1%
Ergo Pensionifond 3P2	1%	1.25%	1%
Ergo Pensionifond 3P3	1%	1.25%	1%

Coverage

The total number of employed persons in Estonia is approximately 650 000. In 2008 there were over 575 000 members in the mandatory system, two thirds of which were contributing to the scheme. This means that close to 60% of all employed persons are currently paying contributions to mandatory pension funds.

Table 8. Percentage of employed individuals in the mandatory funded system, according to age intervals

Age interval	Percentage
20-34	88%
35-50	76%
51-66	24%

About 53% of members of mandatory pension funds are women and 47% are men. About 65% of women who could join the mandatory funds have done so (both on voluntary and mandatory basis), while 62% of men have done so. There are no statistics provided for the voluntary pension system.