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DEVELOPMENTS IN THE ESTONIAN PENSION SYSTEM

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Abstract

This paper provides a description of the reform of the Estonian pension system with a focus on the operation of the new funded scheme. One interesting aspect of the Estonian funded scheme is that it involves centralised contribution collection, account management and record keeping. The Tax Board collects contributions while the Central Registrar for Securities houses the central database where all information on members, their choices, and transactions is gathered. The mandatory pension funds are also protected with a guarantee fund that covers losses in the event of bankruptcy of the fund manager or losses generated by violations of regulations. After one year of operation of the industry, the fund industry shows patterns that are typical in other countries that have introduced such schemes, in particular a high degree of market concentration and investment portfolios invested predominantly in bonds.

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1. Background

1.1 Why did Estonia need pension reform?

There is no mystery why Estonia opted for pension reform rather than staying in the old single-pillar PAYG system. Our country faced the same problem as most of Western society – a changing demographic structure. The proportion of contributors is diminishing while the proportion of retirees keeps increasing. The four main reasons for this trend are the following:

- Fertility rates are low (around 1.3 children per woman);
- Average age is increasing (by approximately 1 year every 10 years);
- Employment rates have been decreasing;
- The effective pension age has decreased (as people have a chance to retire earlier, they tend to do so; options for early retirement should thus be eliminated).

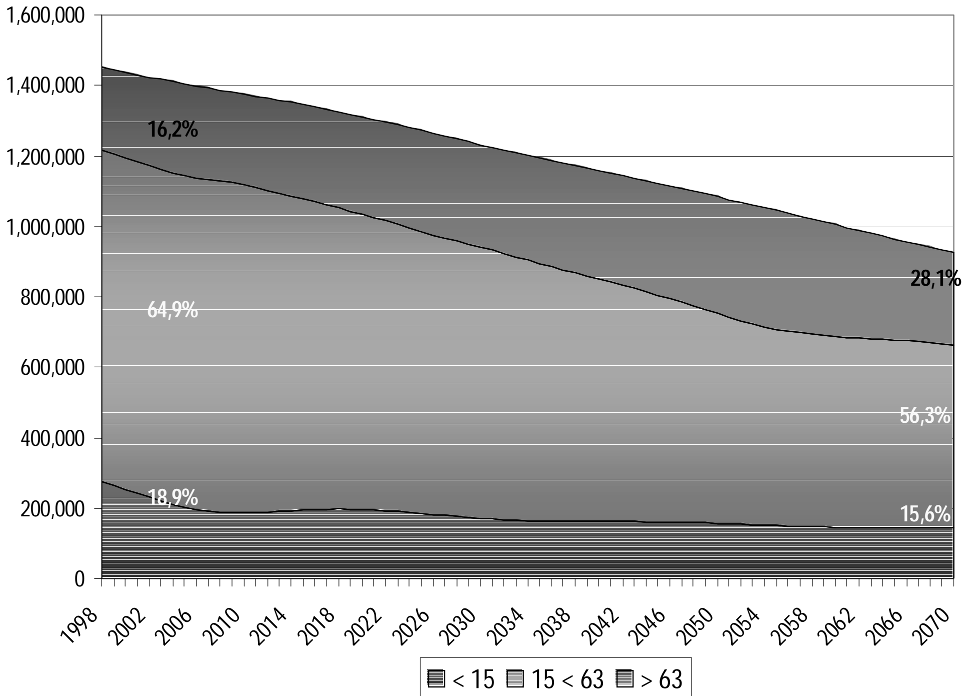
The graph below shows projections of Estonian population dynamics.

1.2 A reformed pension system – what led us there?

The first traces of state pensions in Estonia were established at the beginning of the last century. In 1920, pensions were assigned to veterans of the War of Independence as well as persons appointed for pensions by the Russian czarist system. The Pensions Act was adopted in 1936, aggregating separate legal acts in the pension field. There also existed voluntary pension insurance; in addition, some enterprises paid pensions or subsidies to their long-term employees. In 1939, it was decided to establish a general pension system, but just a year later a Soviet social insurance regime was introduced.

After gaining independence, Estonia needed to make quick changes to the social protection system it had inherited. In the early 1990s, Estonia was still in the Russian ruble zone, where inflation rates were extremely high (160% during the first two months of 1992). That made it impossible to implement the new Pensions Act, adopted the same year. It became pointless to calculate pension on both length of service and individual wages. Since 1993, Estonia has followed a balanced state budget policy, enabling it to pay pensions as permitted by budget discipline. Thus, at the beginning the real value of pensions dropped quite low. However, a comparison of average net wages to average pensions shows that the ratio has remained almost unchanged (38,8% in 1993, 42,6% in 1996, and currently 37%). The ratio of state pension payments to GDP has remained nearly constant, showing a small declining tendency.

Figure 1



Source: Central Statistical Bureau

In 1993, the state Living Money Act was adopted, determining pension payments.

Intense debate has arisen since independence on how best to reform the pension system. A Social Insurance Reform Committee was set up to propose different options for change and make relevant analysis. It was composed of the ministers of Finance and Social Affairs as well as many other high-ranking experts. The solutions offered were summarized in the Pension Reform Concept Paper approved by the government in 1997. It set the basis of the present three-pillar system. The paper resulted in a draft act to change the state pillar being withdrawn from Parliament. Work on new legislative acts to reform or set up pension pillars was begun.

Table 1. Ratio of pension contributions to GDP.

Year	'93	'94	'95	'96	'97
Pension payments	1439.6	1970	2865.6	3966.5	4619.3
GDP	21826.3	29866.7	40896.8	52442.8	64044.7

Year	'98	'99	'00	'01	'02
Pension payments	5205.3	6431.9	6473.8	6621.2	7282.7
GDP	73537.9	76327.1	87378.5	97894.5	108023.6
Ratio	7.08	8.43	7.41	6.76	6.74

Source: Ministry of Finance

1.3 The features of a reformed system

The reformed pension system resides on three pillars:

- The first, or state pension pillar, based on PAYG, was reformed in 1998. Some new features were added: individual collections are taken into account, pensions are indexed and the pension age was gradually raised to 63 for both men and women;

- The second, or mandatory funded pillar, was legislated in 2001 and began operating in 2002;

- The third, or voluntary funded pension pillar, was also legislated in 1998, allowing investments in both special third-pillar insurance contracts and voluntary pension funds. About 8% of contributors have joined that pillar.

The three pillars together aim to provide people with optimum pensions. They neutralize the risks that jeopardize the pillars individually (demographic, investment, political risks, etc.)

2. The State Pension Pillar

2.1 The state pension pillar – what is new?

A new State Pension Insurance Act was adopted in 1998 and fully implemented on 1 April 2000. The new Social Tax Act, which also regulates the state pillar, was passed in April 1998. Many new features were introduced to the state pension system:

- The pensionable age is being raised to 63, for men and women, by 2016;
- There is a provision for early retirement, with pension reduced by 0.4 % each month (4.8% each year) of early retirement;
- Another provision allows deferred retirement, with a 0.9% monthly increase (10.8 % yearly increase) in pension payments;
- A new pension formula has been introduced, composed of three units: the basic unit, the length-of-service unit, and the insurance unit;
- Calculated or paid social tax (the basis for the insurance unit) is now individually recorded, and a relevant register established;
- The option is provided of accumulating pension at retirement from taxable earnings;
- Criteria have been established for pension eligibility and length of pension insurance for survivors and the incapacitated.

State pension benefits are of two types: employment-related and national pensions. The first group comprises old-age pensions, workers' disability pensions and survivors' pensions. The past state pension for low-income earners may appear generous, as the amount did not depend on previous earnings. The process changed in 1999, when individual contributions began to be taken into account, moving the benefits system toward an earnings-related (individual responsibility) concept. The national pension guarantees a minimum income for those not entitled to employment-related benefits. Since both the economically active and the non-active are thus covered, overall coverage of state pensions is almost 100%.

2.2 *Financing of the state pillar*

First-pillar financing comes from the pension insurance part of the social tax, paid by the employer. The social tax is 33% of gross wage, with 13% going for health insurance and 20% for state pensions. There is no income ceiling for contributions or benefits, except in the instance of the self-employed, in which case the ceiling for both contributions and benefits is 15 times the minimum salary.

As mentioned, contributions paid on behalf of each employee are accounted individually to create a linkage between each individual's contributions and benefits. Contributions are calculated into coefficients, where the individual contribution is divided by the average during the year.

Contributing to the system is compulsory. The minimum contribution for a full-time worker is based on the minimum salary, which is EEK 2160 (EUR 138.5) a month. For part-time employees and the self-employed the minimum contribution is based on minimum earnings equal to EEK 700 (EUR 44.9) a month.

The national pension scheme is financed from the general state budget. National pensions are flat-rate benefits.

2.3 *Pension benefits*

The general old-age pension is payable irrespective of engagement in any gainful activity. However, an early-retirement old-age pension, granted up to three years before attaining the general pension age, is not paid to persons who are employed (earning income subject to social tax on the basis of an employment contract, service contract or civil law contract, or self-employed). The early-retirement old-age pension, once granted, is retained after attaining pension age and is not recalculated to a normal old-age pension.

The old-age pension consists of three additional elements:

1. the base amount;

2. the length-of-service component, calculated as the pensionable length of service multiplied by the value of one service year;

3. the insurance component, calculated as the sum of annual pension insurance coefficients multiplied by the value of an annual coefficient.

The base amount is the same for all retirees. As a rule, the amount changes only due to yearly indexation. There have also been exceptional pension raises (as happened this year).

The length-of-service component was calculated for periods up to 31 December 1998. Since 1 January 1999, the insurance component has been calculated on the basis of annual pension insurance coefficients, taking into account only the amounts of social tax registered after that date. Thus, for persons who ceased working by 31 December 1998, the old-age pension is the sum of the first two components, whereas for persons who began their working careers after 1 January 1999, the old-age pension will be a sum of only the first and third components.

The value of the monthly pension depends on two factors: the number of years of pensionable service and the sum of pension insurance coefficients, plus two universal factors: the cash value of the base amount and the cash value of the coefficient. One year of pensionable length-of-service has the same value as the pension insurance coefficient 1.0.

According to the State Pension Insurance Act, the old-age pension shall not be less than the national pension rate. The latter thus serves as a guaranteed minimum for the old-age pension.

The Funded Pensions Act introduced the taxation of pensions. From 2002, state pensions have constituted taxable income. For taxing purposes, first- and second-pillar benefits are summed up. However, that pension amount which is less than three times the non-taxable minimum is not subject to taxation. Accordingly, a 26% income tax is payable only on the part of pension exceeding the three times non-taxable minimum. If the pensioner has no other income, an additional non-taxable income rate applies, to which every person is entitled. In conclusion, tax is paid above sums exceeding four times the non-taxable income level. Currently, only a very small group of people actually pays taxes on their pensions, primarily former members of Parliament. No social security contributions are deducted from state pensions.

Increasing pension amounts had been largely a political matter. With the introduction of the new pension formula, Parliament fixed the base amount of pensions in the state budget, while the government determined the value of one year of pensionable length of service and of an annual pension insurance coefficient depending on budgetary constraints. Beginning in April 2002, pensions have been indexed annually on 1 April. The index is based 50% on the increase of the CPI and 50% on the increase of social tax revenues. The national

pension rates and all components of the old-age pension are calculated by multiplying their values by the index.

3. Mandatory Funded Pension

3.1 The mandatory funded pension – for whom and how much?

The term "mandatory" is used to describe the second pillar, though at present the second pillar is mandatory only for new labor-market entrants – contributors born in 1983 or later. People born from 1942 to 1982 can choose whether to join the system or not. But their time to decide is limited -- by law, the upper age limit for choosing the second pillar is reduced by a year each year, beginning in 2004. The right to join the system goes down linearly until 2024 (see the table for a precise timetable). People older than 60 are not eligible to join the mandatory funded pillar. Contributions are not counted from social taxes paid by the state for certain groups (students, women on maternity leave, etc.). Also, sole proprietors whose only revenues are business-derived income cannot contribute to the mandatory funded pillar. In the new draft of the Funded Pensions Act, the self-employed will no longer be exempted.

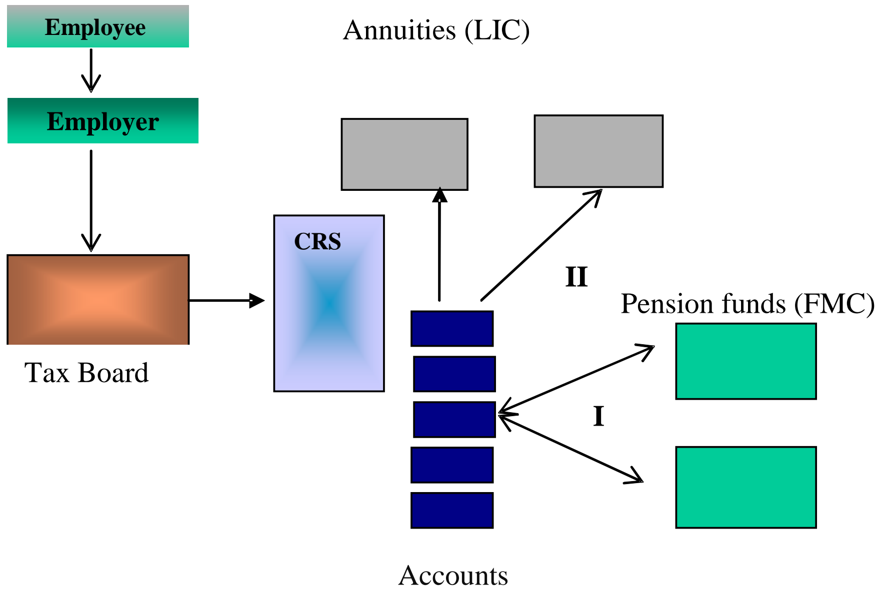
People who have joined the second pillar are obliged to pay an additional 2% of their gross wage (withheld by the employer) to a chosen pension fund. In addition to the 2%, 4 percentage points of the 33% social tax are paid by the employer. In sum, 6 percent of the employee's gross wage is invested into the second pillar. At the same time, due to lower contributions to the state pension pillar, the state pension for members of the funded system is reduced (although somewhat less than proportionally).

3.2 The mandatory funded system – how does it work?

The logistics of the system are not complicated, as shown in Figure 2 below. An employee's taxes and mandatory pension contributions are withheld by the employer, who declares them and sends the declarations and the payments to the Tax Board. The latter checks the data on taxes paid and sends the information with the relevant sums (the 6% contribution) to the Central Registrar for Securities, or CRS. The CRS houses the central database where all information on persons, their pension choices, payments, and so on, is gathered. When money arrives, the CRS issues shares in the amount of the person's contribution to the chosen fund. In the case of mandatory participants, if they have not signed the contract to join the second pillar but tax has been withheld for them, the CRS directs the money to a randomly chosen pension fund. It is distributed among conservatively managed pension funds in alphabetical order.

In the contribution period sums are invested only in pension funds. In the pay-out phase, pensions as a rule are paid from insurance companies. In certain cases (described below) it is possible to withdraw money from pension funds as programmed withdrawals or even in lump sums.

Figure 2



In creating the system, experts aimed for means that would ensure a reliable, efficient and smooth-functioning system. The Tax Board was good at collecting taxes (Estonia's tax-collection rate is as high as 98%). At the same time, the CRS, with its proven expertise in issuing shares and working with financial institutions, had the skills and motivation to work in the mandatory funded pillar network. One important early element in the system was to balance confidentiality against the need of fund-managing companies to know who their clients are. In devising strategies, two countries -- Poland and Sweden -- had recently implemented the second pillar with quite different reform options and results. Poland witnessed extremely high marketing costs and had problems with sales personnel providing misleading information to the public. Sweden, meantime, devised a system in which information on clients was limited to fund managers, thus cutting sales expenses. In the final stage of drafting the law in Estonia, market players lobbied successfully for disclosure of this previously restricted data. They argued that targeted marketing strategies

would help lower costs and possibly increase the total number of switchers, which is tempting for the state. The use of sales personnel was allowed, which was of keen interest to insurance companies with their strong networks of agents.

In reality, the predictions of lower costs and hordes of satisfied switchers did not entirely materialize. First, there were certain legal uncertainties regarding sales personnel and the requirements for truth in advertising (there was a legal prohibition, however, on promising any level of future returns from the fund, and a ban on dissemination of misleading information). Nevertheless, there were many problems with misleading or inaccurate advertising, reversing contracts that by nature are irreversible, and so on. Drafters of a new version of the Funded Pensions Act are attempting to resolve these questions.

3.3 The second pillar -- terms and conditions

Many restrictions apply to the second pillar, but it was also made as flexible as possible to apply to individual requirements. Of key importance to the system is that once you have chosen the second pillar you cannot reverse your decision. To ensure the stability of the system, it is important for people to consider the choice seriously, and not be enticed by salespersons' one-time offers of Mediterranean resort vacations or colorful T-shirts. It was surprisingly common for people to respond positively to several offers from fund management companies. Even some highly educated people wondered whether to choose Fund A, which offered a small starting sum for your pension account, or Fund C, which provided some other service at lower prices.

Collections can be allocated to only one fund at a time. Still, funds can be switched (contributions flow to another fund) or changed (shares of one fund are changed for shares of another). These actions are subject to limits by time and quantity of shares. Both kinds of changes are allowed only once a year. If the relevant application is submitted by 1 November of a given year, the fund or shares are changed by the CRS on 1 January of the following year.

One very important feature for many people is that shares are inheritable, though only to physical persons. The inheritor can withdraw shares from the fund as cash, paying income tax at the 26% rate, or add shares to his or her personal account and take it as a normal pension benefit upon retirement. Accumulations in the payout phase are not inherited as shares of a pension fund. In the case of an insurance agreement in the payout phase, one can choose the contract with a guarantee period of at least five years. During that period, benefits are paid to the beneficiary specified in the contract.

There are also minimum guarantees in the system. Different options were considered but this one was chosen for two reasons:

1. People needed some sort of guarantees to provide confidence, after negative experiences in the past with equity market crashes and financial institutions' bankruptcies;

2. Low guarantees were chosen to keep system costs low – otherwise, the very need for the funded system would have become questionable.

Pension funds are not required to buy insurance. Pension fund management companies that manage mandatory pension funds are, however, obliged to make quarterly contributions to a Pension Guarantee Fund, a sub-fund of the Guarantee Fund. In the event of bankruptcy, or losses generated by violations of investment restrictions set by law or pension fund rules, the following steps are taken to cover members' losses:

1. The pension fund management company's mandatory participation in the pension fund is used to cover the loss;

2. The pension fund management company's own capital is used;

3. The Guarantee Fund covers the loss to scheme participants;

4. The state has the right to guarantee a loan taken by the Guarantee Fund if needed.

The first EUR 10,000 is totally covered for investors; above that level, 90% of losses are covered.

Special attention has been paid to the supervision of funds, which normally is more important than providing certain guarantees. The main functions of supervision are stated in Appendix 2.

The fee structure of funds is set up so as to keep them as low as possible and promote competition among funds (Appendix 3).

3.4 Second-pillar benefits

Certain requirements have been set for receiving second-pillar benefits. A person is entitled to receive payments only after fulfilling all the three conditions named below.

1. The person has attained the old-age pension age;

2. State-pillar benefits or any other pensions due the person by law have started being paid to the person (except for foreigners);

3. At least five years have passed since the person subscribed to the funded pension.

Nevertheless, under the law first payments from Pillar 2 funds will be made after 1 January 2009. Thus, the person will not be able to receive the funded pension before the state pension. However, if he or she has decided to take state pension benefits but continues to work, the person may postpone receiving funded pension benefits.

As a rule, to receive a mandatory funded pension, a person entitled to such pension should enter into an insurance contract for a mandatory funded pension with an insurer chosen by this person. Upon entering into a contract, the person pays the insurer, as a single premium, the redemption price of all the redeemed units of the mandatory pension funds that belong to the person. The transfer is not made by the person himself. Upon request, the CRS converts units in a person's account(s) into cash and then transfers the sums electronically to an insurance company designated by the person.

Payments are made in the form of annuities, that is, periodically payable amounts based on the insurance contract. They can be of equal or increasing amounts, payable at least once a quarter.

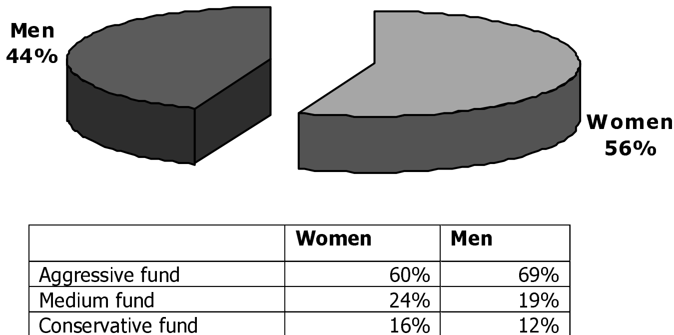
If the monthly annuity exceeds three times the amount of the national pension, the person is entitled to choose periodic payments from the pension fund without entering into an insurance contract to the limit of the amount exceeding three times the national pension amount. If the monthly annuity -- that is, the amount of monthly periodic payments -- is less than one-fourth the national pension, the person is entitled to receive periodic payments from the pension fund to the limit of one-fourth the national pension per month. If the total units are less than twice the national pension rate, the person may request the redemption of all units as a single payment.

3.5 The second pillar in action

Parliament passed the Funded Pensions Act in September 2001. The first round of switching was to have started 1 April 2002, but legal and political questions delayed the launch to 3 May 2002, when most of the funds from which people could choose were registered.

Six fund management companies received licenses to hold second-pillar pension funds, and 15 funds were registered. By law, every financial management company has to have a fund permitted to invest only in fixed-income instruments, and not in stocks. Additionally, such companies can operate funds that invest either up to 25% or up to 50% in stocks. The latter has proved most popular among second-pillar members (see the graph below):

Figure 3: Statistics on Choice of Fund



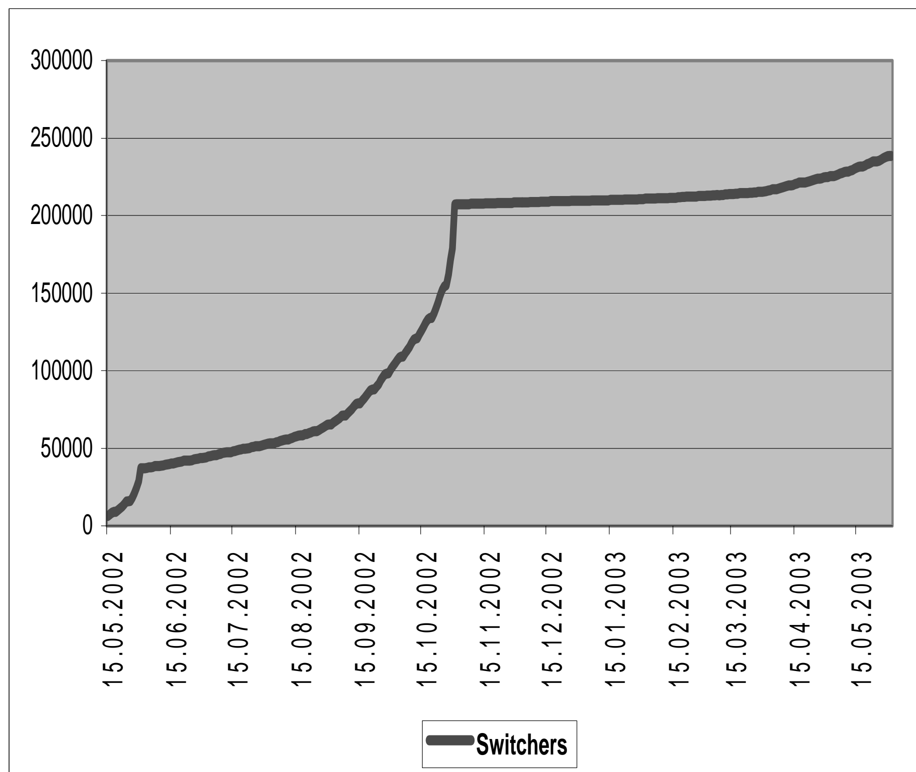
	Women	Men
Aggressive fund	60%	69%
Medium fund	24%	19%
Conservative fund	16%	12%

Source: Ministry of Finance

The first round of switching to the second pillar ended May 31, with an unexpectedly high number of members: 37,055 people had applied for it, and there were about 3,000 contributors for whom the system was mandatory but who had yet to sign a contract.

The second round in 2002 ended Nov. 1. By the end of September, the total number of second-pillar members had reached 94,000. But the ultimate total came as a surprise for most: 207,200.

Figure 4. Number of switchers in dynamics

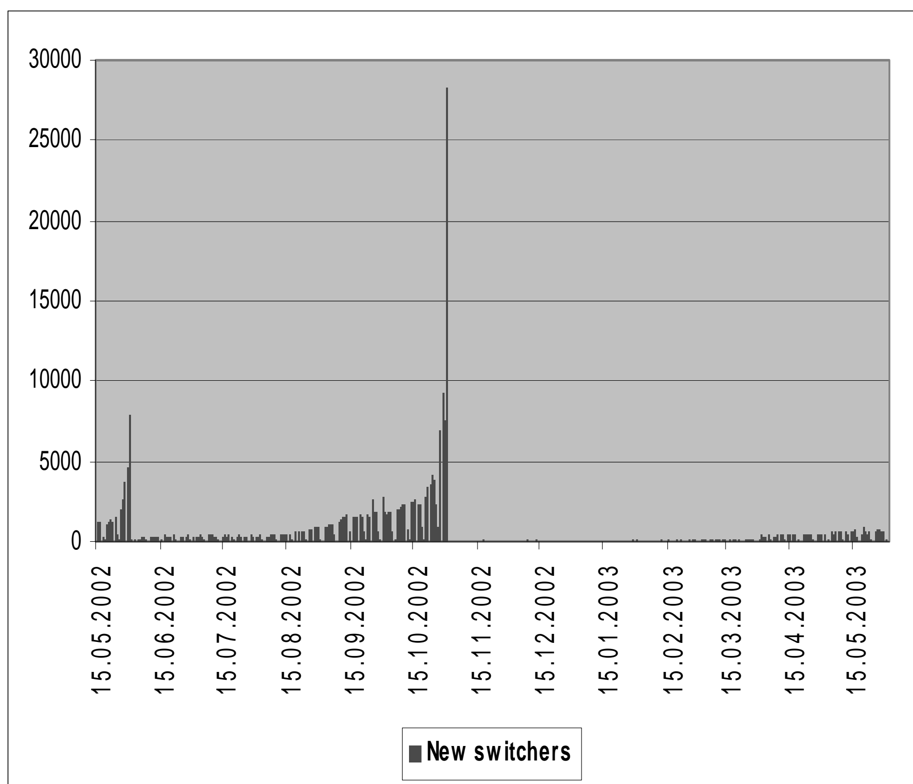


.Source: Ministry of Finance

It was originally projected that at least 50,000 people would join the new system in the first year. To ensure the stability of the state budget (from which the deficit is financed), it was proposed that a maximum of 200,000 be set. It was hoped that the number of fund members would reach 250,000 (half of current taxpayers) by 2007, five years after the start.

About 316,000 switchers are expected to join the second pillar by the latest deadline, 31 October 2003. The number had hit 263,000 by the end of July. As shown in Figure 5, switching activity is low after each deadline (1 June; 1 November), but it increases in time. On 31 October 2002 (the last day of second-round switching), there were 28,354 switchers, constituting up to 2.6% of all people allowed to switch. First projections for the next deadline were around 260,000 switchers, but expectations were raised because switching activity has been higher than expected.

Figure 5 . New switchers by day.



Source: Ministry of Finance

3.6 Statistics on the mandatory funded pillar

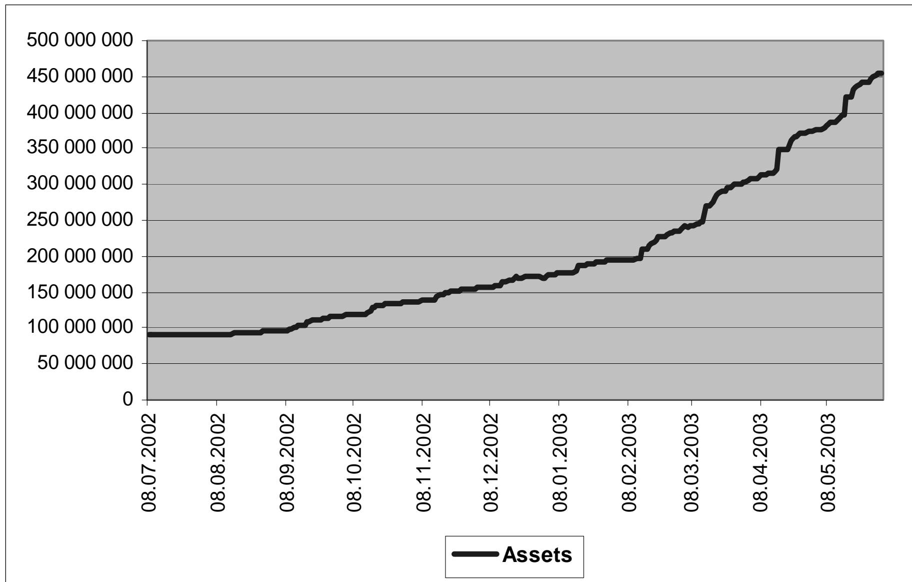
There were no big surprises in switching behavior, but the statistics show interesting results. Women appear to trust the system more than men, or else are less likely to seek out other means of investment for old age -- 56% of switchers are women. Men are more adventurous: 69% of men chose the aggressive fund (in which 50% of assets are invested in shares), and only 12% chose the conservative fund (100% of assets in bonds). Among women, 60% chose the aggressive fund and 16% opted for the conservative fund.

Although some pension funds hold tiny market shares, six pension fund management companies nonetheless operate in the market. They manage a total of 15 different mandatory pension funds. Each pension fund management company has at least two pension funds, one with 100% of assets invested in fixed-income instruments and one with 50% in bonds and 50% in shares. Three

management companies have funds with assets invested 75% in bonds and 25% in shares.

Total assets of mandatory pension funds are approaching a half-billion Estonian kroons. Total assets are increasing by about EEK 75 million a month and are expected to reach 1 billion EEK (0,9% GDP) by the end of the year (see Figure 6).

Figure 6. Total assets accumulation



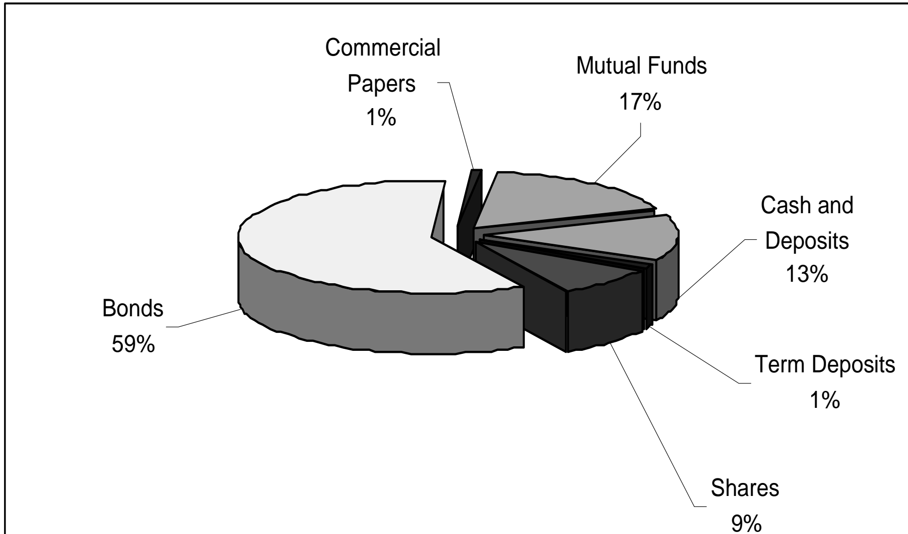
Source : Ministry of Finance.The mandatory pension funds market is quite concentrated. The largest bank in Estonia, Hansabank, has around 50% of assets as well as members of the second pillar. Three pension fund management companies have more than 90% of the market both in switchers and assets.

Figure 7. Mandatory pension fund management companies' market shares by switchers and assets.

	% of switchers	% of payments
Seesam	1.97	1.33
LHV	1.54	3.89
Sampo	14.1	9.56
Hansapank	50.64	51.20
Ühispank	28.41	29.44

Source: Ministry of Finance

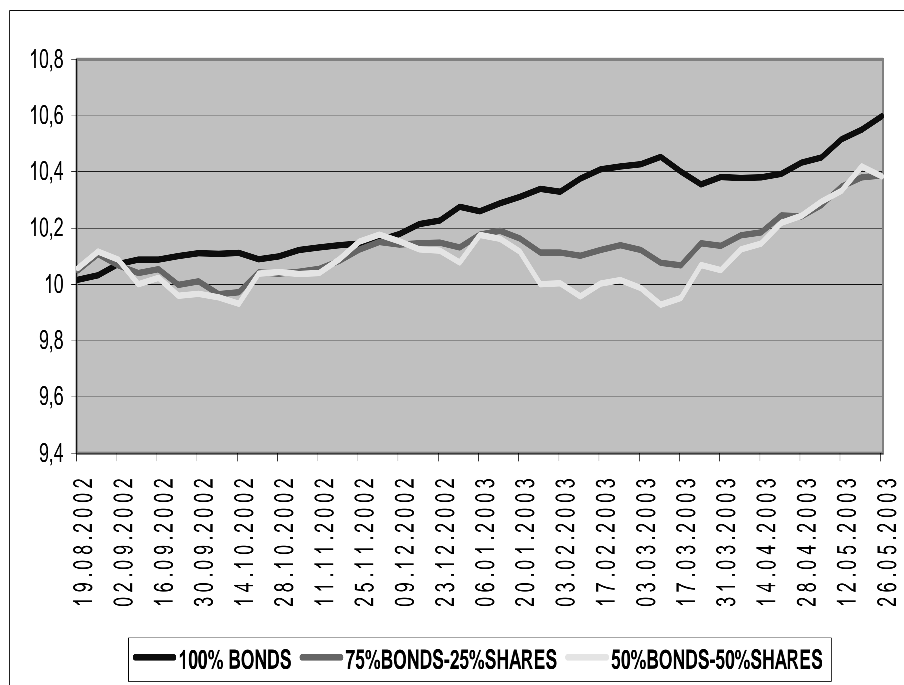
The majority of assets are invested in bonds and in other low-risk assets. This is due first to requirements set by law and second to the fact that bonds have shown higher returns than shares (see graph below).Figure 8. Second-pillar fund investments by asset type.



Source: Ministry of Finance

The latter trend can be observed as well in Figure 9, which shows the average NAV of different types of mandatory pension funds. Most investment is in foreign assets. (Estonian legislation sets no limits on investing in EEA contracting countries, OECD member countries or certain other countries. The reasoning was that as the local market is tiny, a bubble can easily grow, causing negative system-wide results if it bursts. Many people opposed this decision, saying that assets would flow out of the country, reducing economic growth. Still, it was decided to have one goal: securing pension assets to provide sustainable benefits for participants.) Only 3.7% of assets are invested in enterprises listed on the Tallinn Stock Exchange.

Figure 9. NAV by pension fund type.



Source: Ministry of Finance

3.7 Financing reform

The costs of reform have been a major concern of experts and politicians establishing the new system. Many options for splitting the state pillar contribution or raising the overall contribution level were discussed, in a quest to find the optimum balance between costs and benefits. The main combinations discussed were 12+8, 16+6 (the first figure representing tax to the state pillar, and the second the switcher's contribution to the second pillar), 14+4+4 and 15+5+3 (respectively, tax to the state pillar; the part of first-pillar tax going to the second pillar; and the switcher's contribution to the second pillar). Even a 10+10 split was considered, for faster second-pillar growth. The reasoning was that a second-pillar contribution is a deferred income, the employee himself has to pay the contribution, and the rate of social tax is reduced by that amount. The latter, reducing an employee's costs, should have provided inducement to hire

more people, thereby increasing employment. Three-sided negotiations between representatives of the state, employers and employees were held to seek agreement on the new scheme, with some compensation proposed for workers for lost net income. As no agreement was reached, it was decided to leave social taxes unchanged, but allocate 4 percentage points of it to the second pillar, making employees pay an extra 2%.

The table below shows the costs of reform, using different models for how much goes to the state pillar.

Table 2. Initial calculations on cost of different reform options.

	Total transition cost	
	Bln kroons	% of GDP
16 %	24.2	33.6
14 %	36.3	50.4
12%	48.4	67.2
10%	60.5	84.0

Source: Ministry of Finance

As seen, the smallest reduction in the state pillar would of course result in the lowest costs. A mere 4% would not have sufficed to secure sufficient second-pillar benefits (due to various costs and smaller economies of scale). That is why an individual 2% contribution was added.

Although state social tax revenues have decreased, because 4% of switchers' social tax goes to the second pillar, the state pension system budget is currently in surplus and other resources are not needed to finance Pillar II implementation. A surplus remains because Pillar I payments are smaller than revenues. The main reasons for that are a conservative indexation of state pillar benefits and a favorable demographic situation (many of the "baby boomers" born in the early days of Estonian independence are beginning to enter the labor

force, even as the retirement age has been increased). The surplus may diminish this year with a greater number of switchers. Political will also plays an important role, however. One of the three parties in the current governing coalition has set a goal of raising the replacement rate of pensions by 10 percentage points, without providing any source of financing for the raise. Pensions were augmented by 100 kroons this July after politicians found the state-pillar surplus too large.

Implementation costs according to official projections for switchers are shown below. As mentioned, the number of switchers has been adjusted to reflect continued high interest in switching.

Table 3 . Finances of reform.

	2002	**2003**	**2004**	**2005**	**2006**
Switchers	40.000	207.000	260.000	310.000	350.000
Social tax to the II pillar					
Million EEK	57	597	828.2	1079.9	1329.5
% of GDP	0.05	0.52	0.65	0.77	0.86
Deficit in I pillar					
Million EEK	714.8	94.5	114.5	199.3	283
% of GDP	0.67	0.08	0.09	0.14	0.18

Source: Ministry of Finance

4. Voluntary Funded Pension

The third pension pillar is the voluntary private pension scheme, where the state encourages participation by providing tax incentives. It was implemented before the second pillar in order to gain experience in managing pension funds and solving problems that might arise with such schemes.

The legal framework of the third pillar was enacted by the Pension Funds Act (effective from 1 August 1998). The law also made substantial amendments to the Insurance Act and the Income Tax Act.

The third pillar's principal characteristics are:

- Voluntary participation;
- An individual-centered nature;
- Private management;
- A pre-funding financing principle;
- Free choice between insurance and the fund instrument;
- Free choice between the defined-benefit and the defined-contribution type schemes;
- Strong tax incentives provided by the state.

Individual participation in the voluntary schemes can take two forms:

1. Special pension insurance policies are offered by licensed private insurance companies (allowing income tax reduction);
2. Units of pension funds managed by private asset managers can be acquired.

Statistics show that those who choose the first option are mainly average and lower earners who make payments regularly. The second is generally chosen by higher earners who usually contribute once a year, in December (leaving them with the shortest time before tax reimbursement).

To encourage participation in the voluntary private pension schemes, the following tax incentives have been introduced:

- Contributions (premiums paid on the basis of pension insurance policy or sums paid to purchase units of a private pension fund) are deductible from taxable income, with the income tax up to 15 % of total annual income;

- Benefits paid on the basis of a private pension insurance policy or from redemption of the units of a pension fund are subject to a lower 10% income tax rate, instead of the normal 26%;

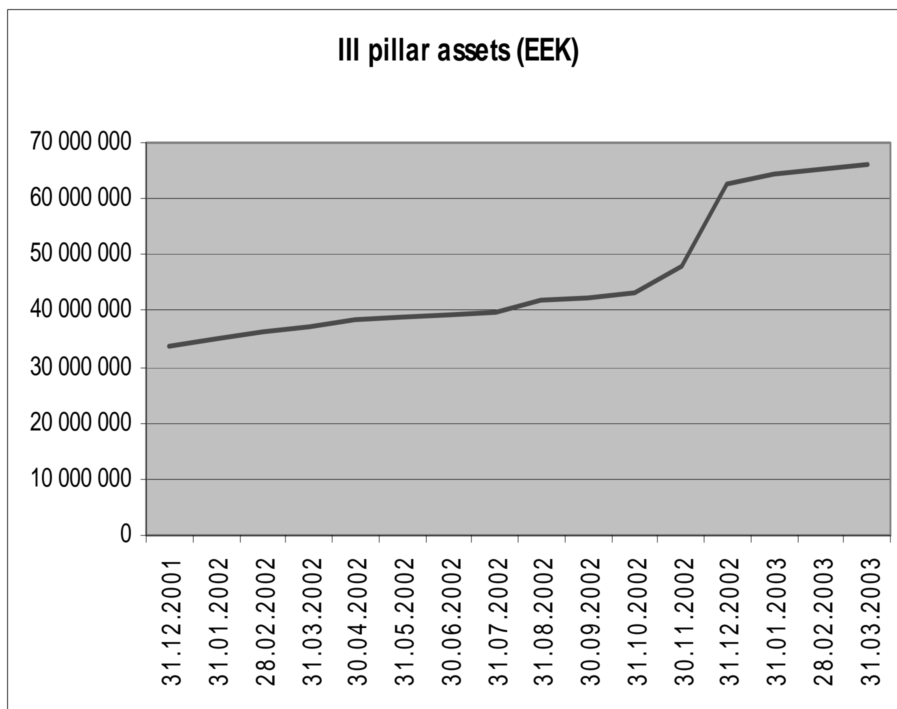
- Benefits paid regularly lifelong, on the basis of defined-benefit type pension insurance policy in equal or increasing amounts, are not taxable.

This means that an unusually favorable EEE taxation scheme applies to Pillar III when the person chooses to take benefits as lifetime annuities.

In the voluntary schemes, the pension age is a matter of contract between the person and the insurance company, except that the minimum contractual age in which the tax exceptions apply is 55 years.

There are currently five life insurance companies in Estonia which have licenses to sell pension insurance policies under favorable tax treatment. There are now about 50,000 Pillar III insurance contracts. In March 1999, the first fund manager (Hansa Asset Management) obtained a license to run a private pension fund (Hansa Pension Fund). There are now four Pillar III pension funds operating. They collect total sums reaching EEK 67 million.

Figure 10 . Pillar III pension fund assets in dynamics.



Source: Ministry of Finance

Although tax incentives are very favorable, around 10% of employed people take part in the third pillar. Due to heavy advertising and increased understanding of the need to save for retirement, we expect interest in the third pillar to grow.

APPENDIX 1. SCHEDULE FOR JOINING THE SECOND PILLAR.

Persons born before 1983 are entitled to make contributions to a mandatory funded pension and to acquire units of a mandatory pension fund if they submit an application as follows:

1. persons born in 1942–1956, before 1 November 2002;
2. persons born in 1957–1961, before 1 November 2003;
3. persons born in 1962, before 1 November 2004;
4. persons born in 1963, before 1 November 2005;
5. persons born in 1964, before 1 November 2006;
6. persons born in 1965, before 1 November 2007;
7. persons born in 1966, before 1 November 2008;
8. persons born in 1967, before 1 November 2009;
9. persons born in 1968, before 1 November 2010;
10. persons born in 1969, before 1 November 2011;
11. persons born in 1970, before 1 November 2012;
12. persons born in 1971, before 1 November 2013;
13. persons born in 1972, before 1 November 2014;
14. persons born in 1973, before 1 November 2015;
15. persons born in 1974, before 1 November 2016;
16. persons born in 1975, before 1 November 2017;
17. persons born in 1976, before 1 November 2018;
18. persons born in 1977, before 1 November 2019;
19. persons born in 1978, before 1 November 2020;
20. persons born in 1979, before 1 November 2021;
21. persons born in 1980, before 1 November 2022;
22. persons born in 1981, before 1 November 2023;
23. persons born in 1982, before 1 November 2024.

Persons born before 1942 are not allowed to join the second pillar of funded pension.

APPENDIX 2. MAIN FUNCTIONS OF THE FINANCIAL SUPERVISORY AUTHORITY (FSA).

Since 1 January 2002, Estonia has had a unified supervisory agency, replacing three former entities in the banking, insurance and securities sectors. The unification was deemed necessary to increase the efficiency of financial-market supervision and because some companies were closely linked, judicially and through ownership rights.

In the context of pensions the FSA supervises the activities of pension fund management companies and pension funds. It is an agency of the Bank of Estonia, with autonomous authority and a separate budget. The Financial Supervision Authority Act sets out the procedures for its management and reporting requirements. The FSA conducts financial supervision in the name of the state and is independent in the conduct of financial supervision.

As concerns financial supervision, the FSA has the authority to:

1. Issue and cancel activity licenses and other matters related to activity licenses;
2. Give consent, approval or permission;
3. Decide over issues concerning the registration of entities and the administration of the registration list;
4. Issue precepts, apply coercive administrative measures, and impose administrative penalties;
5. Order special audits or expert assessments;
6. Establish a moratorium or special regime to file a bankruptcy petition and to carry out related activities.

To carry out its supervisory objectives, the FSA regularly monitors the financial sector and supervised entities. Monitoring as a supervisory process implies constant observation and analysis of the operations and the status of supervised entities, identification of the main risk areas and supervision of compliance with the law. The FSA conducts on-site inspections of the supervised entities. It can also issue advisory guidelines in order to shape a common practice for implementing legislation, as necessary.

APPENDIX 3. FEE STRUCTURE OF MANDATORY PENSION FUNDS

There are two types of fees: those payable from the account of the fund and those payable by the fund management company. The first group includes:

1. a fee to the fund management company for managing a pension fund (management fee);
2. fees to a depositary for the provision of depositary services (depositary's charge);
3. transfer charges and service charges directly related to transactions performed from the pension fund as issuing and redemption fees (transaction costs).

The second group includes:

1. A depository fee related to management of the pension fund;
2. A registrar's charge for issuing and redeeming units, keeping pension accounts and performing other services set by law;
3. mandatory contributions to the Guarantee Fund.

The size of the management fee is determined as a proportion of the market value of the assets of the pension fund and must be indicated in the pension fund rules for a full year, where a year equals 365 days. The management fee should not exceed the limit established by the Minister of Finance. The limit may differ depending on the market value of the assets of mandatory pension funds or the structure of investments of the pension funds.

The rate of the total management fee of a mandatory pension fund investing also in equities should not constitute more than 2% of the market value of the pension fund assets. In case of a type of pension fund investing only in fixed-interest instruments the maximum management fee is 1,5% of the market value of the pension fund assets.

Depository and registrar's charges are determined as a proportion of the market value of the assets and are set in the rules of the fund.

Until 1 January 2005, the rate of units' issue fee of pension funds should not exceed 3% of the net asset value of the unit. The rate of the redemption fee for a unit of a pension fund should not exceed 1% of the net asset value of the unit.

Below you can see an example of fees of "aggressive" pension funds (investing up to 50% in equities), charged by pension fund management companies and advertised as a table on Internet site:

	Eesti Ühispanga pensionif. progress	Ergo Tuleviku Pensioni-fond	Hansa Pensioni-fond K3	LHV Aktsia-pensioni-fond	Sampo Pension 50	Seesami Kasvu Pensioni-fond
Management fee	1.5%	1.25%	1.59%	2%	1.85%	1.88%
Issuing fee	1.5%	3%	1.5%	1%	1%	2%
Redemption fee	1%	1%	1%	1%	1%	1%

Source: Pension Fund Management Companies

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