Promises of Private Pension Funds in Slovakia and Reality

Vladimir M. Bachishin[1](✉), Maria B. Vladimirova[2], and Ivana Lenerová[3]

[1] Comenius Analytica, Ltd., Bratislava, Slovakia
[2] Lomonosov Moscow State University, Moscow, Russia
[3] University of Economics in Bratislava, Bratislava, Slovakia

Abstract. The pension system for the population of the 27 countries of the European Union is based on the fact that today's population pays pensions to those who have retired. It can hold up well only in several ways: either by an increase in the retirement age or by the creation of a private savings system. The article analyzes the state of various pension reforms in the world, including in Slovakia.

Keywords: Pensions · Savings · Funds · Capital markets

1 Introduction

The most important demographic change in Europe will probably be the apparent shift towards a much older population structure, a development of which can already be seen in several of the 27 EU member states.

As a result, the share of working-age people in the 27 EU countries is falling, while the relative number of retirees is growing. The proportion of the elderly in the total population will increase significantly in the coming decades. In turn, this will increase the burden on working-age people who will have to finance the social spending required for a range of services to support an aging population.

Currently, 20.3% of the population of Western Europe is over 65 years old. However, in 2050, this category will account for up to thirty percent of the total population.

All of these have serious implications, especially in terms of the cost of pension systems, especially in Europe, where individual pension schemes are rather generous. But will they be socially and financially sustainable in the medium or long term?

It turns out that the most viable way, in addition to constant funding, is also the accumulation of funds paid by employees and employers and their investment in a promising active business. This trend seems to be more transient compared to what is happening today – simple "reuse" of the funds raised and their payment to today's retirees will not be enough to maintain the current level for several years.

The demographic arithmetic is relentless: in the European Union, there are currently more than four working-age people per person aged 65 and over. However, this ratio will change rapidly. By 2030, two working-age people will "work" for one pensioner, while in 2050; this ratio will be equal to at least 1.5:1.

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Thus, it is clear that maintaining the current level of retirement benefits in relation to average earnings will become extremely costly or financially unacceptable.

Social security benefits and their high standard in continental European countries can significantly weaken the competitiveness of their economies in the global market. They can also jeopardize public expenditure projects if they lead to budget deficits.

The current form of unfunded financing of PAYG (pay-as-you-go) pension schemes no longer has the desired effect. Where they looked for funded pension schemes, for example, in the Netherlands, Switzerland and the UK, the assets acquired grew up to 100% of the gross domestic product. Suppose that there are no such schemes in France and Italy. However, the fact is that PAYG and other unfunded platforms in the European Union contribute up to 84% to funding for retirement benefits [1]. This situation is also alarming, since the EU has a common labor market and free movement of workers, which is very disappointing and irritating for employers in multinational companies, for which maintaining pension standards is an increasingly serious problem.

Pensions should perform three main functions – insurance against certain risks (longevity, disability), savings (income transfer from the youth to the elderly) and redistribution (from the rich to the poor). It is reasonable to divide the provision of these different services from each other into different "pillars". Redistribution is best ensured by the pillar of the state, while savings can accumulate well in the pillar of private capital. Insurance is best performed by all the components together. The real situation is putting serious pressure on reforming pension models in various combinations.

This is not only about Europe, since this trend is global in nature. In the recent past, 125 countries have undertaken partial or fundamental pension reform. Basically, these were partial steps – most often a change in the amount of contributions (51 cases), then a change in the pension calculation coefficients (24 cases) and a change in the retirement age (15 cases).

A significant number of less developed countries, from Mexico to Poland, have introduced or are constantly preparing a mandatory fund system that more or less follows the Chilean model of the 1980s. These countries have a particular interest and motivation to obtain long-term resources and prevent volatility in foreign investment flows. If the capital market in their countries stabilizes, it can be assumed that the long-term economic growth will accelerate, which will have a positive impact on the pension sector.

However, it is currently controversial whether only a pension saving scheme capitalizing on "old-age contributions" will contribute to the financing of pensions in the developed part of Europe. This is not to say that the unfunded system in France puts the country's economy and growth at a disadvantage compared to the UK, where financial schemes work to a large extent.

However, this scheme aims to "settle down" in the long term, which is relevant and, above all, is of paramount importance in the demographic context. In addition, it has several comparative advantages: it shifts the pension burden from the population to the public sector, it is a tool for establishing international pension schemes, it has an incentive to harmonize tax systems and, above all, it protects pensioners in countries with a shrinking population. It is also characterized by long-term growth prospects.

In some other European countries, such as Italy and Spain, pension saving schemes are developing flexibly, but very slowly.

The need to reform the pension system is also evident in Germany, although there are the most sophisticated and complex pension schemes.

2 Methods

2.1 Pension Market in the USA

The problem of pension funds in the USA has diametrically opposite dimensions. Their expansion will develop into the creation of global structures, which will further increase the capacity of the domestic market. An example is the recent acquisition by the Nationwide Mutual Insurance Company (Columbus, Ohio), which paid over £1 billion for Gartmore, one of the UK's leading retirement businesses.

This is the first international platform of the mentioned expansion. The second one is the predation of US pension funds in the domestic capital market. The share of these funds in the portfolio of ordinary domestic shares is constantly growing. Due to the fast-emerging market with a steep rise in share prices, the strongest US pension funds have achieved average returns of 6–7%, and this level has stabilized at least in recent years.

However, US pension fund managers are also cautious. In recent years, the investment in common stock has been very profitable, but some of the proceeds are usually invested in less risky government bonds.

It should be added that US pension fund managers manage a large amount of assets – according to estimates, 18.8 billion dollars [2].

There are over 3,000 private and public pension funds operating in the USA – this "club" of large funds includes the funds with assets of more than $100 million.

The American pension model can simply be characterized by the fact that an employee contributes to a fund, and these resources are subsequently invested in the market. This means that pension contributions are well defined, but the final yield depends on the market.

The old model is a defined income scheme, in which retirement benefits are paid by the employer and the pension amount is defined as a portion of an employee's real wages until the end of his working career.

However, these pension schemes are also becoming too expensive due to the demographic aspect, and the aforementioned "undefined retirement income", the amount of which depends on the market mechanisms, comes to the fore.

The existing "defined pension scheme" stems from the freedom of decision and choice of the employee, who decides for himself what benefits he will pay for his retirement age, choosing from the pension proposals where to invest the money.

2.2 Japan

The aging of the Japanese population is the most significant of all industrialized countries, which has a very strong impact on the financing of pension funds.

In Japan, the demographic arithmetic is even more ruthless than in Europe. In the coming decades, one employee will fund two or three retirees! In the past decade, this ratio has been 1: 1. A similar demographic trend may have prevailed in the USA, but it has been eliminated there by the immigration policy. The United Nations Organization has pointed to the negative demographic development of several Japanese governments, but without a more tangible effect. Japan is proud of its ethnic homogeneity, which is an important factor in social cohesion. Probably, in the future, Japan will not allow a liberal immigration model, which, however, will negatively affect the structure of the pension plan. The PAYG (pay-as-you-go) model, which assumes that the current generation of working-age people provides financial resources to pay pensions to retirees, is unacceptable in times of labor market shortages.

The government and employers are looking for a way out, but they constantly face the same problem – Japanese pension funds are severely undercapitalized [3].

Despite the efforts of some banks (Sakura and Sanwa Bank) to place temporarily spare financial resources in pension funds, there is still no systemic solution. The government wants to raise the retirement age and hastily introduce a new law to the parliament to define the 401K pension scheme for the first time. This is a model similar to the American one: an employee pays remuneration to the fund, which is then evaluated as part of the investment in the capital market. Fixed contributions and uncertain income are in stark contrast to the level of retirement benefits, at which the Japanese know exactly what their pension will be. The new law strongly opposes Japanese trade unions, which argue that it is highly inappropriate for employees who have worked hard for many years to be exposed to possible risk capital market shocks.

Thus, the 401K pension scheme can be expected to be significantly modified, but even then the current situation in Japan is ripe for a new fund boom. Proof of this is an agency "PASONA" that offers different combinations of insurance products and investment options within a graduated monthly fee.

2.3 Chile

Forced saving by Chilean citizens through pension funds has become one of the cornerstones of long-term economic prosperity and extraordinary domestic saving dynamics. Today's pension funds are more than double the foreign exchange reserves of the Central Bank of Chile. The economic situation of the Chile pension fund management company (AFP – Administradoras de Fondos de Pensiones) is extremely important for the above reasons, and every decision they make has a short-term and long-term macroeconomic effect. For example, 60% of the mortgage loans for social housing come from the sources accumulated in pension funds. A kind of social pact and trust in pension funds has been created, as they focus on both the individual future of contributors and the financial needs of the national economy [4].

Chilean pension funds are waiting for some adjustments in the short term. They will aim at enhancing individuality and easing the tight government oversight that was needed to lay the foundations. The younger generation of policyholders with a longer retirement period will be given the opportunity to make more risky investments with a higher return, and thus the overall return will increase the achieved pensions. The autonomy of contributors in choosing investment options, up to the possibility of exit and independent maintenance of the pension account, is a growing trend. Before the cancellation, a so-called profitability zone is also held, which must contain all AFPs under threat of recall.

Pension funds need to address this new issue with the utmost caution, since they are overseen not only by the government, but also, for example, by the Social Investment Forum, which assesses carefully how pension funds perform their obligations in the context of socially responsible investment.

3 Results and Discussion

3.1 Private Compulsory Pension Funds in Slovakia

What is the main characteristic of the pension system in the Slovak Republic?

It has three components [5]. The first component is pay-as-you-go. The second component is compulsory private savings in funds.

What are old-age pension savings? Old-age pension savings (Component II) are savings which purpose – along with pension insurance – the so-called first component, is to provide income to contributors in old age or to survivors in the event of a contributor's death. Old-age pension savings represent a capitalization component, which is a fixed contribution, i.e. the amount of the retirement benefit depends on the contributions paid to this component and their increment.

Entry into Component II is voluntary, but after the transition to this level, old-age pension savings become mandatory, i.e. the exit from it is impossible and along with the first component, it forms the basis of pension benefits.

A contributor is an individual who has a concluded funded old-age pension agreement (hereinafter referred to as the "Agreement with the Management Company"), entered into the register of agreements with companies managing private savings, or has entered into an agreement on the payment of an old-age or early retirement pension. The old-age pension depends on the chosen program.

A contributor is also an individual whose pension fund management company has been appointed by the Social Insurance Agency. The first agreement can be concluded by a person who has entered into the first pension insurance agreement and has not reached the age of 35 on the date of signing the first agreement.

Contributions are paid to the contributor's personal pension account. The funded contributions for old-age pensions are compulsory and voluntary.

The collection of compulsory contributions is handled by the Social Insurance Agency, which is obliged to transfer them to the contributor's pension management company, which then credits them to contributors' respective personal pension accounts held in pension funds.

The amount of compulsory contributions is determined as a percentage of the tax base achieved in the relevant period. From 01 September 2012 to 31 December 2016, this rate was 4% of the tax base. After this period, the rate increases by 0.25% annually. In 2024 and in subsequent years, the rate will remain at 6% of the tax base.

Contributors can also send voluntary contributions to their personal pension accounts to increase their pension savings, the amount of which is not limited.

Compulsory contributions and voluntary contributions of a contributor shall be paid to his personal pension account, which is managed by the chosen pension management company. A contributor can choose a pension fund management company, as well as a pension fund, in which the paid contributions will be distributed in accordance with the investment strategy of this pension fund.

To better protect allocated savings from unexpected negative events in financial markets, the gradual and automatic transfer of assets to conservative bond funds begins at the age of 52. This transfer only applies to the assets consisting of compulsory contributions.

The assets qualifying for voluntary contributions can be invested by a contributor in any pension fund, regardless of his age and in accordance with his investment risk profile.

A pension recipient shall be paid an old-age pension from assessed contributions, an early retirement pension or a survivor pension can be paid to survivors. At the decision of a pension recipient, the pension shall be paid to him either by the chosen insurance company (life and temporary pension) or by a pension fund management company (choice of a pension scheme).

In the event of the contributor's death, the authorized person specified by the contributor in the agreement with the savings management company shall become entitled to payment of the corresponding amount from the personal pension account of the deceased contributor. If the contributor has not indicated an authorized person in the pension agreement in the event of his death or does not have such a person, his property shall become an inherited item after his death.

3.2 Pension Savings

At the end of 2019, there were 9.37 billion euros in accounts of pension fund management companies, which is 10% of the volume of the Slovak economy. There were 1,564,152 contributors in the system, which is 57% of the economically active population of Slovakia. Bond-backed pension funds had the largest share of pension fund assets (the most conservative investment option) at 72%.

The pension system in Slovakia has been operating for 15 years. It is possible to solve the above problem only partly, because the system is significantly inferior to its capabilities and does not really appreciate the Slovakian savings.

The system as such does not achieve its potential. There are several reasons. The first is political interference. Frequent political intervention does not benefit the pension system, which aims to ensure the long-term sustainability of the system and provide pensions that are enough for people to keep alive. The rules change and the settings change frequently.

The second negative phenomenon is the ineffective investment strategies of pension fund management companies. Compared to other countries in Europe and beyond, the performance of Slovakian pension fund management companies is significantly lower than in other countries.

How much do private pension funds earn? Not much for conservative investors. The average appreciation for the studied period reached 1.58%, which, unfortunately, is below the average inflation rate, and therefore savings are not valued. A fee charged by management companies, which is also deducted from the amount saved, should also be mentioned.

Those who invested in index funds got an increase of 5.3%. For equity funds, it is 2%, for mixed funds – 1.5%, for bond funds (the most conservative option) – 1.1% [6].

4 Conclusion

Can this be improved so that the Slovaks have more money in savings accounts? If so, in what way? Yes, it is possible and can be achieved through the principles underlying the reform of compulsory and voluntary retirement savings.

The first principle is to change the basic "system setup". This means automatically logging in, choosing an investment strategy and being able to log out at a specified time.

The second one is a change in the distribution of current contributors to support the transition of the Slovaks to significant risks, long-term investments to compensate for short-term losses.

The third one is the introduction of investment performance benchmarks – they are needed to compare whether a chosen strategy is profitable and how effectively a management company invests savings.

The fourth one is a reduction in fees – the current payment system is difficult to justify compared to compatible systems elsewhere in the world. Currently, the fees for actively and passively managed funds are the same, this needs to be changed.

The fifth one is to take into account the life cycle – it is necessary to automatically adjust the system to a gradual decrease in equity capital – a more risky and simultaneously more profitable component of the portfolio. The older a person is, the less risky his/her portfolio is.

A political risk cannot be completely eliminated from pension schemes, but it can be reduced and transformed. It is necessary to strengthen the pension system in the form of a constitutional law to minimize the negative impact. This change will allow eliminating the risk of poor performance and contributors will receive a significant pension.

Ethics should also be taken into account when investing. Fund managers are also required to fulfill their obligations to employees and employers who are exposed to investment risks in the fund's operations. This means that if a certain profit cannot be obtained through the fund's fault, the number of recipients shall not be reduced any way.

Fund managers will need to ensure that their managers and advisors clearly manage all the matters related to socially responsible investments to be able to clearly assess social, environmental and ethical issues, as well as the changing business and entrepreneurial climate in the long-term increase in the cost of financial resources of pension funds.

The relationship between the pension fund and the savings rate has attracted the attention of economists for decades. The main question was whether a pay-as-you-go pension system reduces aggregate national savings or the greater importance of funded pension schemes leads to an increase in national savings. If a corresponding strong correlation were found between these indicators, this would mean that changes in the pension policy could be used to increase overall national savings and, as a consequence, higher economic indicators per capita.

Analytical reports usually conclude that there is insufficient evidence to hypothesize that introducing a rolling system would lower national saving rates. There may be some indications, but they are either insignificant based on empirical evidence or their impact is hidden by other factors.

It has been similarly shown, mainly based on data from the USA, that the accumulation of assets in pension accounts will lead to an increase in total household savings, albeit to a lesser extent than an increase in balances in these accounts. The positive effect of developed pension funds seems to be in a shadow or replaced by the “behavior” of other components of national savings. At the very least, in OECD countries, there was virtually no correlation between the growth rate of pension assets and the growth rate of total savings in the economy.

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