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Contribution of Private Fund Managers to the Accumulation of Pension Capital of the Second Tier of Latvian Pension System in 2012-2016

Larisa Bule[1], Liga Leitane [2]

Abstract:

Fourteen years passed since the resources of the second tier- Mandatory State Funded Pension Scheme- were transferred from Latvian State Treasury to private fund managers. Rates of return of private fund managers in 2003-2016 were very different. The previous research of the authors showed, that in 2003-2013 an average performance of the second tier was lower, than the rates of inflation and average growth of salary. As far as crisis years were included in previous study, the aim of this paper is to assess the contribution of private fund managers to the accumulation of pension capital in post-crisis period.

For the analysis of profitability 20 pension plans were divided into different groups. Then the authors analyzed the following indicators: performance of 20 pension plans in 2012-2016; profitability depending on the declared risk of pension plan; dynamics of private fund managers' fees and population opinion on Latvian pension system. Latvian indicators were compared with Lithuania and Estonia.

The conclusions about the results of the analysis were drawn. On the basis of conclusions, the authors estimated the contribution of the private fund managers to the accumulation of pension capital of the second tier of Latvian pension system. In the concluding remarks of the paper the authors made proposals for increasing the contribution of private fund managers to the accumulation of capital in the Mandatory State Funded Pension Scheme. One of the main proposals is to continue the digitalization of the system. As far as Latvian system is a model for many other countries all over the world, the authors' proposals may be actual also in other countries.

Keywords: *fund manager fee, mandatory state funded pension scheme, performance of private fund managers*

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[1] *University of Latvia*
[2] *University of Latvia*

1. Introduction

In 1990 Latvia started to reform its system of pension assurance according to the tendencies of state socioeconomic development. Unfavorable demographic situation gradually exhausted the resources of traditional one level solidary provision, that's why Latvia as well as other European countries had to improve the system significantly (Athanasenas, *et al.,* 2015; Cristea and Thalassinos, 2016; Thalassinos and Liapis, 2013). Latvia was one of the first countries in the Central and Eastern Europe which started the introduction of multi-pillar pension system and the first country in the world which introduced the non-funded generation solidarity pension scheme based on the principles of capital accumulation (Ministry of Welfare, 2017).

At present Latvian pension system is supposed to be the 7th most sustainable in Allianz Pension Sustainability Index (International Pension Papers, 2016). It is also a subject of research for scientists and international organizations, such as IMF, World Bank and OECD.

Latvian system consists of three levels- two obligatory and one voluntary- which provide different opportunities of pension capital accumulation. At the same time, such structure also balances social expenditures at present and probably will reduce them in future (Danilina et al., 2015; Liapis *et al.,* 2013; Anikina *et al.,* 2016). From the very beginning, 20% of gross salary (a part of social insurance contributions) finances two levels of the mandatory pension insurance.

The first level or pillar- state obligatory non-funded pension scheme- is solider. All contributions here provide financing for current pensioners and are not accrued. At the same time, data about the amount of contributions of some certain tax payer are accumulated, in that way the notional pension capital is formed. In 2017 14% of gross salary forms person's notional capital and finances current pensioners.

The second pillar- state obligatory funded pension scheme- ensures pension capital accumulation as far as participants' contributions are transferred to private fund managers with the aim to invest them. This level started to work in 2000. In 2000-2003 the State Treasury was the only fund manager and its performance achieved 7% annually. During this period, private fund managers lobbied actively their opportunity to manage obligatory investments.

As a result, in 2003 all assets were transferred to private companies and at present the State Treasury doesn't manage the second level. Positive performance is not guaranteed at the second pillar, that's why an amount of pension capital may increase or decrease. Any reduction of capital is not covered by reserves or State Guarantee Funds, that's why state obligatory funded pension scheme is supposed to be risky. For example, in 2008 the annual rate of return of the most popular pension plan Swedbank ''Dinamika'' was -24,5% (Swedbank ''Dinamika'' annual report, 2008). At the end of 2016 the total assets of the second level achieved 2,34 billion EUR (Quarterly Report, 2016).

The third level provides voluntary pension insurance carried out by private pension funds. It is not very popular in Latvia despite all motivating activities of Latvian Government and private pension funds, thus two previous pillars remain the most significant in pension provision.

2. Analysis of Performance of Private Fund Managers

Previous research of the authors showed, that in 2003-2012 private fund managers in Latvia didn't provide the real growth of pension capital. The performance of private fund managers was almost twice lower than the consumer price index (Bule and Leitane, 2013). The aim of this paper is to assess the contribution of private fund managers to the accumulation of pension capital in post-crisis period. Social insurance contributions (obligatory tax payments) form the basis of pension capital of the second tier. The amount of contributions is determined by Government and it doesn't stay constant, that's why even if a salary stays the same, tax payments may increase or decrease.

Table 1. *Redistribution of total pension capital contributions between the 1st and 2nd tier of the pension scheme and the amount of monthly contribution to the 2nd tier*

Years	1st tier	2nd tier	Average gross salary, EUR	Average contribution, EUR
2012	18%	2%	685	13,7
2013	16%	4%	716	28,64
2014	16%	4%	765	30,6
2015	15%	5%	818	40,9
2016	14%	6%	859	51,54

Source: *State Social Insurance Agency, 2017, Central Statistical Bureau, 2017*

Since 2012 the amount of average contributions became almost 4 times bigger. Participant's tax payments provide an opportunity to purchase the shares of assets of some certain pension plan. Pension capital value depends on the number of shares and their net asset value. Net asset value growth or decline shows the performance of private fund manager. Obviously, real pension capital appears only when the value of one share increases at least faster than the consumer price index. The amount of private fund managers and pension plans didn't change significantly in 2012-2016, that means that this area of pension system stays rather stable.

Table 2. *Number of private fund managers and pension plans in Latvia at the end of the year in 2012-2016*

Years	Number of private fund managers	Number of pension plans
2012	8	26

2013	8	23
2014	8	23
2015	7	20
2016	7	20

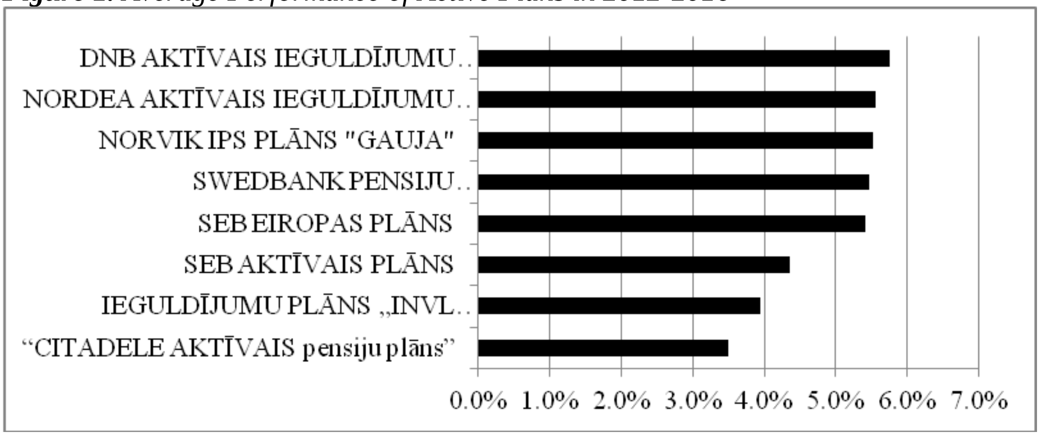
Source: *Financial and Capital Market Commission, 2017*

During the same period, net asset value of the second tier increased by 89% from 1,46 billion EUR in 2012 till 2,76 in 2016 (Quarterly Report, 2016). The main reason of this growth is the higher amount of contributions (Table 1), but not the outstanding performance of private fund managers.

All pension plans are divided in 3 traditional groups: active, balanced and conservative. Active plans (8 in 2016) are the most popular, usually 62-64% of tax payers participate there, and the same % of total assets concentrates in active plans. 9-10% of participants and assets belong to balanced plans (4 in 2016) and up to 30% to conservative plans (Latvian Central Depository, 2017).

In 2012-2016 an average performance of 6 plans (Figure 1) was higher than the consumer price index of the same period (3,9%). The indicator of the most popular plan Swedbank ‘’Dinamika’’, which in 2016 managed 32% of the general assets of the 2nd level and provided investments for 33% of system’s participants, was not the highest one. Such situation is traditional, that means that most of Latvian taxpayers choose pension plans without considering its performance.

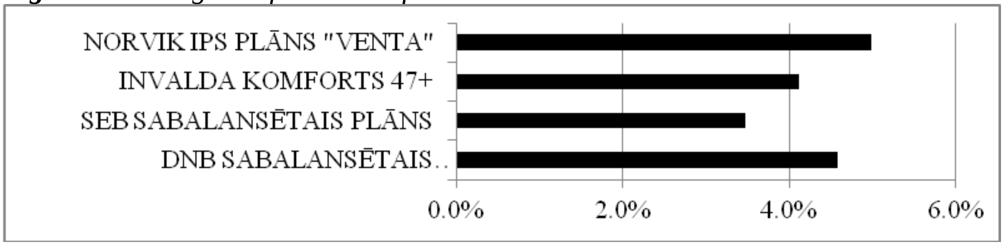
Figure 1. *Average Performance of Active Plans in 2012-2016*



Source: *author’s calculations based on Annual Reports, 2016*

An average performance for 3 of 4 balanced plans was higher than inflation (Figure 2). The only plan, which didn’t achieve sufficient profitability, was the most popular SEB Plan. This situation shows again, that profitability is not the main factor of choice for most taxpayers.

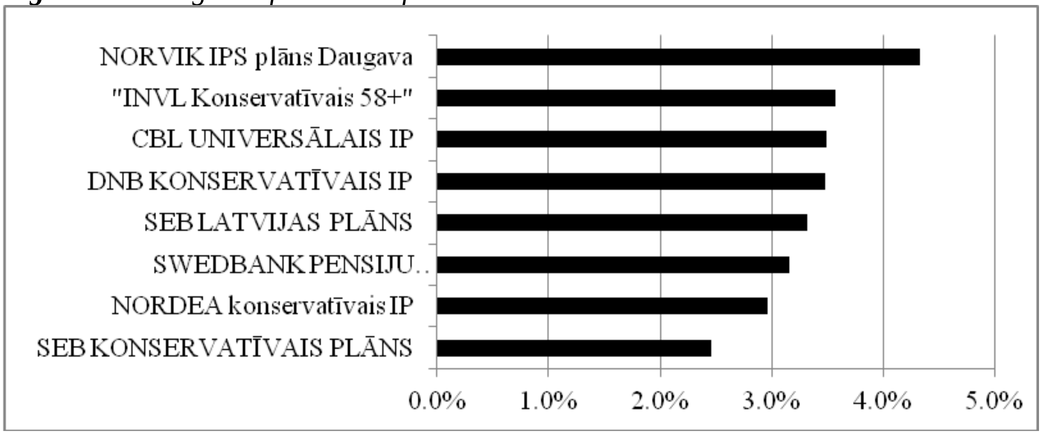
Figure 2. *Average Performance of Balanced Plans in 2012-2016*



Source*: author's calculations based on Annual Reports, 2016*

Seven out of 8 conservative plans in general had positive performance (Figure 3), but didn't achieve the level of the consumer price index, therefore, didn't provide the real growth of capital. The most popular plan among all conservative plans Swedbank Plan had the third worst result in the whole group. At the same time, it had 10% of system's assets and the same number of investors despite the fact, that such performance is its traditional.

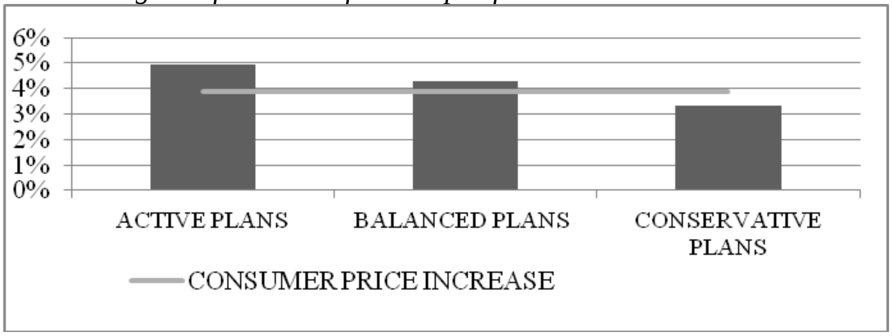
Figure 3. *Average Performance of Conservative Plans in 2012-2016*



Source: *author's calculations based on Annual Reports, 2016*

An average performance of the whole group of conservative plans was lower than the inflation rate, so thus the contribution of conservative plans to the accumulation of pension capital was insufficient. Conservative plans didn't even provide capital's ''conservation''.

Figure 4. *Average Performance of 3 Groups of Plans in 2012-2016*



Source*: author's calculations based on Annual Reports, 2016*

In comparison with other Baltic countries, Latvian rates of return usually were the lowest (Table 3). Higher equity exposure in Lithuanian private fund managers investments have ensured average higher income over time than in Latvia and Estonia.

Table 3. *Weighted average investment returns, Baltic 2nd level funds in 2012-2015*

Year	Latvia	Estonia	Lithuania
2012	8,40%	9,88%	11,54%
2013	2,38%	3,33%	4,44%
2014	5,36%	5,36%	8,09%
2015	2,23%	3,33%	4,42%

Source*: Baltic Pension Outlook 2015-2025*

3. Analysis of Fees of Private Fund Managers

The expenses of taxpayer connected with private fund management comprise manager's fees and custodian bank fees. In 2016 the costs of managing the assets of the 2nd tier of Latvian pension system was the highest in OECD countries (Kreicbergs T., 2017). Obviously, such level of expenditures significantly diminishes the performance of pension plans.

Table 4. *Investment plan management expenses in 2012-2016, %*

Indicator	2012	2013	2014	2015	2016
Investment plan management expenses*, %	1.51	1.52	1.52	1.46	1.56
incl. conservative plans	1.23	1.20	1.21	1.28	1.24
incl. balanced plans	1.51	1.49	1.49	1.36	1.58
incl. active plans	1.69	1.67	1.65	1.55	1.69

Source: *Quarterly Report, 2016*

Despite the growth of total assets, the rate of expenses didn't become smaller, that's why total fees of private fund managers also became higher (Table 4).

Table 4. *Expenses of Investments Plans for State-funded Pension Scheme Assets, thousand of euro*

Indicator	2012	2013	2014	2015	2016
Total Expenses	20,974	23,701	27,991	31,863	39,594
Expenses on interest payments	0	0	0	0	1
Management fee	18,419	20,963	24,792	28,624	35,960
Custodian fee	2,418	2,649	3,122	3,100	3,573
Other expenses for investment plan management	126,635	70	56	120	32
Other expenses	9,96	18	22	19	27

Source*: Quarterly Report, 2016*

Table 4 data show, that the most substantial elements of expenses are management fee and custodian fee. In 2012-2016 management fee increased by almost 90% and the question is if such fees are adequate to the performance achieved. Taking into consideration that in comparison with other Baltic countries, the results of Latvian private fund managers are lower, the authors assume, that one of the reasons is an increasing level of fees.

4. Assessment of Population Opinion on the Contribution of Private Fund Managers

The analysis showed that most of private fund managers provide pension capital accumulation and growth during the after-crisis period. The next question is if the participants of the system appreciate the activities of the 2nd tier.

Latest research proved low pension awareness and trust. SEB Baltic Retirement Readiness research shows that people in the Baltics are not aware on how their pension is formed and what decisions of today affect the size of it in the future. The study also shows clear correlations that where there is no understanding there is no trust, which results in blind ignorance of the problem (Baltic Pension Outlook 2015-2025).

Table 5. *Baltic Retirement Readiness Indicators 2015 of Future Pensioners Currently in Active Employment, aged 35-55*

Opinion	Latvia	Lithuania	Estonia
Do not trust sustainability of pension system	76%	69%	72%
Do not know how big their pension will be	77%	69%	77%
Are not confident about having sufficient funding for retirement	69%	69%	60%

Source: *Baltic Pension Outlook 2015-2025*

Ignorance of the negative future prognosis might turn it into the only pension perspective for today's active taxpayers. In Latvia, the indicators of ignorance are very high. Recent commercial banks' surveys (SEB survey 2017; Swedbank survey 2017) discovered the following major problems:

- 95% of the respondents doesn't know, how much do they contribute to pension insurance;
- only 6% of tax payers in Latvia are informed about the amount of pension capital of the 2nd tier (in Lithuania 30%, in Estonia 45%);
- 25% of respondents don't know, where to get such information;
- 38% suppose that it is available in online banking (not available, if pension capital is funded in anouther bank);
- 25% don't know what company manages their capital;
- 60% don't know what is their pension plan;
- 62% of respondents doesn't believe, that in future they will get the whole sum of accrued capital;
- 61% delegates pension capital investments to their own bank;
- 5% supposes, that there is no matter, who manages their pension capital.

Also, the Baltic Retirement Readiness Research indicates that the state would be the most trusted source for pension-related information and more than 70% of respondents confirmed that they have no sufficient information on the pension problems they are facing already today (Baltic Pension Outlook 2015-2025).

Taking into consideration the results of survey, SEB Bank calculated the Pension Readiness Index for Baltic states: In Latvia, it is 3,4 of maximum 10 points, in comparison with 3,5 in Lithuania and 3,8 in Estonia (SEB survey 2017). Swedbank assessment showed that Latvian population evaluated the sustainability of pension system only with 5 of 10 points (Swedbank survey, 2017), despite the opinion of experts considering Latvian system as one of the most sustainable in the world.

5. Conclusions and Proposals

1. To fully capitalize on the Baltic three-pillar pension systems individuals are expected to work interruptedly, pay all taxes and consciously save money (or have their employer to do that) to retain upon retirement the recommended income level at around 65-70% from the last salary.
2. Currently the Baltic countries fail to meet at least two out of these preconditions: tax payments that determine the size of the pension capital of future pensioners are low and irregular due to poor economies, there still is a high share of shadow economy and high unemployment rate.
3. Engagement in voluntary pension insurance is very low. This exposes a lot of the future pensioners to a high poverty risk upon retirement. 1/3rd of Latvian working age population receives low salaries and is subjected to ruthless optimization of their daily spending already today. They will have to manage further

15-25% income drop in retirement. And almost half of future pensioners can expect income drop that exceeds 50%.

4. Significantly decreased income in the largest cohort of population which is economically inactive and vulnerable will eventually not only limit consumption and economic growth, but also bounce back to the social budget, putting additional pressure to the taxation system or social security service basket (Baltic Pension Outlook 2015-2025).

5. Such statements increase the importance of the State funded pension scheme.

6. With no doubt Latvian private fund managers' contribution to the accumulation of pension capital may be considered as positive.

7. At the same time, the performance is not significantly higher than the inflation rate, managers' fees are the highest in OECD and investment policy differs from neighbor countries that are why the performance of pension investments in Latvia is traditionally lower, than in Lithuania and Estonia.

8. From the point of view of the authors, an additional factor, which has a negative impact on the performance of private fund managers, is the ignorance and low awareness and trust. Latvian taxpayers choose pension plans at their own banks or due to aggressive advertisement and usually don't assess the performance and other factors. That's why the situation, when some pension plan with the worst results has the biggest number of investors, is rather traditional in Latvia.

9. In Lithuania and Estonia population is more interested in getting the information about the activities of management companies, that's why managers get additional motivation to achieve better results. From the other hand, low awareness and trust eliminate the motivation of taxpayers to participate in the system fully.

10. Latvian Central Depositary supports a special website- www.manapensija.lv, where every participant can obtain the information on all aspects of pension system, including financial indicators; the information on the amount of accrued capital is available via Latvian official website latvija.lv; State Social Insurance Agency also provides such data.

11. Despite all informational activities of private fund managers, The Ministry of welfare and others, 70% of respondents still admit that they have no sufficient information on the pension problems they are facing already today.

The following proposals may improve the situation in the pension system and the contribution of the private fund managers:

1. Government must be engaged in massive pension communication programmes as one of the main recommended activities to treat the problems mentioned previously.
2. State Social Insurance Agency, private fund managers and banks must provide the information about the main indicators of pension capital accumulation via all available sources, also via online banking or paper mail, like it happened before crisis.
3. Government must determine managers' fee limit. The information on fund expenditures and risk must be provided in more comprehensible form, for

example, pension plan rating system may be introduced on the official pension website manapensija.lv.

4. Understanding of risks and strong collaboration among all stakeholders: the state, individuals, employers and financial institutions, should serve as a common ground for finding the best solutions on how to generate sufficient assets in all three pension pillars and to safeguard the future lifestyle and wellbeing of the Baltic societies.

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