## The supplementary pension insurance in Slovenia

## – a brief overview of the current situation

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### 1. INTRODUCTION

Slovenia gained it's independence in 1991 and it had its first pension reform in 1993. It introduced only some minor changes. No second or third pillar was introduced. In the 1990s because of the disintegration of Yugoslavia and the civil wars that followed, Slovenia's economy lost roughly 80% of its markets. The result was a huge economic downturn which was followed by massive unemployment. Birth rates also declined sharply. One of the ways to fight unemployment was to send people out of the labour market into retirement. The ratio between works paying pension insurance and pensioners declined from 3,6:1 in 1980 to 1,55:1 in 2010, making it one of the worst in Europe.

2. THE STATE PESNIONS

The first »big« reform started in the year 2000 with the new pension and disability insurance law. Regarding the state run first pillar, it gradually increased the minimum retirement age for men to 63 and for women to 61. It also prolonged the number of year taken into account for calculating the state pension from best ten consecutive years to eighteen years.

Figure 1[2]:

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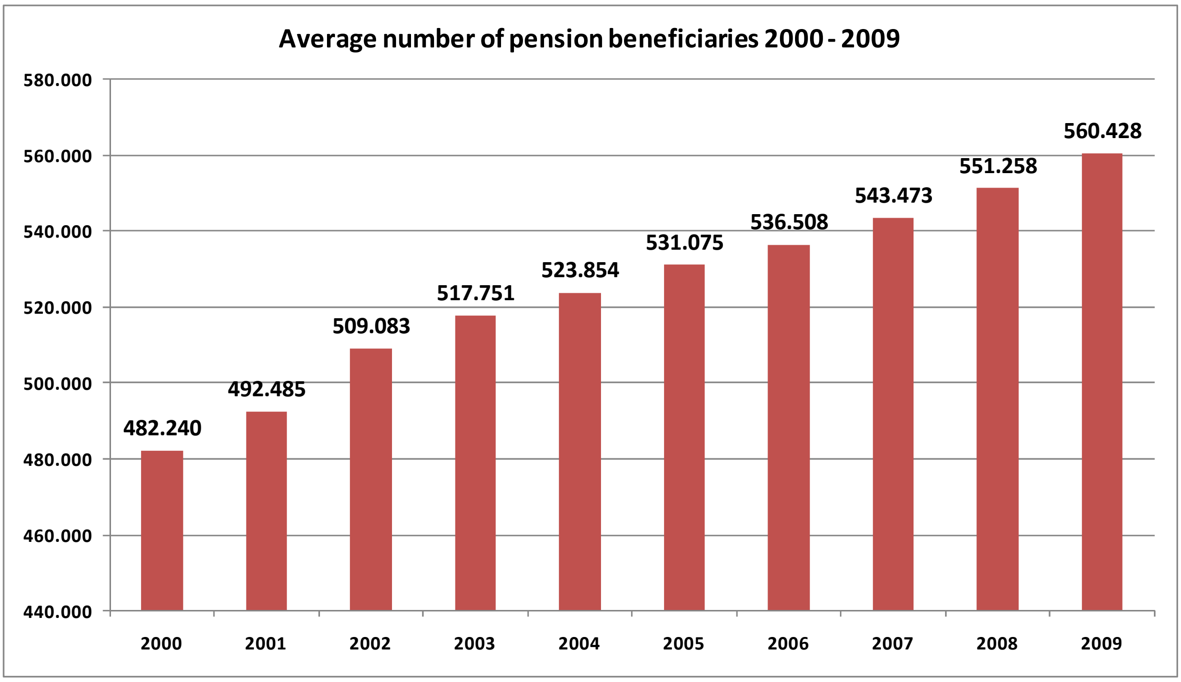
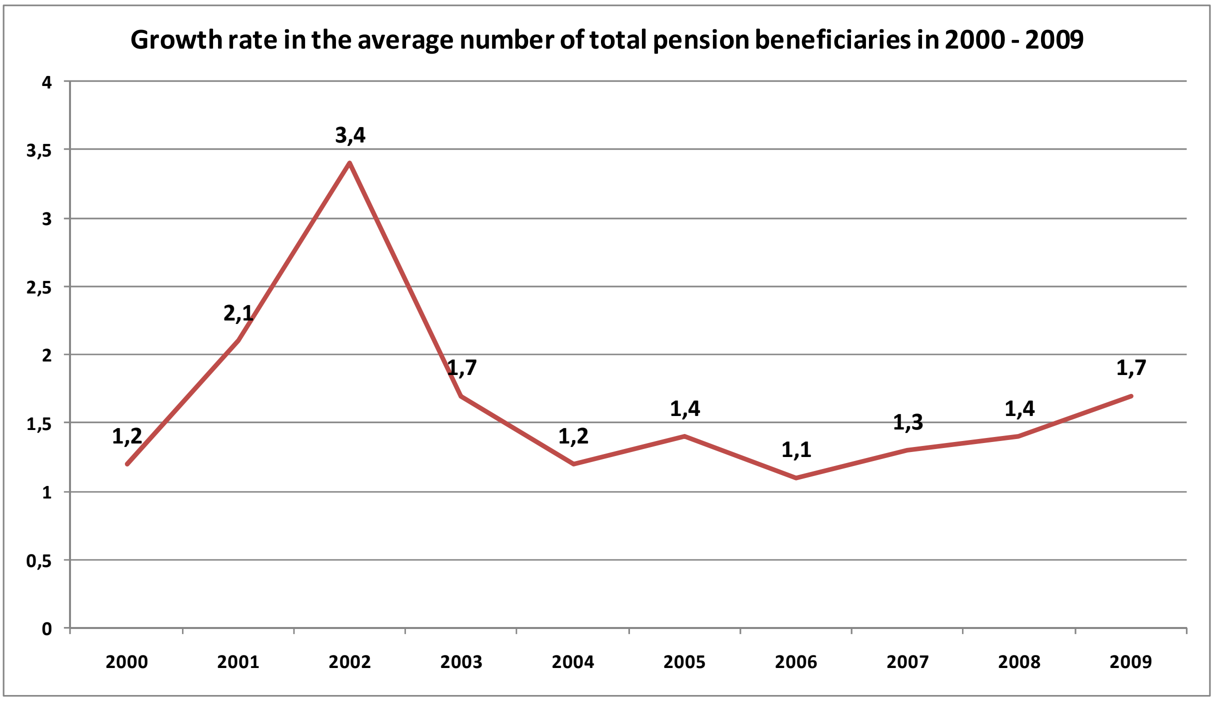
[2] Figure 1 and figure 2 are based on the Annual publication for 2009 of the state operated Pension organization »Zavod za pokojninsko in invalidsko zavarovanje« at www.ZPIZ.si




The official number of pension beneficiaries for 2010 is expected to be at an all time high at 575.000.

Figure 2:




The number of workers is decreasing, but the number of pensioners is steadily rising.

TABEL 1: Salaries and state pensions

| | Year 2000 | Year 2009 |
|---|---|---|
| Average net salary | 503 EUR | 930 EUR |
| Average net pension | 343 EUR | 570 EUR |
| Ratio average salary/av. pension | 68,2% | 61,3% |
| Budget aid to sate pension system | 0,64 billion EUR | 1,33 billion EUR |

Average net pension is falling fast compared to the net salary and we also see that the state budget aid is increasing dramatically.

## 3. SUPPLEMENTARY PENSION INSURANCE

Slovenia decided in the year 1999 to make the pension system basically in line with the “EU Green Paper on supplementary insurance in the Single Market (1997)[3]

### 3.1. PENSION FUND OPERATORS

Table 1: Slovenia's pension system

| | |
|---|---|
| Pillar 1 | State operated system |
| Pillar 2 | Individual accounts<br>- Voluntary pension insurance (collective and individual)<br>- Mandatory pension insurance (workers in harsh conditions and pension plan for state employees<br>- |
| Pillar 3 | Mutual funds, life policies, etc. |

The year 2000 reform also introduced the funded defined contribution second pillar, with tax breaks for individuals and companies. The emphasis was on collective pension insurance meaning the weight of the funding was on companies rather than on individuals.

The license for operating pension plans could be gained by insurance companies, banks, specialized insurance companies called pension companies and the state owned company “Kapitalska Druzba”[4]. Kapitalska družba during the privatization process in the 1990s received 10% of every Slovenian company. It rapidly sold most of its stakes in smaller or non important companies and concentrated it’s stakes to the most important companies. It used it influence to conclude pension contracts with mayor Slovenian companies in the years of 2001 and 2002.

3 The www link: europa.eu/documents/comm/green_papers/pdf/com-1997-283_en.pdf

4 Kaptalska družba in english translates as »Capital Company«

In the years 2000 and 2001 six special insurance companies called “pension companies” were formed. They had to meet a condition to gain at least 15.000 members within one year after establishment. Two companies failed that obstacle. They booth transferred their portfolios (clients and assets) to other pension companies. The procedure of the portfolio transfer is highly regulated and supervised by the Slovenian Agency for Insurance supervision. One of the pension companies called Prva pokojninska družba or in English First pension company in 2007 became an insurance company, so now there are only three pension companies left. In 2004 one insurance company also returned its license and sold its portfolio. So in the beginning there were 14 pension fund operators, now there are 11. All the mergers and acquisitions took place in the years 2002 to 2004.

## 3.2. TAX INCENITVES AND SUPPLEMENTARY PESNION CONTRACT CONCLUSION

The premium is limited to a max. of 5,84% of the gross salary, but no more than 223,60 EUR a month or 2.683,26 EUR a year. This also means if the gross salary is i.e. 800 EUR, the maximum premium is 46,7 EUR per month. The company paying premium has an advantage in using the tax incentives, meaning if the company pays the maximum premium, the employee can not add his own contribution. The premium paid is in a way a representing a “cost” to the employer. It still costs 100 EUR for the company, in order for the member to get 100 EUR on his individual account, but nothing more. On this premium there are no taxes or social contribution in the savings part. If a company would pay 100 EUR as a gross salary, the worker would get roughly only 50 EUR in his pocket (some more some less, depending on income and supported family members of the worker). The tax incentives for individual pension insurance comprise only of personal income tax relief, but social contributions must be paid.

Tax incentives are the supplementary pension insurance main feature and sales driver. It makes more sense for the employee that the company instead of a salary raise gives him money in form of premium on his individual account.

For a company to join a pension plan, it must make a contract with the employee representatives, namely the trade unions. If there is no trade union within the company, then it is the workers council and thirdly if the later does not exist an employee representative is elected. The later is especially true in small companies with fewer than 50 employees. Secondly 51% of the workers must sign a written offer. If enough workers fail to do so, there is no supplementary insurance. This typically happens when workers must contribute their part, i.e. the company pays 40 EUR if the employee pays also 40 EUR, to form an monthly premium of 80 EUR.

In small companies there is a very problematic legal obstacle. If a company owner of at least 25% or more is employed, by law he can not join the pension plan. This rule was introduced in 2002, two years after the pension reform. It proves to be a mayor obstacle for introducing pension insurance in a number of companies, especially small ones with a couple of workers. The director is in most cases also the owner of the company. So in practice, it he owner an not join, his workers also can't.

From the design of the system we can see, that it was first meant for large companies with strong trade unions, ie. the public railroad company, banks, telecoms etc and not for small businesses.

## 3.3. THE DEVELOPMENT OF THE MARKET

TABEL 1[5]: The development of the supplementary pension insurance

| date | number of members |
|---|---|
| 31.12.2009 | 529.275 |
| 31.12.2008 | 515.132 |
| 31.12.2007 | 491.066 |
| 30.11.2006 | 451.758 |
| 31.12.2005 | 411.211 |
| 31.12.2004 | 376.930 |
| 31.12.2003 | 210.463 |
| 31.12.2002 | 173.044 |
| 31.12.2001 | 81.895 |

Today 95% of the members are included through collective insurance by it's employers and only 5% pay individually.

In 2003 roughly 150.000 public employees entered the system at once. Preliminary figures show that in 2010 the market increased only for a few thousand members, as unemployment increased dramatically because of the economic crisis. The total number of all Slovenia's employed is roughly 850.000 so that 60% of workers have concluded an additional pension insurance contract. But not all pay premium regularly and there are no statistics about active members. At the end of 2009 the pension funds accumulated only 1,52 billion EUR, which means that the average member had roughly only 3.000 EUR of additional pension savings. The savings levels are really low and in most cases do not allow for real supplementary pension to be paid out.

In Slovenia, there are approx. 50.000 companies which have at least one employee. Out of them roughly 6000 concluded collective pension agreements. Better run

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5 Tebel 1 and other data on this page is based on the data form the Ministry of Labour, available at http://www.mddsz.gov.si/si/uveljavljanje_pravic/statistika/dodatno_pokojninsko_zavarovanje/.

companies were more prone to conclude such contracts. So if Slovenia wants to raise the number of insured for an additional 100.000 member, roughly 10.000 or more contracts with companies should be made. It seems like an impossible task to do in this moment.

It is fair to say that the reform of the year 2000 achieved only one goal and that is to lower the average pillar one pension.

## 3.4. MINIMUM GUARANTEED YIELD

Minimum guaranteed yield is the most important feature which determines the investment policy. The members take investment risk for the premium paid that is above the minimum guaranteed yield. The minimum guaranteed yield is determined by the Ministry of finance twice per year and is relevant for a period of the next six months. It is stipulated that it is at least 40% of yield which applies to state issued bonds with duration of more than 1 year. Currently this 40% means 1,28% p.a.. The pension providers can voluntarily increase this figure. Some providers offer this minimum guaranteed yield at 60% which is currently 1,93% If a company fails to meet its investment goal, it should cover the loss from its own capital. That happened in the largest pension plan for public employees with more than 190.000 members called “ZVPSJU” which is run by Kapitalska družba. Due to a negative yield of 9,05%[6] Kapitalska družba paid 25,4 million EUR in to the ZVPSJU fund, without the possibility to get it back. However in a controversial move they somehow “changed the rules” in the other two funds run by Kapitalska družba (fund called “KVPS” and fund called “SODPZ”). Both funds encountered similar or even higher losses in 2008, than ZVPSJU fund. So in 2008 and 2009 the pension funds assets from KVPS and SODPZ funds were lower than their obligations to members. For the resulting difference Kapitalska družba were allowed to form reserves within the capital of the company. So in a way public employees were the only ones to get real money on their accounts and thus were privileged in front of ordinary citizens. To the authors knowledge no court procedures were filed from the members of the fund KVPS and SODPZ to recollect the difference.

But on the other hand the effect of the paying of millions of EUR to a pension fund had also a profound effect on the way all pension funds in Slovenia are managed. Basically the pension funds can not afford to take serious investment risks, such as with big % of stocks in their portfolio. So Kapitalska družba went from 20% of stocks in 2008 to under 5% in 2011. Other operators are all under 10% in shares, as the downside risk is apparently too much for them or the entire industry.

If the markets go up, the client benefits, but if they go down, the risk falls on the pension plan operator.

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[6] Information about yields of most pension funds is available at http://www.finance.si/skladi.php

## 3.5. THE CUSTODY BANK

In 2004 the custody bank was introduced. It means that all pension funds are separated from the pension fund operators sole control and are subject to daily supervision by a custody bank. The custody bank function besides settlement also includes control of the asset valuation and conformity of the asset allocation with the laws and bylaws. The aim of the introduction of the custody bank was to increase supervision and public trust in to the private pension insurance.

## 3.6. THE PAY OUT PHASE

The money is all collected into individual accounts which can be inherited. The money that is paid by the companies (95% of all money in the 2$^{nd}$ pillar) can be withdrawn early in form of a lump sum payment, but only after 10 years of membership. The members then pay personal income tax at a rate of 25% and with a possible additional pay of 16%, totaling the tax rate of 41%. Additional 1% goes to the pension fund operator as an exit fee. At first glance it seems not logical, for a person to pay i.e. from accumulated 10.000 EUR 4.100 to the state and 100 to the pension fund operator.

If members opt for an additional pension instead of a lump sum payment, 90% of the retirees should pay only up to 3% tax or 0% tax. After the age of 65 additional tax breaks are available and the tax rate should effectively go to 0%. However only the people with the highest pensions in Slovenia (around 1500 EUR net) could face the maximum of 20,5% income tax on their additional pension. The additional pension contract can be concluded only if all of the three conditions are met: 58 years of age, retirement and 10 years of membership in the system.

Events in the beginning of 2011 show that early withdrawals are currently the mayor issue of the industry, as many contracts were concluded in 2001. Some providers experience up to 30% or more percent of members withdrawing their money. This are the members with the longest membership (all have ten years of membership), the amount of money withdrawn could be more than 50% of all accumulated money in the 2$^{nd}$ pillar. For instance some pension fund operators have a premium inflow of 20 million of EUR per year and they face paying 50-100 million in one year. It makes their asset management difficult and it makes them invest in a very short term, so high yields are not likely. Poor investment results can then trigger the next round of withdrawals. They also face the minimum guaranteed yield hurdle which has to be met.

What the main reason for such behavior is still unclear. Some reasons could be that the state pension is still high enough and guaranteed; the absence of a savings culture for old age; on average very low premium is being paid into the 2$^{nd}$ pillar and many say such low savings make no difference anyway (i.e. the state pays to its employees only 26,10 EUR per month), etc.

## 3.7. MANDATORY SUPLEMENTARY PENSION INSURANCE

Mandatory pension insurance includes two funds. On both funds the monopoly provider is the 100% state owned Kapitalska Družba. In a way not one of the mandatory solutions is proving to be effective. One reason is for sure that funding is set too low and the other is total absence of competition. Maybe it is time to set up a system similar to the one in Poland or in other CEE countries.

### 3.7.1. THE MANDATORY SUPLEMENTARY FUND[7]

This pension fund was established in the year 2001 and was first designed for workers under the age of 40 working in harsh conditions or in risky jobs such as miners or policemen. In this way Kapitalska Družba instantly gained some 25.000 members for which it is still is the sole operator. This fund should cover the time period until full pillar one retirement occurs for workers who are too young to retire with a pillar one pension. But currently it is clear, that the savings are too low for anybody to achieve that goal. And the members were also charged with much too high fees, as if it was a voluntary fund. First members according to this plan should retire at the end of this year, but if this will actually happen is unclear.

### 3.7.2. THE PUBLIC EMPLOYEES FUND[8]

The state employees fund is in fact “a mandatory” system as the employees do not need to sign a contract, they are enrolled automatically upon employment with the state and its legal entities such as schools, libraries, hospitals, etc.. The system was started in 2004 after a special law was passed. The license for the pension fund operator was granted to Kapitalska Družba and the license has no expiry date. The state has the option to make room for competition, but it seems that it has no intention in doing so. This fund has more than 190.000 members, but the premiums are very low. An average public employee after seven or eight years of membership has only 2.500 EUR on his account.

# 4. THE PROPSED PENSION REFORM

In December 2010 the parliament passed the pension reform, which should take effect on January 1st 2011. But the trade unions gathered 40.000 voters support to

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7 In Slovenian language the fund is called »SODPZ«
8 The fund's name in slovenian language is »ZVPSJU«

have a referendum whether the law should come into force or not. The government challenged the trade unions move on the Constitutional court, on grounds that it is illegal to have a referendum on such an issue. In March 2011 the Constitutional court ruled, that such referendums are allowed as the government failed to prove its case. Currently a date for the referendum has not been set yet, but it should somewhere in May 2011.

If the new law steps into place, it will have the following changes on to the 2nd pillar system:

- Lifting the ban company owner to join the private insurance system.
- Multiple pension providers are allowed to be within one company. This is true for voluntary pension plans, but it preserves the state owned Kapitalska družba's monopoly over public employees.
- It abolishes the 51% of workers must join rule, as anew all works are required to join except those who explicitly do not want to (applying opting out as currently opting in is the case).
- All new premium paid to pension funds by the employer can not be withdrawn as a lump sum, unless the accumulated sum is below 5.000 EUR. This makes life annuities the norm. This measure is aimed at correcting the possibility of early withdrawal after ten years of membership in collective pension plans. The premium accumulated until the new law enters into force will not be affected by this rule.
- It introduces life cycle funds. It is a move away form the minimum guaranteed yield funds. Minimum guaranteed yield funds are still mandatory for workers which are near retirement. Two additional funds must be organized by every private pension provider, one for young workers and one “mid life” fund. The rationale is, that young workers take on more risk, hence bringing them extra return over longer periods of time. So that 20--50 year olds would be in a fund with 50-70% of equity type investment, then the equity part would decrease to 20% and then the member would enter the minimum guaranteed yield fund. In the “equity” funds there is no minimum guaranteed yield. The rules when somebody must switch to a more conservative fund are left to private pension providers, but the state can make rules if the assess it is necessary to intervene. Younger members can switch annually free of charge to less riskier funds, but old member near retirement are banned from choosing equity funds. All existing members would have to make a choice which fund they want.
- The asset management fee is reduced to maximum one percent, which is quite low, especially if newly created funds should be actively managed equity funds. The existing funds are currently limited to 1,5 % p.a. management fee.

- The exit fee in case of a switch from one provider to another is reduced form 1% to 15 EUR. The move is aimed at encouraging membesr to switch more often.

- Asset management companies can establish and operate their own pension plans, which should bring more completion. So far they were barred from doing so. But in the small Slovenian market there are already 11 operators so this move is unclear.

- Pension plan operators should in case of non payment or late payment of premiums of the company report the company to the labor inspection and the company paying late can be fined. Failing to report is also a reason to fine the pension plan operator.

- Pension plans should be strictly separated between the savings part and the pay out part. For the pay out phase separate bylaws will be made. It is planned that men and women should have the same lifelong annuity rent, which is a major difference form the current situation where men because of their shorter life span receive higher amounts.

## 5. THE CONCLUSION

For the supplementary pension insurance view, it really does not matter if the pension reform this year will enter into force or not. For sure it has some desirable solutions, such as the introduction of the life cycle funds. But in the end it will not significantly increase savings or bring in scores of new members to supplementary pension insurance. And most importantly, it will not raise premiums to levels where the second pillar can seriously start replacing the first pillar. The only real solution would be to start a true mandatory system, where it is obligatory for young people to join the defined contribution pension system and where the obligatory social pension contributions are in some way divided to the state and partly to individual accounts. This is the only fair solution for young generations as it is almost certain that when those who are thirty or forty year old today will retire, the ratio between workers and pensioners will be one pensioner per one worker.