SECOND PILLAR OF PENSION INSURANCE COMPLETES FIRST YEAR OF REAL OPERATION

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The term "pension reform" was noted for being the most used collocation in 2004. It really is no wonder. The information campaign conducted by the Ministry of Labour, Social Affairs and Family of the Slovak Republic, as well as the advertising campaigns of pension fund management companies, certainly played a large part in making it so. But the frequent usage of this term reflects mainly the fact that the transformation of the pension system has been materially and financially the most demanding reform since 1989; its exceptionality is based on a large volume of accumulated funds, length of operation and the fact that it concerns every citizen.

Slovakia's second pillar of pension insurance completed its first year of real operation at the end of April 2006. The pension fund management companies (PFMCs) came into being at the end of the third quarter of 2004 and became fully operational in January 2005. It was not, however, until the end of March 2005 that the second pillar started to be fully functioning, with the first transfer of contributions from the Social Insurance Agency to savers' personal pension accounts.

This article provides a closer overview of the results of PFMC activities in 2005.

The launch of PFMCs was demanding both organizationally (the establishment of new companies and the roll-out of their activities), and above all financially. The steep expenses were largely related to setting up in the market – through an intensive advertising campaign in print and, in particular, electronic media, and also through building up and financing a network of intermediaries to conclude agreements on the company's behalf. The direct expenses for concluding a single contract increased to several times more than the original estimates of between SKK 800-1,100. At the same time, the PFMCs had limited funds in 2005 since their only possible income is from asset management and from maintaining savers' pension accounts, which is directly bound to the amount of contributions from the Social Insurance Agency. As a result, the loss made by the PFMCs in their first year of operation was heavier than what they had predicted. As regards last year's expenses related to the acquisition of clients, some companies opted to record them in the current accounting period, and others to accrue them over several years. In the case of the first group of companies, it means that all client acquisition expenses (direct and indirect) are recorded in the current accounting period and are therefore fully reflected in the financial results for 2005. Since these companies record all expenses for the period during which they are incurred, the expenses in question will not adversely affect the company's financial performance in future years. This approach has been adopted by VÚB Generali d.s.s., a.s., and Aegon d.s.s., a.s.

As for the second group, the selected accrual approach resulted in only a small part of the client acquisition expenses appearing in the published financial statements. The remainder will be carried over to expenses in future years. The number of years should depend on the period during which the given saver is a client of the PFMC, and therefore the period during which the company will earn income on the saver. This accounting method has been applied by Allianz-Slovenská d.s.s., a.s., Winterthur d.s.s., a.s., ČSOB d.s.s., a.s. and ING d.s.s., a.s. High initial expenses related to unmet expectations led the shareholders of two PFMCs to sell the companies. Out of the original eight companies that started out in 2005, there are now six still operating in the market. Sympatia-Pohoda d.s.s., a.s. was bought by ING d.s.s., and a similar end befell Prvá dôchodková sporiteľňa d.s.s., a.s. when it was purchased by Allianz-Slovenská d.s.s.

Client demand for joining the second pillar of pension insurance was unexpectedly high. At the start of the pen-

Table 1: Financial results of pension fund management companies in 2005

Company	Loss (SKK m)	Accrual
Aegon d.s.s.	317,95	no
Allianz-Slovenská d.s.s.	209,85	yes
ČSOB d.s.s.	125,8	yes
ING. d.s.s.	222,3	yes
VÚB Generali, d.s.s.	528,8	nio
Winterthur d.s.s.	193,3	yes

Note: The summary does not include Sympatia-Pohoda d.s.s. and Prvá dôchodková sporiteľňa d.s.s., which were terminated by merger.

sion reform, the Ministry of Labour, Social Affairs and Family had expected interest and involvement from around one million people. This figure was already surpassed before the end of 2005 and the number of people now registered with PFMCs is now almost two hundred thousand higher. It is assumed, also with regard to experience from abroad, that hitherto undecided clients will account for the increase in the last few weeks. The final number of people involved in the second pillar will probably reach 1.4 million, a figure that was considered excessively optimistic at the outset of the reform.

There are probably two causes of the unexpected interest in retirement pension savings. One is the fact that both the PFMCs and the Ministry promoted pension reform as the chance to secure a higher pension. Such a promise cannot and must not be guaranteed, but the premise is sufficiently likely given that income from contributions under the first pillar will be constantly falling due to the ageing population, while the number of recipients will be growing. Second-pillar savings are in private ownership and therefore offer greater security than do pledges about the indexation of state pensions. Similar considerations were among the main incentives for deciding to join the second pillar. The second significant cause lay in the commissions for concluded agreements – in other words the financial motivation of the intermediaries. Expenses soared in comparison with the original estimates, and the acquisition of clients turned out to provide a very respectable income last year.

After the preliminary acquisition of clients during the last two months of 2004, the registration of clients began from 1 January 2005. They are recorded in the Register of Policyholders and Savers maintained by the Social Insurance Agency. Despite the initial qualms of professionals, the Agency's technical provision was sufficient for it to cope with the upsurge in registrations for the second pillar. This demand is illustrated by the fact that in the first half of January alone, the Agency recorded 324,000 agreements on retirement pension savings, representing approximately one quarter of the total number of registered savers.

As regards age structure, the savers who have joined and are joining the second pillar fall mainly into the younger age groups of between 20 and 40 years. Indeed, more than three quarters of the total number of savers belong to this age bracket. Chart 1 shows the breakdown of savers by age.

Just as surprising as people's keen interest in joining the second pillar was their decision-making about the type of fund in which to invest their savings. Due to their age structure, savers probably saw retirement pension savings as a long-term allocation of savings and therefore took the riskier option of growth pension funds that represent a more aggressive investment strategy; it

Chart 1: Breakdown of savers by age

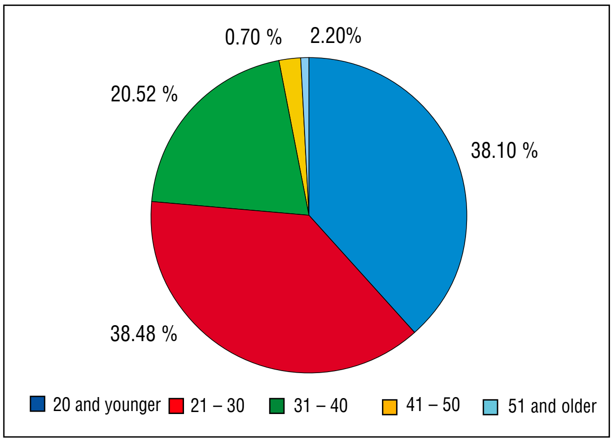
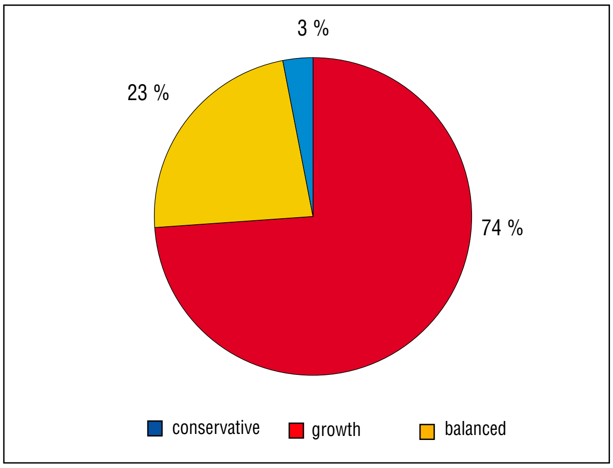


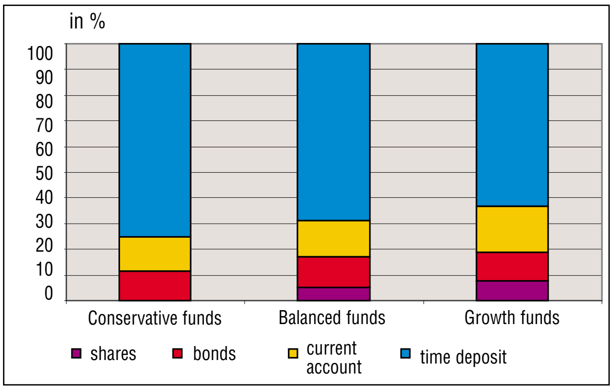
Chart 2: Types of pension funds by share of savers



should be noted that voluntary saving is more attuned to conservative investments.

Three quarters of savers have registered with growth funds. Such unexpectedly high interest in growth pension funds probably caused subsequent corrections in the investment strategies of PFMCs. As regards share investments, the companies started out cautiously and are still a long way from making maximum (80%) use of growth fund assets for share investments. Even with share investments, the main purchase for asset funds are index certificates that mirror the development of the underlying index. One reason for this is the still relatively low volume of fund assets, which does not allow for individual share titles to be purchased so as to achieve the required diversification of risks. Another significant reason is, however, the unexpectedly high interest in the riskiest funds. The caution stems from concerns about how clients will behave in the event of stock market fluctuations, and that is why assets are invested into less volatile instruments. Reaching the 80% limit on invested assets in share investments will take around 10 years, according to the estimates of PFMC representatives. As fund assets increase, it will become more difficult to meet the minimum

Chart 3: Structure of assets in individual types of pension funds



investment in Slovakia, prescribed by law at 30%, due to the shortage of suitable investment opportunities.

As Chart 3 shows, the composition of assets in each type of pension fund is very conservative. Fully 80% of the assets are in the form of deposits in bank current accounts, while the rest are bond and share investments. The appreciation of the funds is, however, more attractive. During the first year of operation, conservative funds reported a value increase of 3.02-3.66%, balanced funds 3.6-5% and growth funds 3.9-5%. Should the long-term return on savings be sustained at the same level, with inflation matching the low forecast, then assets may be expected to appreciate in real terms. Yet every investment carries a certain risk that the investment return will be lower than that expected when the investment objective was set, or even that the investor will alter their initial investment when their asset is expected to appreciate.

Indicators of return should as standard be accompanied by information regarding the risk of a given investment. The benchmark indicator in world finance is the return-to-risk ratio. In this case, the return-to-risk ratio expresses the number of units of return per unit of risk which the PFMC made for the period in question, from 23 March 2005 to 24 March 2006. The higher the given ratio, the better the company's management of the assets with regard to the risk. The risk in this case is understood to be the percentage change in the return on the pension unit for one year. As for standard deviation, it is reckoned as the monthly averages of the weekly changes in the value of the pension unit for the period, i.e. from 23 March 2005 to 24 March 2006. The higher the risk, the greater the probability of future fluctuation in the value of the pension unit, whether an increase or decrease. The following charts show the return-to-risk ratios in pension funds.

The first year of pension reform operation may be evaluated as successful, and in several respects unexpectedly so. The PFMCs acquired sufficient clients with which to successfully launch their activities. Likewise the preparedness of the Social Insurance Agency could be assessed positively despite persisting problems with the remittance of contributions. The further development will

Chart 4: Comparison of nominal yield and risk – conservative pension fund

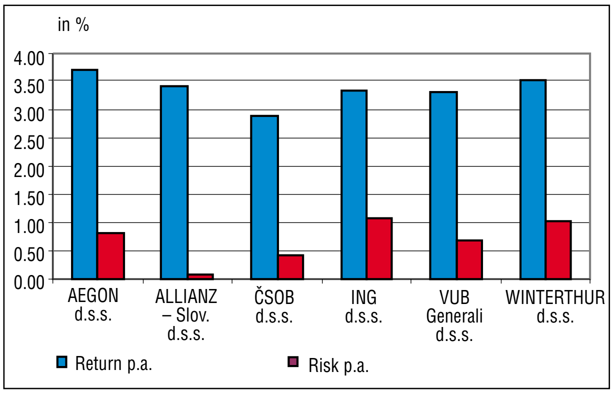


Chart 5: Comparison of nominal yield and risk – balanced pension fund

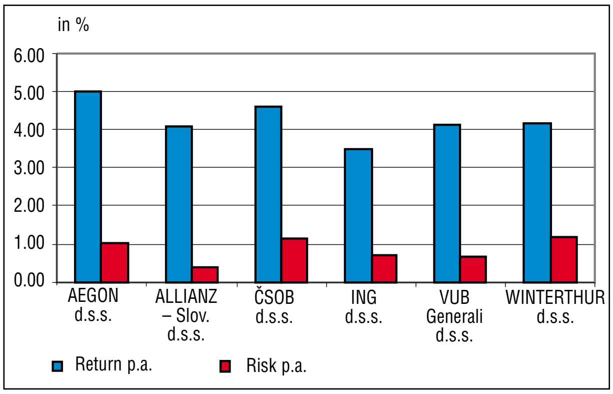


Chart 6: Comparison of nominal yield and risk – growth pension fund

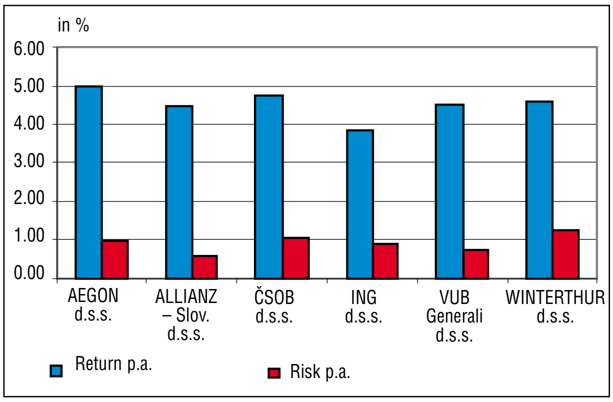
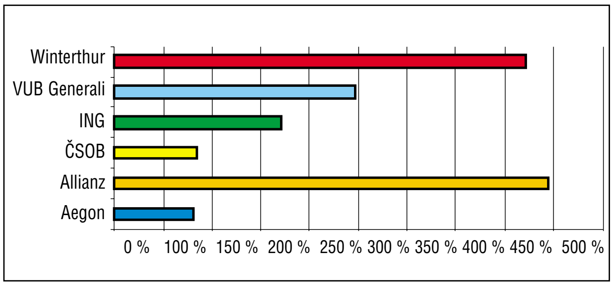


Chart 7: Market share in retirement pension savings as at April-end 2006



be interesting. PFMCs are becoming significant players in terms of the volume of assets under management. Within several years the volume of assets with these companies will rise to almost 30% in ratio to Slovakia's GDP.

As present experience shows, some parameters will within a relatively short time have to set differently to how they were envisaged when the reform was prepared, largely due to its unexpectedly great success. Such changes will largely concern the capital adequacy of PFMCs, investment possibilities, how the companies' performances are compared, and the calculation and fixing of pensions as life annuities. These changes will not, though, affect the character of the system. They are parameter changes that will not have a negative effect in regard to the client, and will in fact bring opportunities for a more secure and more modern approach to increasing the value of funds in personal pension accounts.

Table 2: Forecast for the development of retirement pension savings with the predicted average appreciation of assets at 3% p.a.

Year	Number of savers	Assets in funds SKK bn	Ratio of fund assets to GDP
2005	1 114 513	9.04 Sk	0.61 %
2006	1 350 000	43.28 Sk	2.78 %
2007	1 390 000	73.60 Sk	4.52 %
2008	1 430 000	106.89 Sk	6.28 %
2009	1 470 000	141.64 Sk	7.96 %
2010	1 510 000	179.76 Sk	9.67 %
2011	1 550 000	221.43 Sk	11.45 %
2012	1 590 000	266.83 Sk	13.27 %
2013	1 630 000	316.15 Sk	15.11 %
2014	1 670 000	369.60 Sk	16.99 %
2015	1 710 000	427.36 Sk	18.89 %
2016	1 750 000	489.66 Sk	20.81 %
2017	1 790 000	556.70 Sk	22.75 %
2018	1 830 000	628.71 Sk	24.70 %
2019	1 870 000	705.93 Sk	26.80 %
2020	1 910 000	788.57 Sk	28.92 %

Source: Estimates from the Statistical Office of the Slovak Republic (ŠÚ SR), the Ministry of Finance of the Slovak Republic, the NBS, and own calculations.

Chart 8: Respons to the question "What is your assessment of the pension reform?"

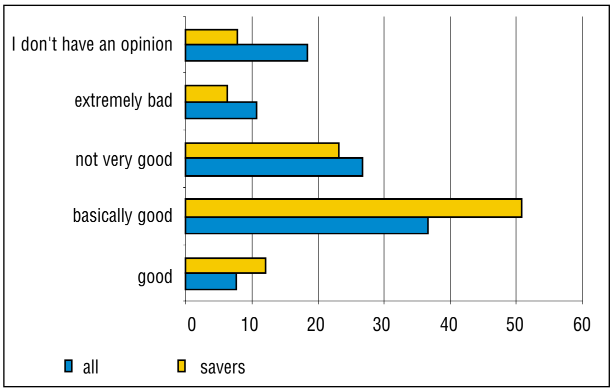


Chart 9: Importance of the private ownership of savings under the second pillar and their inheritability

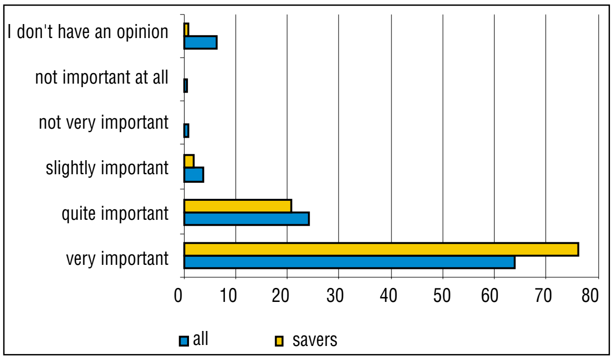
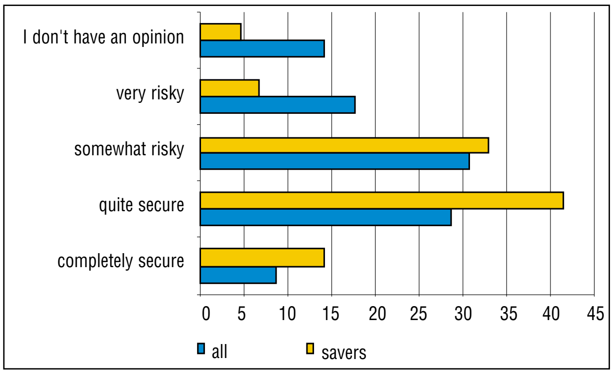


Chart 10: Security of the second pillar of pension reform



Source: MVK agency.

How the public perceives pension reform

Between 17 and 23 March 2006, a public opinion survey was conducted by MVK agency on a representative sample of 1,500 people aged between 18 and 40 years. The results of this survey show that 44% of the Slovak public consider the pension reform of the whole system of pension insurance (1st, 2nd and 3rd pillars) to be either "basically good" or "good". What is particularly important in their view is the private ownership of pension savings in the 2nd pillar and their related inheritability. This was seen by 88% of the respondents as either "very important" or "quite important". The security of the second pillar was also considered very significant. In this regard, an overwhelming majority believe it is important to have tight controls on the management of funds in personal pension accounts.