COUNTRY SPOTLIGHT ESTONIA

Estonia: A new pensions architecture

Francesca Fabrizi looks at why Estonia's recent pension reform has created much debate and controversy over the past year

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January 2021 saw big changes hit the Estonian pension system, with the second pillar converted to a voluntary system giving savers the right, whatever their age, to access their pension pots early.

The dramatic move was rushed through last year, despite much disagreement and debate, with even the government and the country's president, Kersti Kaljulaid, at odds over the changes.

The Estonian pension system was originally built on a traditional three-pillar model – the first the state pay-as-you-go pension, the second a mandatory funded pension and the third a voluntary funded pension.

The funding of the second pillar included a 2 per cent payment from the employee based on their gross salary, and a further 4 per cent supplemented by the state budget. This proved to be one of the sticking points for the president who argued that the 4 per cent contribution – which was originally intended for pension and national health insurance purposes – should remain so. The new pension reforms would change that purpose, which, in her view, was unconstitutional.

Given her concerns, the legislation went back and forth, eventually ending up in the hands of the Supreme Court, which finally ruled

against her in October 2020. The president was forced to sign the bill and the majority of the provisions took effect from January this year.

A political decision

At this point in time, there are strong public opinions both for and against the reform, says BNT Attorneys-at-Law partner, Aet Bergmann, although it is hard to state any reliable numbers of who is for and who is against, as the political landscape is changing all the time, she says: “The pension reform was the election promise of the political party Isamaa, who received 13.7 per cent of the votes in the parliamentary elections of 2019 and was one of three parties in the coalition government of Estonia. However, right now, after premier Jüri Ratas declared his resignation in January, a new coalition is being formed without Isamaa.”

Swedbank pension support area manager, Jarno Edur, concurs that the reform was a political decision driven by a relatively small party who ended up in coalition and pushed it through as their main agenda. “So it was not a well thought through pension reform as such – rather it was a political promise that needed to be executed to give people the possibility to withdraw their pension savings earlier than at retirement,” he says.

A true indication of the reform’s popularity will come to light once the number of people choosing to leave pillar II has been revealed, although it may be some time before those figures are finalised as individuals need not make the decision straight away, says Mercer multinational client service leader for Estonia, Britta Hunt: “It is not necessary to do anything immediately when the changes take effect. Everyone who wants to can continue to contribute to the second pillar in peace.”

Similarly, those who were not previously part of pillar II can also join. For those who do choose to leave and withdraw their money, the earlier they do so, the earlier they will receive their savings. Those opting to leave the schemes between 1 January and 31 March will be given a lump sum payment in September, minus 20 per cent income tax. Those who apply between 1 April and 31 July will get their tax-deducted payment on 1 January 2022, and those between 1 August and 30 November will be paid in May 2022.

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Under the new regime, savers will also have the option to transfer their money to a local Personal Investment Account (PIK), where returns are reinvested tax-free and savers can make their own investment choices.

To date, unsurprisingly, interest in withdrawing money has been quite high, confirms Edur, with up to 10 per cent of all pillar II participants opting to do so, “but that was expected, with surveys having indicated withdrawal interest at around 20-25 per cent,” he says.

At this stage, he adds, it is hard to say whether more or less of the expected level will leave pillar II. “The start was expectedly intensive, but the figures are decreasing day-by-day. Also, there is a clear window for several months to reconsider the decision that has been made (and every day we have customers who have reconsidered) and probably all market players will fight for their customers.”

There is also a state-level campaign, he continues, which emphasises that there is no need to rush into the decision of withdrawal as it will be a permanent change in the pillar II system, “so the withdrawal option should be used only as a last option if all others have been used,” he says.

Arguments for the reform

Giving individuals more control over their savings is always going to resonate with a proportion of the population, especially if it gives them the potential to invest their money in more rewarding assets or vehicles. One key factor behind the reform was in fact the general dissatisfaction regarding the performance of the second pillar, argues Estonian Insurance Association CEO, Mart Jesse, which had been slowly building over the years due to “low investment returns in comparison with other OECD countries”, he comments.

The Estonian reform, therefore, gives pension savers the potential to do financially better than they could have otherwise done under the old regime.

Aon head of branch in Estonia, Riina Neljand, explains: “Pension portfolio gains have been relatively low and service fees have been quite high – with smart investment plans, much higher investment returns are possible.”

The change could particularly benefit individuals with good financial knowledge, she adds, who make sound investment decisions via ETFs, stocks or real estate, for example.

On an individual level, the pension reform brings other positive aspects too, says Edur, such as “more tax optimal withdrawals at retirement age, more flexible usage of monies while at retirement, as well as more flexible investment options, such as the pension investment account, which is an investment vehicle within the pillar II framework allowing people to invest funds on their own".

The positive changes could be even longer term and indeed wider reaching too than just pensions, according to Hunt. "While we don't think the impact will be noticed right away, in a few years' time, the market for local pension insurance will open up due to this change and this will mean new possibilities for companies and employees.

"At the moment, we have the state pension system and private pension insurance is not something employers are offering due to the high tax rate that applies (a fringe benefit tax, almost 80 per cent on top of the premium). It is highly possible that, due to the pillar II changes, there will be some kind of change in legislation and hopefully a tax-free limit for pension insurance will also be implemented. If this happens, Estonian employers will have the possibility and motivation to offer their employees additional pension insurance," she says.

The government also looks to benefit from the reform, due to the boost in income tax and VAT revenues.

Arguments against

Despite its lacklustre performance and hence the desire for some individuals to withdraw their money, the second pillar has still become crucial for many pension savers, argues Bergmann. "An average Estonian who has also made payments to the (totally voluntary) third pillar could by now expect a remarkable part of their pension to come from the second pillar. For example, in my personal case about one quarter. For people who have not been saving into pillar III, the importance of pillar II is even higher," she states.

"THIS IS WHY NATIONWIDE IMPROVEMENT OF FINANCIAL KNOWLEDGE IS ESSENTIAL"

More significantly, the concerns around the adverse effect on long-term pension provision in Estonia, originally highlighted by President Kaljulaid, have not gone away. "The reform means two-thirds of funds invested by the government originally intended to secure the sustainability of the pension system could be used for consumption and purposes other than providing a pension," argues Jesse.

"The rhetoric behind the change was to give freedom and flexibility to people. At the same time, projections even by the government itself showed a decline of the future pension replacement rate," he says.

Meanwhile, Bergmann adds that, while the main political argument for the reform was "the promise that everyone was wise enough to save for their pension themselves without any administration and any fees by banks", the fact that everyone actually has to take care of their retirement plans in time has hardly been addressed.

Even more worrying is the fact that market surveys suggest the people most likely to withdraw the funds are those with less savings and lower levels of education, which could open up a whole new set of problems, Neljand warns. "Individuals who have inadequate knowledge of investing may lose considerable amounts of their savings if they make poor investment plans; or may not invest it and just spend it on things that do not bring any financial return at all."

This is why nationwide improvement of financial knowledge is essential, she urges. "The government should apply some kind of instrument to raise people's awareness of financial matters so that we can all benefit from the changes."

Indeed, approximately 33 per cent of all pillar II investors have saved less than €2,000, explains Bergmann, and it is hard to imagine that they will use this money for anything else other than food, clothes, or minor household expenses, she comments: "About 48 per cent have saved between €2,000 and €10,000; an optimistic view would be that they invest wisely in stocks, property (with an additional loan), or their children's education; but polls have shown that, for most of this money, there is no plan yet. A used car, reserve money for unforeseen expenses or once-in-a-lifetime travel after the pandemic are options that sound more realistic."

Finally, only about 19 per cent have more than €10,000, this being the part of the nation that has been within the second pillar system for a long time, with a better income and probably better investment knowledge. She continues: "The individuals in Estonia who possess more than €200,000 in their pillar II account are not the ones we should worry about; but rather the average Estonian who takes their money and runs to spend it, as they may be the poor pensioner in some 20 or 30 years.”

Significantly, once they have left the second pillar, individuals are unable to join again for 10 years. The people who celebrate the freedom of their money today, she warns, are leaving this part of the pension system for a long time, maybe forever. “My personal fear is that they will be in urgent need of help from the state once they are old. The diminishing population with a growing percentage of elderly will have a hard time supporting them.

“It is fine to amend systems if they are not sustainable; but in this case I see no real alternative, no action towards securing the living standard of future pensioners, no campaign for developing a realistic plan for the future. As the main problems to be solved were the bank costs and the low productivity of the pillar II money, that would have been the logical point of reform; instead, a solution by axe method was chosen. Therefore, in my opinion, the ‘free money’ promise is a populistic and short-sighted approach”, she adds.

Neljand argues too that the negative impacts could go even further than just the pensions industry: “Quick additional money will increase inflation, plus a considerable amount of pension fund money has been invested in the local market to date, so withdrawal may give rise to problems in construction, real estate, banking and other sectors. Add to this, raised tax in the long run,” she says.

All in all, Estonia as a state and banking sector might lose considerably, she warns.

The other obvious drawback of pension freedom is the increased risk of exposure to pension scammers, as highlighted by Swedbank Estonia earlier this year. The bank informed its clients that phone calls from scammers have been made with increasing frequency in recent months, with scammers offering, among other things, what they describe as options to withdraw from the second pension pillar on favourable terms.

Edur comments: “We can assume investment frauds to be increasing and this has also been identified at government and ministerial levels. On this matter, therefore, more and more information needs to be provided. We have seen banking scams already through last year increasing and more and more information is being provided on this topic as well.”

Into 2021

All in all, the arguments for and against the reform are numerous and, as Neljand puts it, “every big change brings out some controversy and pension reform is no different”. Some people will benefit and for others there are drawbacks.

Encouragingly, the newly-formed coalition is already promising to work hard to make the best of the reform, argues Edur: “As the previous coalition fell apart in January, the new coalition is being formed and their main message is that there is no intention to turn the reform around, rather they will focus on informing people more about the long-term savings need.

“Also, market participants are working heavily to introduce the new investment option to its customers. So on a societal level, we probably will see some groups with less pension income but, on the positive side, we could expect to see an increased level of financial education.”

Whatever the current opinion, there is no doubt, however, that other governments in the region will be keeping a close eye on Estonia’s reform to see how it develops over the coming year. As Willis Towers Watson developing and emerging markets leader, Michael Brough, concludes: “The various multi-pillar pension systems established in Central and Eastern Europe following European Union accession have all struggled due to ageing populations and the nature of their funding arrangements. Other governments may well look to copy the Estonian approach if it proves to be popular and successful in short-term tax generation given the current state of government finances.” ■