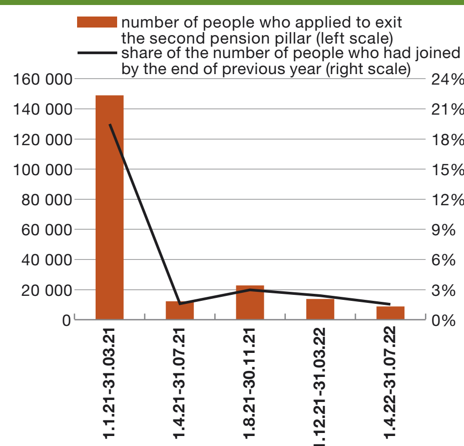
APPENDIX 2. THE EFFECT OF THE PENSION REFORM ON PENSION FUNDS

Changes to the pension system started to apply at the start of 2021, the most important of which was that pension investors could exit the second pension pillar before reaching retirement age. Eesti Pank carried out an impact analysis before the change came into force[27], and one of the impacts it considered was the possible effect of the pension reform on financial stability. The main ways that Eesti Pank considered the reform might impact financial stability were that it could create liquidity problems for funds whose assets were largely illiquid, that the increased need for liquidity could lead to changes in the asset structure of pension funds, that rapid sales of assets could cause losses, and that various new risks could arise for pension savers as the Guarantee Fund does not cover incorrect and therefore loss-making transactions made by individual investors. Eesti Pank also pointed out that before the change came into force, people were notably more passive about saving pension assets voluntarily than doing so automatically through the second pillar, and there may be relatively fewer investors in the future who are prepared to increase their pension savings independently, given the savings habits of people in Estonia.

The original pension reform law was amended to extend the time allowed for payouts to five months, which helped the funds cover the withdrawals within the time limit allowed for them without any major hitches. There had been several rounds of withdrawals from the second pillar by August 2022, with the largest departures coming during the first round in 1.1.2021–31.03.2021 as almost 20% of savers left. The share of pension savers leaving the pillar was notably smaller in subsequent rounds and was generally below 3% (see Figure A2.1). Although the number leaving in the first round was relatively large, the funds did not suffer any short-term liquidity problems because of the early withdrawals, and the payouts were made on time.

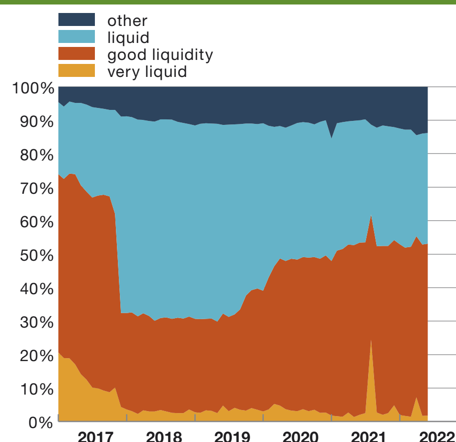
The share of liquid instruments in the asset structure of the funds as a whole has increased a little. In early 2019 before the pension reform, 30% of assets had very good or good liquidity[28], but by the time the reform first passed the Riigikogu that share had increased to almost 50% (see Figure A2.2). At the end of June 2022, 53% of assets were in that category. The volume of the least liquid assets has not particularly changed since the pension reform came into force, and 14% of assets are in that category. The share of foreign bonds in the holdings of funds has fallen since early 2021 from 25% to 10%, while the share of

Figure A2.1. The number of people who have exited the second pension pillar



Sources: Pensionikeskus, Eesti Pank calculations

Figure A2.2. Pension fund investments by liquidity



Source: Eesti Pank

27 Impact analysis of the changes to the pension system, November 2019 (https://www.eestipank.ee/en/press/eesti-pank-has-prepared-detailed-impact-analysis-changes-pension-system-01112019).

28 The liquidity of assets uses the following classification: very liquid means deposits and money market instruments; good liquidity means foreign fund units; liquid is foreign securities and Estonian shares; and other means assets with low liquidity including real property in Estonia, fund units, unlisted bonds and similar.

foreign equity funds has increased from 33% to 41%, and the share of equities has increased from 13% to 21%. The changes for other instruments have been quite marginal.

Developments in financial markets were generally positive and supported the sale of the assets needed to cover the payouts. Rapid sales of assets in financial markets often mean that the assets have to be sold at below the market price, but there was long enough between applications for withdrawals being submitted and the payouts being made for this risk to be reduced. Beneficial trends in financial markets also helped reduce this risk, as the prices of the assets continued to rise, and so they did not need to be sold at a loss. The overall EPI index rose for example by 8% during the first round of withdrawals and by 5% during the second. The volatility and uncertainty in financial markets meant that the results for the third and fourth rounds were negative, meaning that people who withdrew their savings during those rounds got less money on average from the funds than they would have had at the point they applied to withdraw. The EPI index fell by 1.4% during the third round and by 10% during the fourth round, showing that the risk remains that a fall in the market during the withdrawal period can reduce the value of the investment.

Relatively little use has been made of individual pension investment accounts for independent pension saving. One of the main changes of the pension reform was to allow people to invest their own money through independent accounts in the second pillar. A relatively small number of pension savers have so far made use of this option. There are only a little over 4300 such active investors[29] and as at 13 September 2022 they accounted for less than 1% of all pension savers. Earlier Estonian Household Finance and Consumption Surveys[30] have shown that financial assets are still dominated by deposits, which partly illustrates a conservative attitude to investing financial assets, and partly the preference of people in Estonia for investment in real assets rather than financial investment. The banks also report that a part of the money withdrawn from the pension pillar has been put into real estate. Investing independently in securities markets also requires quite a lot of knowledge, skill and time, meaning that this is not necessarily a good option for a large proportion of pension savers, and there is no guarantee that independent investors will be any more successful in their investments than, for example, pension funds. Although too little time has passed since the pension reform to draw any conclusions about whether the results of individual investors have been better or worse than those of the pension funds on average, the first signs indicate that the returns for those who have invested through an individual pension investment account have been lower than the average for pension funds[31].

The option of exiting the second pillar early has created the risk that some pension savers may decide to withdraw their money from the second pension pillar before reaching retirement age because of volatility in securities markets, a sharp fall in prices or temporary financial difficulties. It was not possible for pension savers to exit the second pillar early before the pension reform, which meant that the risk of savers withdrawing from investments was very low, as it could only be done by switching fund, or almost non-existent, but this risk has materialised after the reform. This risk has been clearly illuminated by what has happened with savings in the third pension pillar. When securities prices dropped and incomes fell during the previous global financial crisis, the volume of early withdrawals from the third pillar funds increased (for more see page 23 of Financial Stability Review 1/2020), and so making the second pillar voluntary has meant the same may happen to that pillar in the future.

In conclusion the impact of the pension reform on pension funds has so far been quite modest. The introduction of the pension reform allowed savers in the second pension pillar to withdraw the money they had saved early, which was a major change from the earlier system. It can now be observed, a year and a half later, that the impact on pension funds has remained relatively limited.

29 The number of active investors includes people who make payments into the second pillar by obligation and whose active choice in the second pillar is a pension investment account.

30 The Estonian Household Finance and Consumption Survey 2013 and 2017. https://statistika.eestipank.ee/#/en/p/LEIBKONDADE_VARAD_JA/r/2432/2240

31 How did savers through LHV PIK fare last year? (in Estonian) https://fp.lhv.ee/news/newsView?newsId=5638379.

Pension fund managers had enough time to make the payouts on time in the first round of withdrawals, when there were the largest number of departures. The share of liquid instruments in the structure of the assets of the pension funds increased, but there was no major change in the share of the least liquid instruments. The trends and development in the financial markets were favourable at first, and so the investors who decided to withdraw their money early did not suffer additional loss.