U.S.-EU-SLOVAKIA ACTION COMMISSION

International Seminar on Pension Reform in Slovakia,

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Hotel Forum Bratislava, Congress Hall

Will the Slovak Republic citizen become a serf paying regular tithe to the feudalist, the current pension system management company?

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As for solving the Pillar II pension system we can currently say that majority of solutions submitted by experts or politicians of individual political parties in the Slovak Republic have been harmonized on the basis of World Bank where the Pillar II is established by capitalization system, having to ensure risk diversification with the Pillar II representing labour revenues and the Pillar II is to depend on capital return.

The fundamental question is: ***Will the Slovak pension system be based on feudal principle of making mandatory contributions of tithe to the feudalist and church in the modern system with management companies appointed by law?***

At first glance an aggressive question can be without much effort documented and solutions to this question basically depend on whether we want *such assets amounting to 20-40% of the pension benefit to be transferred to the future rich asset management companies or to give them to those who had actually contributed it into the system and which are the results of their work, that means to the future pensioners of the Slovak Republic?*

As it is in Chile, where pension funds represent at least one GNP in balanced condition we can see that also in case of Slovak Republic the Pillar II shall experience balanced conditions with around one GNP during the period of 35 years and shall fluctuate depending on demography and slightly on unemployment development. ***The question thus is whether the management companies shall, in the 35-year long run, absorb around1/3 GNP for administration of those accounts or whether one, maximum two per cent will remain to pensioners for ensuring decent life at the time of retirement.*** *Three graphs below clearly show that an amount of one per cent of the managed assets paid every year for the period of 35 years means decreasing the value of the insurer's account by 20% after 35 years. From this point each tenth* of a per cent of the assets value decreases the value of an account by around 2% in comparison to ideal state.

If we consider that all systems, evaluated and assessed, will passively invest in for example state bonds of just one state then, as for returns, such bonds will be with the same result. In other words, risks and bond returns will be the same. The only thing that will differ are the expenditures.

As shown by analysis only expenditures represent factor the most significant for assessing whether given solution is suitable or not in case of investments in capital markets by means of such funds. If we analyse individual systems from the point of expenditures we will find out the following: If we create a basic pension fund model according to picture 4, consisting of management companies and a fund with individual clients' accounts, we find out that the management company fulfils two main functions:

- manages individual client’s accounts
- manages assets in such accounts.

Such tasks are awarded by commission that can be set by law and has limits exactly defined limits.

The analysis points out that no matter whether the management company is public institution or private institution, there is ***always conflict of interests between these two functions. It leads to reducing the returns in clients' accounts and due to charges for accounts management it leads to absorbing returns for the benefit of the management company.***

Only after separating these two functions and introducing the third entity *is it possible to achieve situation in which the assets management, through competitive assets management companies of the private sector, creates competition in market by decreasing expenditures to 0.1% of assets per annum - Trift Plan USA, or to 0.2% of assets per annum as a maximum charge, being presented by the Canadian Investment Committee, and thus maximize returns and minimize expenditures.*

The same is it with the accounts management issue which can be divided into the situation with competition - the Pillar III, or the competition is substituted by mandatory pension system into which each person is obliged to pay part of his or her contributions. If we are aware that a person is not able to decide on the basis of returns but only expenditures (that means according to real facts) it is obvious that he or she must be offered such product which describes the system with defined returns (benchmark system) while having minimum expenditures.

A developed capital market of the USA enables to introduce products based on passive investing at three different risk levels which are recommended to people according to their age, or in other words, according to three different periods of investing, which are the following:

1. the bond funds with lower returns, lower risks and higher liquidity. It is the fund with an investment period of 5 - 10 years.
2. Index Standard and Poor 500 is an instrument for passive investing with relatively low risks of investment into shares, higher returns in comparison to bond funds, with an investment period of 5 - 15 years.
3. Index Russel 3000 is relatively aggressive type for investing, suitable for younger people.

The Trift plan participants can decide, upon recommendations regarding their age, or period for investing described above, but they cannot actually freely decide whether to invest into their own account or to choose appropriate fund which does not have defined product in terms of exactly defined investment structure. As proved by literature sources, this system shows the lowest costs of 0.1% of assets per annum, which does not represents more than around 1% of potential value of an account in ideal conditions, expenditures excluded, after the period of 35 years.

The same system with investment committee had been introduced in Canada where the assets management based on competitive management companies in a private sector is strictly separated from the account management based on solely public institution without any competition and where they make sure that this institution, similar to our Social Insurance Agency, has the lowest possible administration costs. In case of Canadian system, expenditures amount to 0.1 - 0.2 % of assets per annum, while the Investment Committee is responsible for defining the products according to competitive private sector for assets appreciation and chooses the best possible solutions which are submitted to the Board of directors so that the maximum returns with reasonable risk are to be achieved.

As for the mandatory system, all the other systems, either in Chile or Great Britain,
started to apply an opportunity of choice, while the analysis point out the fact that people are not able to

make decision according to real facts even if they would be qualified in the area of investment banking, because in order to do so they would need to have knowledge of the fund efficiency within the period of 20 - 800 years. For this reason, participants can decide only according to their emotions, in other words, according to well proposed marketing plan. The cost analyses show that such marketing plan costs 0.4 - 0.6% of assets per annum. In case of mandatory systems with competitive insurance companies one has to expect changes, such as a participant changing insurance companies and for this reason the fund investment strategy may not be optimal, neither from the point of liquidity, time nor amount of invested sources. Analysts point out the alternative expenditures that amount to 0.1 - 0.3% of assets per annum.

While dividing assets into various funds, it is necessary to examine the size of market because it's been evidenced that up to the value of assets, around SKK 1000 billion it is possible to decrease expenditures depending on extent. Alternative expenditures can be anticipated again to 0.1 - 0.2% per annum.

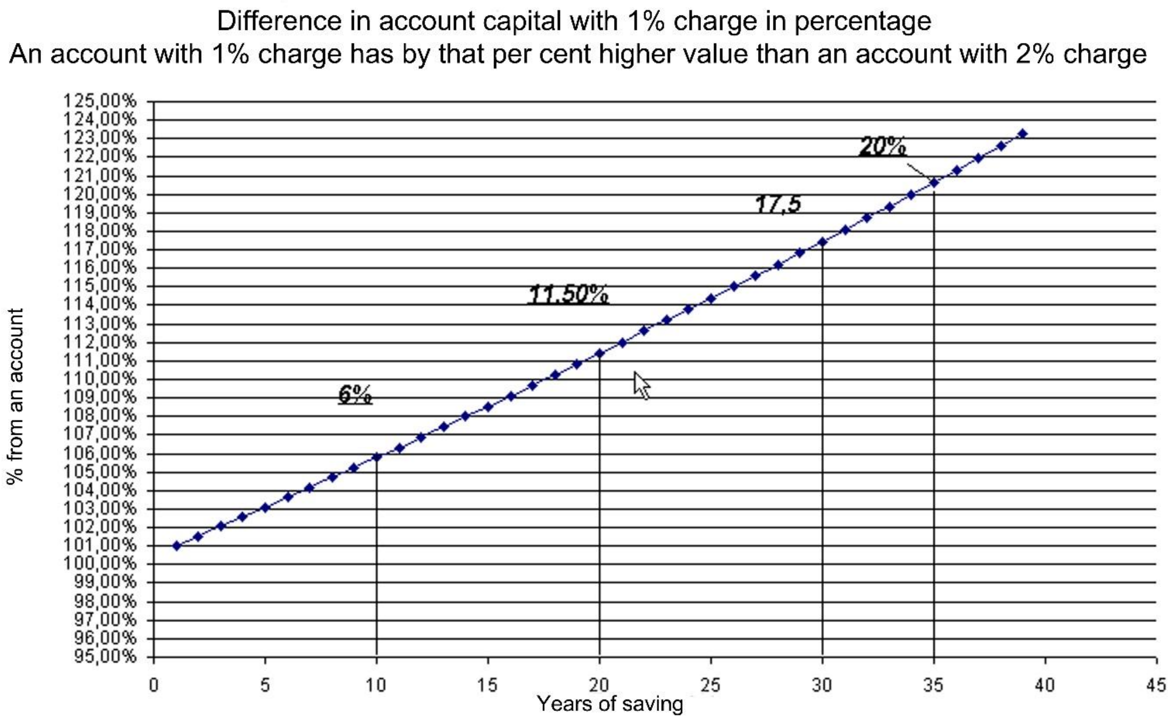
If we thus define that a person cannot make a decision according to returns in which fund of the mandatory pension system he or she wants to be insured then we can say that the mandatory system with the accounts management separated from the assets management, where private management companies naturally compete, is the system with minimal expenditures providing maximum returns. Moreover, such system solves the conflict of interests arising out of the assets management and accounts management being managed by one management company.

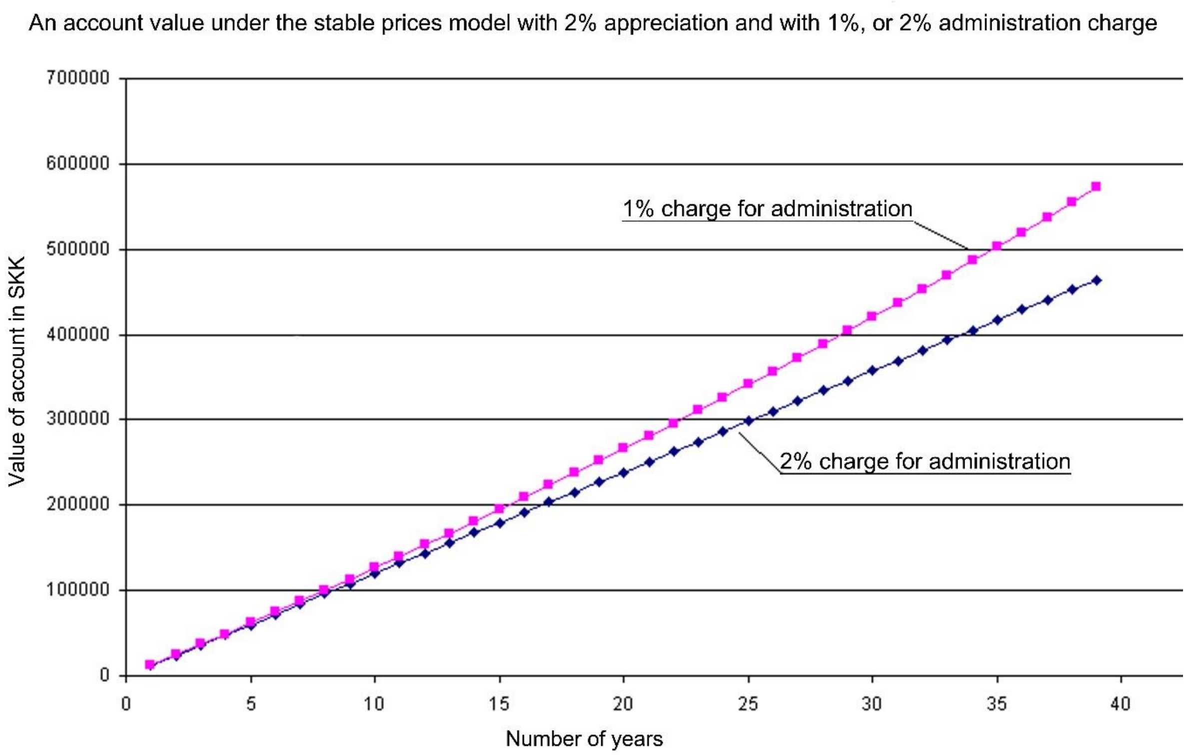
If we add up cost item we find out that additional expenditures can be calculated at 0.8 - 1% from the point of account management, having to decrease the value of pension from 15 - 20% in comparison to ideal conditions. If we add up also a certain undefined part arising from the conflict of interests, which for example in Great Britain amounted to 0.7 - 1% we can assume that ignoring these facts may lead to yet bigger assets depreciation, as it can be already seen in the running supplementary pension insurance under the Slovak Republic conditions. There are currently analyses in progress assessing the results of appreciation for preceding four years and the first results point to the low appreciation of assets in the participants' accounts, yet even below inflation. This implies that assets are being depreciated.

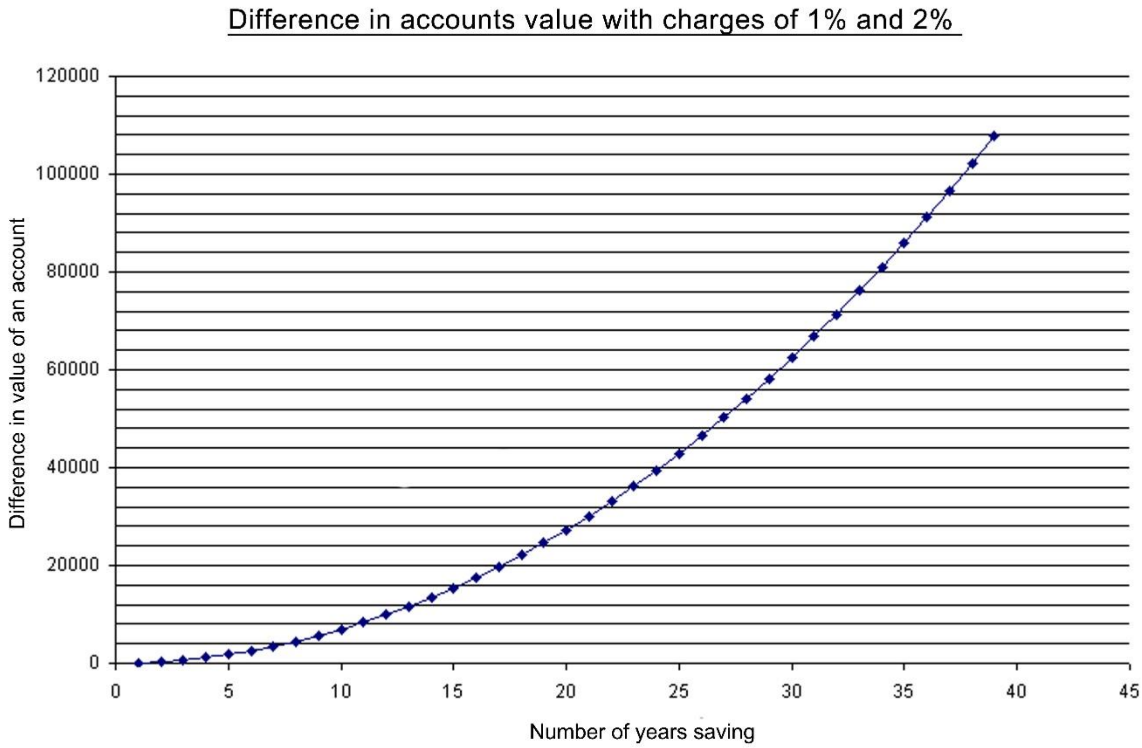
Summary

A solution based on competition between private pension funds implies that the value of pension after the period of 35 years of having to save shall decrease by 20 - 40%, as it happened in Chile or Great Britain, and in comparison to modern technologies introduced in the USA and Canada where value of these accounts is reduced by maximum 2 - 4%, leads to a situation similar to feudal system that had been in Slovakia with a serf paying a tithe to a feudalist and a tithe to church. The question is: ***Will the political parties enforce a system that turn the pension management companies into the modern feudalists and people of Slovakia into new serfs.***

At Liptovskom Mikuláši 5 June 2002 Dušan Lukášik


Difference in account capital with 1% charge in percentage
An account with 1% charge has by that per cent higher value than an account with 2% charge
% from an account
Years of saving
6%
11,50%
17,5
20%


An account value under the stable prices model with 2% appreciation and with 1%, or 2% administration charge
Value of account in SKK
Number of years
1% charge for administration
2% charge for administration


Difference in accounts value with charges of 1% and 2%
Difference in value of an account
Number of years saving
120000
100000
80000
60000
40000
20000
0
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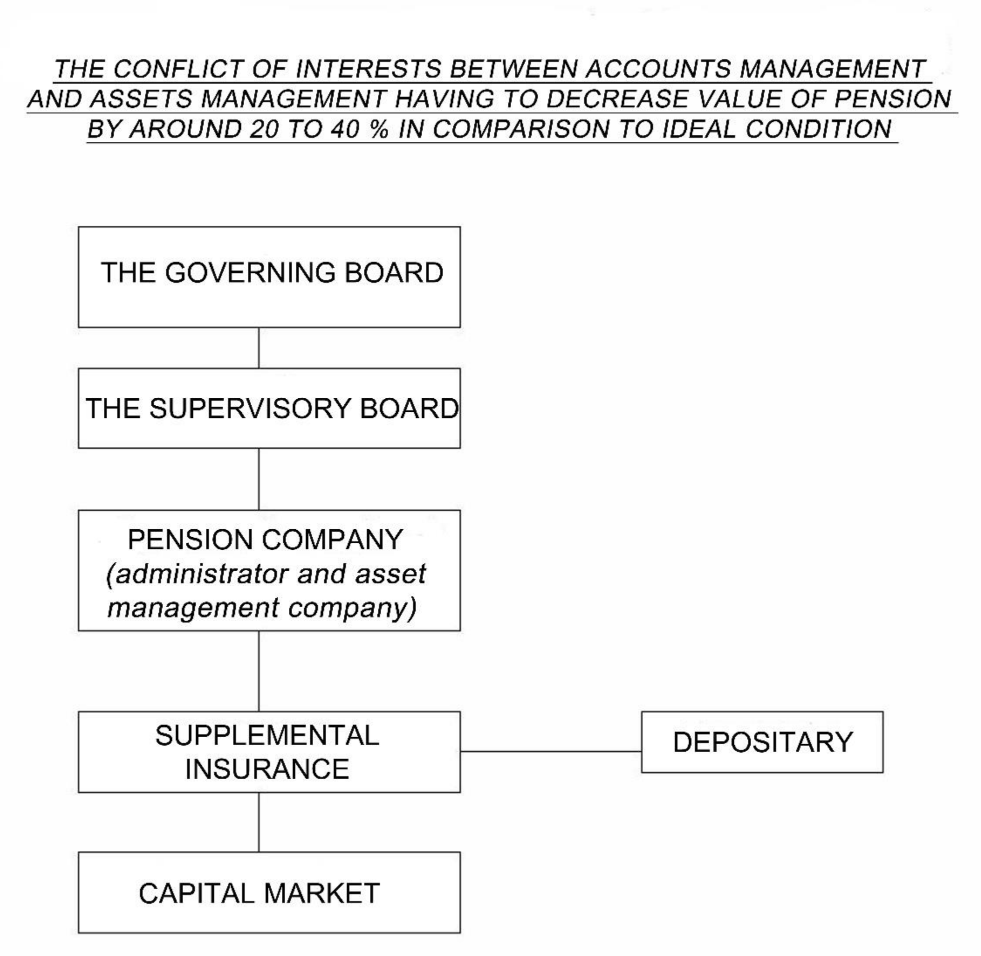
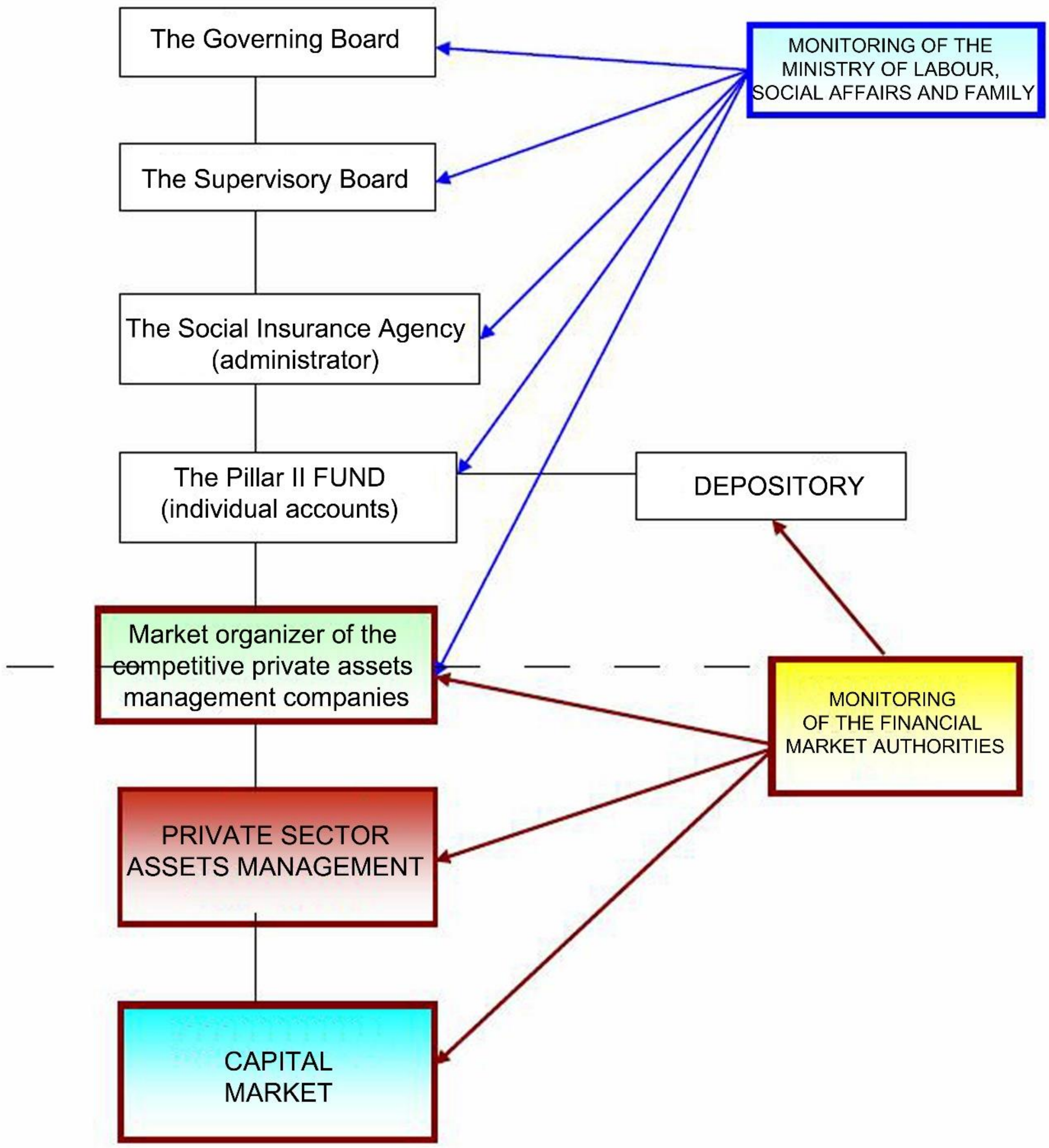
5
10
15
20
25
30
35
40
45


THE CONFLICT OF INTERESTS BETWEEN ACCOUNTS MANAGEMENT AND ASSETS MANAGEMENT HAVING TO DECREASE VALUE OF PENSION BY AROUND 20 TO 40 % IN COMPARISON TO IDEAL CONDITION
THE GOVERNING BOARD
THE SUPERVISORY BOARD
PENSION COMPANY (administrator and asset management company)
SUPPLEMENTAL INSURANCE
DEPOSITARY
CAPITAL MARKET

THE CONFLICT OF INTERESTS BETWEEN ACCOUNT MANAGEMENT AND ASSETS MANAGEMENT IS SOLVED BY SEPARATING THEM AND CREATING INVESTMENT COMMITTEE HAVING TO DECREASE PENSION BY 2 TO 4 % IN COMPARISON TO IDEAL CONDI TION



Proposed organizational structure