Croatia: Consumer Protection in the Pensions Sector

Croatia has installed a classical 3-pillar pension system, with 30% of the population registered in the mandatory private pension funds. There are more than 1.4 million members in the mandatory second pillar from a population of approximately 4.6 million. While the second pillar’s contribution rate is relatively low at 5%, funds under management have grown rapidly since the system began to operate in 2002, reflecting high compliance levels and good real rates of return. As of December 2008 there were HRK 23 billion under management through mandatory arrangements and HRK 800 million through voluntary arrangements.

Pension funds in Croatia have “no legal personality” and are similar to life insurance segregated funds (rather than being mutual organizations where members are responsible for the financial state of a self-managing legal entity). They are managed by commercial “pension companies” and much of the relevant law is concerned with prudential and operational controls over the activities of these entities. Croatia has sensibly not fragmented the various activities involved in running a pension fund.

Each mandatory fund is only allowed one manager and consolidation rules applied until 2007, where a fund had to attract at least 80,000 account holders within 3 years to remain in the market. This situation led to some early mergers and acquisitions. Every employed person in Croatia who has joined the mandatory system is only allowed one account at a time. In contrast the minimum number of members for a voluntary pension fund is 2,000 (also after 3 years) and eligible individuals are allowed to hold more than one voluntary pension fund account.

All contributions to mandatory funds are initially remitted to a best-practice information clearing house called the Central Registry of Insured Persons (REGOS). REGOS carries out relevant individual record-keeping. When initially becoming eligible to join a mandatory fund, individuals are required to sign the relevant forms and choose a fund in neutral surroundings such as an office of the Financial Agency (FINA). Only information provided by HANFA (the non-bank financial supervisory agency) may be visible at this stage. To date between 80% and 90% of eligible new members have elected to be randomly allocated to a mandatory fund. While it is strictly not necessary, mandatory pension companies maintain individual member records and would probably prefer to continue to do so as consumer databases are seen to have value.

There are 25 funds in the Croatian pensions system. The system is composed of 4 mandatory second pillar pension funds, 6 voluntary open-ended pension funds (i.e. retail funds) and 15 voluntary closed-ended pension funds (i.e. employer- or association-based). Retirement under the second pillar occurs at the same time as retirement under the first pillar. Each of the current licensed second-pillar managers is associated with a foreign financial institution and two of them (Raffeisen and Az) hold more than 32% of total members each.

At the end of 2008, there were 1.48 million mandatory pension funds’ account holders, 128 thousand open-ended voluntary pension funds’ account holders and 17 thousand closed-ended voluntary pension funds’ account holders. Voluntary pensions are eligible for return enhancement via a governmental contribution subsidy of 25% of the employee’s contribution (subject to a flat cap). As seen in Table 8, the number of members in the voluntary pension open funds is growing rapidly.

The decumulation arrangement would appear to be one of the main weaknesses in the existing system. The economic capital required to back the indexed life annuities can be very
high given reinvestment and longevity risks. In addition, the system is dependent on a single regulated private annuity provider. An indexed participating life annuity has to be purchased with the proceeds of the mandatory second pillar, although this may incorporate term certain and survivorship options. The compulsory nature of the annuity choice under the second pillar is forced by the need to prevent selection effects and the decision to use unisex mortality assumptions.

Voluntary pensions can be taken after age 50 and up to a 30% commutation is allowed. In addition term annuities for periods as low as 5 years can be taken, and they will inevitably provide much better value for money than life annuities. In the normal course of events a voluntary pension’s life annuity would provide less value for money than a mandatory pension’s life annuity because of the additional capital needed to cover selection effects.

For mandatory life annuities Croatia could possibly consider something along the lines of the Swedish system. In this system, the cost of capital is removed from the equation by having a partially self-balancing State-based arrangement that adjusts payments according to the results of ongoing annuitant mortality investigations. This would lead to larger initial annuities and the possibility of a flatter income stream over time, possibly reducing in real terms. Regardless of which approach is adopted, the current approach is unsustainable as the capital needs driven by incoming annuitants will eventually overwhelm the current monopolist supplier.

As the mandatory system is approaching a degree of maturity, the only way in which substantial market share changes will occur in future is through switching. This reality is beginning to be reflected in increasing commissions paid to the pension fund’s representatives/agents, which are now becoming more active in canvassing existing members of mandatory pension funds. Commissions for switching members tend to be flat as information on balances and contributions has been successfully held confidential. Approximately 2% of mandatory fund members switched in 2006 and there is now some data emerging that suggests that members who are switching tend to be in the lower-income and less well-educated sections of the population.

In this regard, it is relevant to note that pension funds in Croatia have some of the characteristics of standard retail collective investment vehicles. For example, back-end charges apply if a member decides to switch funds within a few years of joining a fund (0.8% in the first years reducing to zero in the fourth year). These back-end loads (originally designed to discourage early switching) are seen as a formal part of the income of pension companies as caps apply to the charges on contributions and assets under management (AUM) – 0.8% maximum on contribution and 0.95% for AUM. Overall charges amount to a little over 1.0% of AUM, which is comparable with retail mutual fund charges in industrial markets. The charges would be considerably higher if the national budget did not cover REGOS’ costs (estimated at 1% of AUM for the mandatory pillar).

Another special feature of the Croatian system is the very high initial and ongoing capital requirements of pension companies. Mandatory pension companies must have a minimum initial capital of HRK 40 million, of which at least 50% must be maintained at all times. Voluntary pension companies require an initial minimum capital of HRK 15 million. Additional capital of HRK 1 million is required by a mandatory pension company for every additional

---

14 See for example Olivieri, a. and Pitacco, E. Solvency requirements for pension annuities, http://journals.cambridge.org/download.php?file=%2FPEF%2FPEF2_02%2FS1474747203001276a.pdf&code=03a38a274c300d1cd36eeb438633b36
10,000 members (over and above 100,000 members). The onerous second pillar’s capital requirements presumably reflect the financial risk inherent in return guarantees that have to be underwritten by the reserves and capital of the pension companies (and ultimately the State)\(^\text{15}\).

**Table 8: Growth in Number of Members of Second and Third Pillar Funds**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of 2nd Pillar’s Account Holders (thousands)</td>
<td>983.3</td>
<td>1,070.9</td>
<td>1,170.1</td>
<td>1,248.9</td>
<td>1,322.0</td>
<td>1,395.7</td>
<td>1,475.7</td>
</tr>
<tr>
<td>Growth rate (%)</td>
<td>8.9</td>
<td>9.3</td>
<td>6.7</td>
<td>5.8</td>
<td>5.6</td>
<td>5.7</td>
<td></td>
</tr>
<tr>
<td>Number of 3rd Pillar’s Account Holders (thousands)</td>
<td>1.3</td>
<td>8.8</td>
<td>31.1</td>
<td>56.5</td>
<td>85.8</td>
<td>115.9</td>
<td>145.0</td>
</tr>
<tr>
<td>Growth rate (%)</td>
<td>552.2</td>
<td>254.9</td>
<td>81.3</td>
<td>52.0</td>
<td>35.1</td>
<td>25.2</td>
<td></td>
</tr>
</tbody>
</table>

Source: HANFA

Aside from own staff, three classes of pension intermediaries are acknowledged by the Mandatory and Voluntary Pension Funds Law. These are brokers, agents/representatives (Article 66) and investment advisors. However only investment advisors and brokers need to pass examinations and be registered. The specific roles and responsibilities of the three categories of intermediary are not defined anywhere in the pension law or regulations.

The major public awareness issue affecting the supplementary pension sector is the plight of a number of individuals (mainly women) who partially opted out of the first pillar under a provision available to those between the ages of 40 and 50. Membership of the second pillar was mandatory for those under 40 at the time of its introduction. Many of these individuals made their election based on a bequest motive (i.e. their second pillar’s balance can be passed on to dependents) and most evidently assumed that they would continue working for a considerable number of years. A number of these individuals are now retired and worse off than if they had stayed solely in the first pillar’s social transfer arrangement. This situation could be seen as a consumer protection issue, depending on the information and incentives that were provided at the time the individuals concerned made their election and on the circumstances surrounding their early retirement. However it is worth to note that an extensive public campaign was conducted before and during the implementation of the new pension system, through a wide range of communication channels (television, press, radio, internet, dedicated telephone lines, etc.)\(^\text{16}\) HANFA notes that, according to a survey conducted after the campaign, the general public was well informed on the pension system reform.

**Legal Framework**

The privately managed pension sector has a relatively self contained and integrated body of governing legislation. The main statutes are the Mandatory and Voluntary Pension Funds Law (OG 49/1999, OG 63/2000, OG 103/2003, OG 177/2004 and OG 71/2007) and the Law on Pension Insurance Companies and Payment of Pension Annuities based on Individual Capitalized Savings (OG 106/1999, OG 63/2000 and OG 107/2007). These are supported by a range of consumer protection sub-laws (ordinances) covering the marketing of pension funds, prospectuses, switching between funds, allocation of members to funds and professional training of brokers, investment advisors and fund managers.

\(^{15}\) International rules of thumb for the cost of operational risk alone lie between 0.5% and 1.0% of AUM.

\(^{16}\) During the transition period in 2002 HANFA set up a provisional calculator on its website enabling potential ‘opt-out’ members of the second pillar to compare possible outcomes.


**Institutional Arrangement**

The relevant supervisor of the pensions sector (HANFA) is also responsible for all non-banking financial institutions. It was established by the Act on the Croatian Financial Services Supervisory Agency (OG 140/2005) effective in November 2005. HANFA has particularly demanding supervisory responsibilities under the Mandatory and Voluntary Pension Funds Law, which is the responsibility of the Ministry of Economy, Labor and Entrepreneurship.

There are other key institutions associated with consumer protection in private pensions. These institutions are the Central Registry of Insured Persons (REGOS) which keeps the official member records and collects all contributions, the taxation authority which is responsible for enforcement and on-site compliance inspections, and public entities such as the Financial Agency (FINA) which provides funds payment and transfer infrastructure.