



ANNEX 88

Twinning Project AZ/13/ENP/SO/24

Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulating their activity

Thematic Mid-term visibility

Funded component of insurance – pension system

Jana Muizniece

**Director of Department of Social Insurance
of the Ministry of Welfare of Republic of Latvia**

29th April, 2015



Gesellschaft für
Versicherungswissenschaft
und -gestaltung e.V.



Content

1. The main framework of the funded component
2. Proposal on activation of voluntary component of labor pensions in Azerbaijan
3. Options for introduction of the funded component
4. Operation of the funded component
5. Conclusion

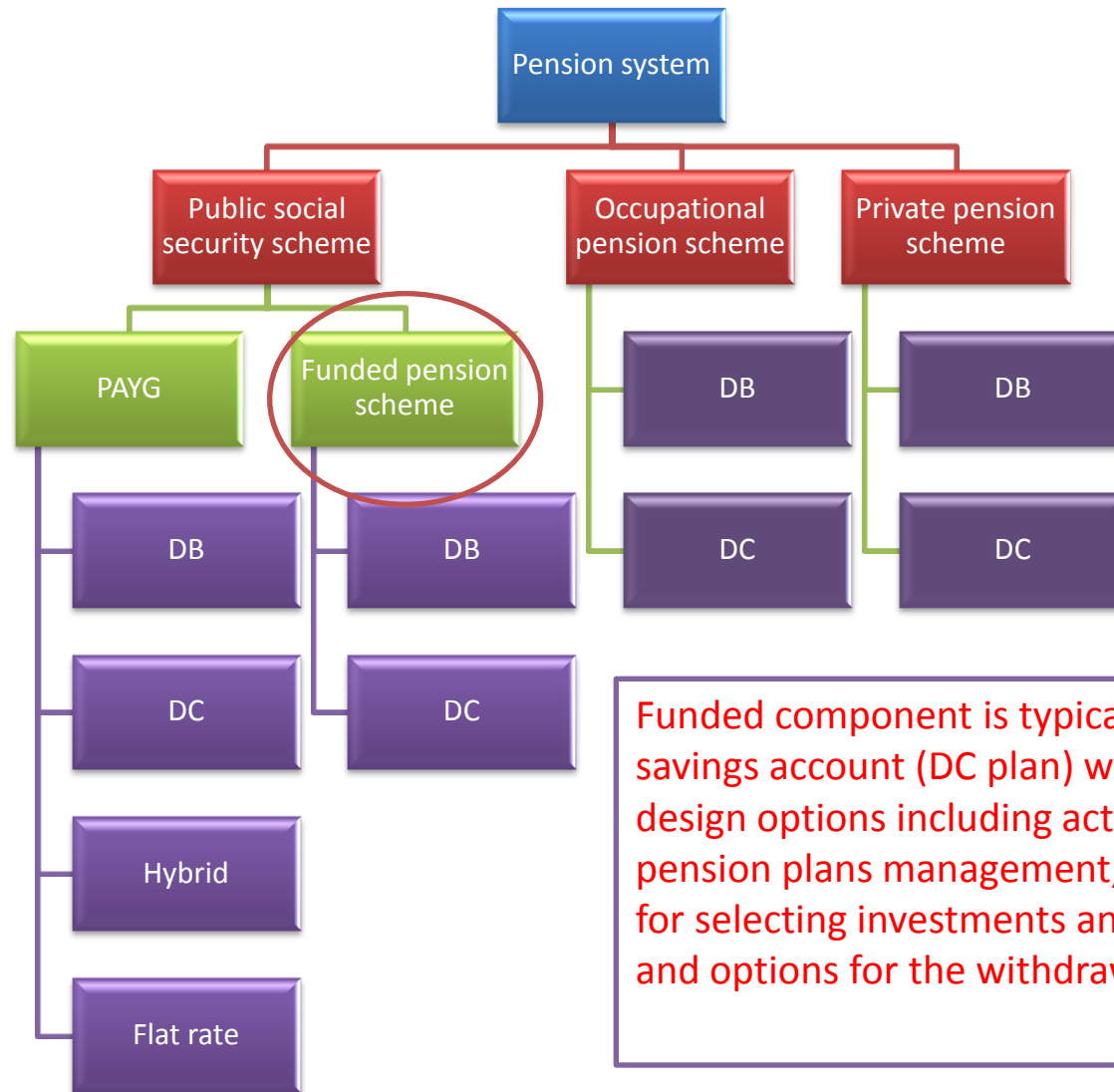
1. The main framework of the funded component

Goals of pension systems

To promote pension system financial stability in long term - diversification of demographical and economical risks

To increase replacement rate - protection of insured persons by saving more money for retirement

Different types of retirement-income provision in EU countries



Defined benefit schemes (DB) - Scheme where the pension payment is defined as a percentage of income and employment career.

Defined contribution schemes (DC) - Scheme where the pension payment depends on the level of defined pension contributions, the career and the returns on investments. The employee has to bear the risk of longevity and the risk of investment. Pension contributions can be paid by the employee and/or the employer and/or the state.

Hybrid pension schemes - Hybrid schemes combine elements of defined benefits and defined contribution systems.

Redistribution of risks

Between government and individuals

Between individuals

Between generations

Various pension pillars can help create sustainable pension systems

The timely established state funded pension component

To reduce the state liabilities for future pensioners and stimulate financial sustainability of pension system

To provide higher replacement rate

To develop, stabilise capital market and to stimulate the growth of the economy

Financial stability of
social insurance
system in long term

Replacement rate
for individuals

Total pension capital

Pension capital index
for public pension
part

Right contribution
size

Participation rate

Interest rate for
funded component



International experience

Some countries in EU has chosen funded component as one of pension system component in order to reduce the long-term cost of pensions, to reduce pension system less dependence from short term political decisions, to provide higher replacement rate and to develop, stabilise capital market and to stimulate the growth of the economy

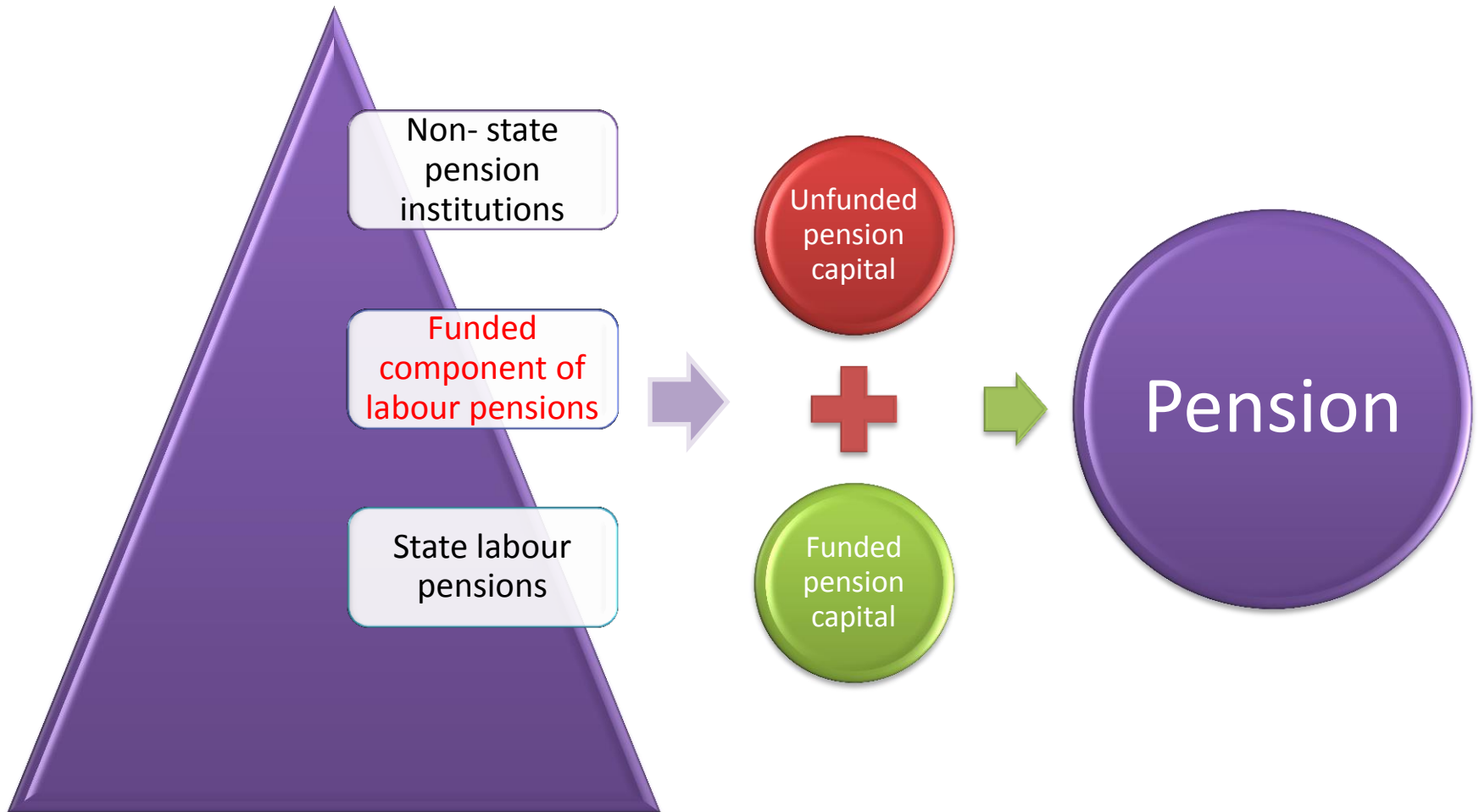
Funded component is established in several EU countries – Latvia, Estonia, Lithuania, Slovakia, Poland, Sweden, Czech Republic, Bulgaria

2. Proposal on activation of voluntary component of labor pensions in Azerbaijan

Reforms of pension provision system in the Republic of Azerbaijan in 2014-2020

5.7. Activation of voluntary funded component of labour pensions and development of non-state pension institutes. In order to achieve a reliable pension provision of people, it is intended to form mechanisms that allow provision **additional to the mandatory state social insurance**. It is considered reasonable to introduce voluntary social insurance on order to establish funded component in state pension provision system, as well as non-state pension institutions. To this end, it is intended to use a number of promotional means.

Reforms of pension provision system in the Republic of Azerbaijan in 2014-2020



**Relevant and feasible reform options depend
on country specific circumstances**



3. Options for introduction of the funded component

Different voluntary approach

International experience based on principle that contribution rate for funded component is included in contribution rate for old age pensions, with additional contribution from participant's side. It is crucial important find the best balance between liabilities for pension payments and replacement rate for future pensioners.

Contribution

Individual +
redistributed
pension
capital

4%+2%

Individual +
other financial
resources

4%+2%

Redistributed
pension
capital

4%

Individual

4%

Scope of participation

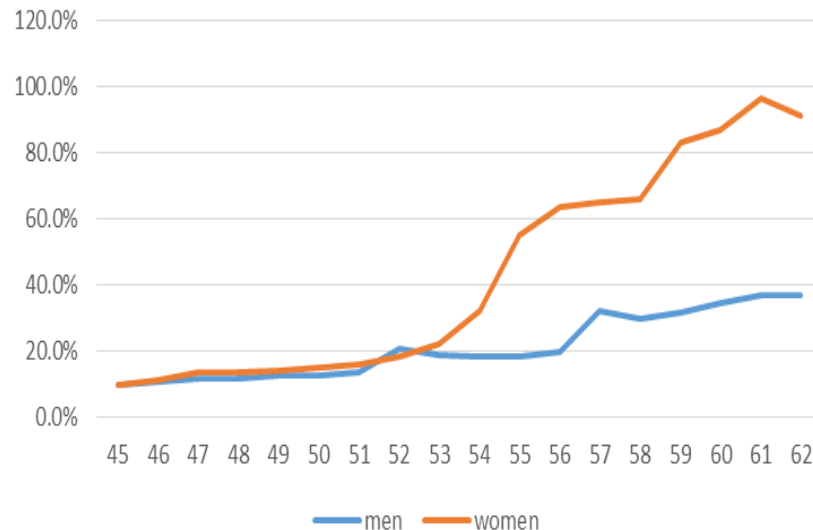
Participants' should be persons who born in 1971 and later for both gender. Individuals born before 1971 are not feasible to include in the funded component due to the short period for capital accumulation

Scope of participation should be flexible (like as 5-10 years until retirement age)

Scope of participation should be without restriction

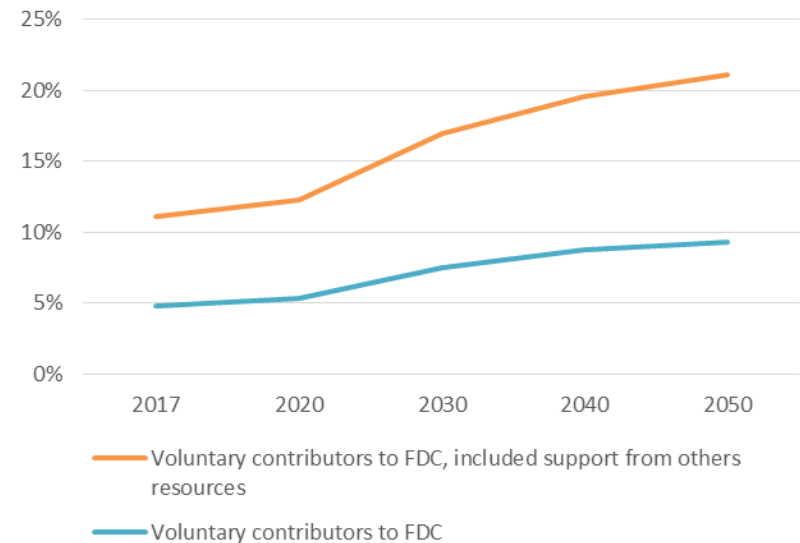
Scope of participation

Difference between population and pensioners in
01/07/2014



Comparing the number of pensioners (old age, disability and survivors) and the number of population of a given age group, there is a tendency to choose early retirement rights. More as half women in age group from 55-60 year had chosen eligibility to pension like

Participation rate to FDC (%)



Calculations show that participants to funded (FDC) component increase gradually and will reach 9% from total contributors in 2050. According experts' view of points voluntary approach with state support could increase participation rate reaching 21% from total contributors in 2050.

Risks to be Covered

Old age only, **not survivor and disability**

Participation will be suspended in case of reaching retirement age or in case of death

If a participant has died prior to requesting an old age pension, funded capital will be inheritable

Contribution rate

Individual wage

**Gross replacement
rate**

Retirement age

Rate of return

Replacement rate

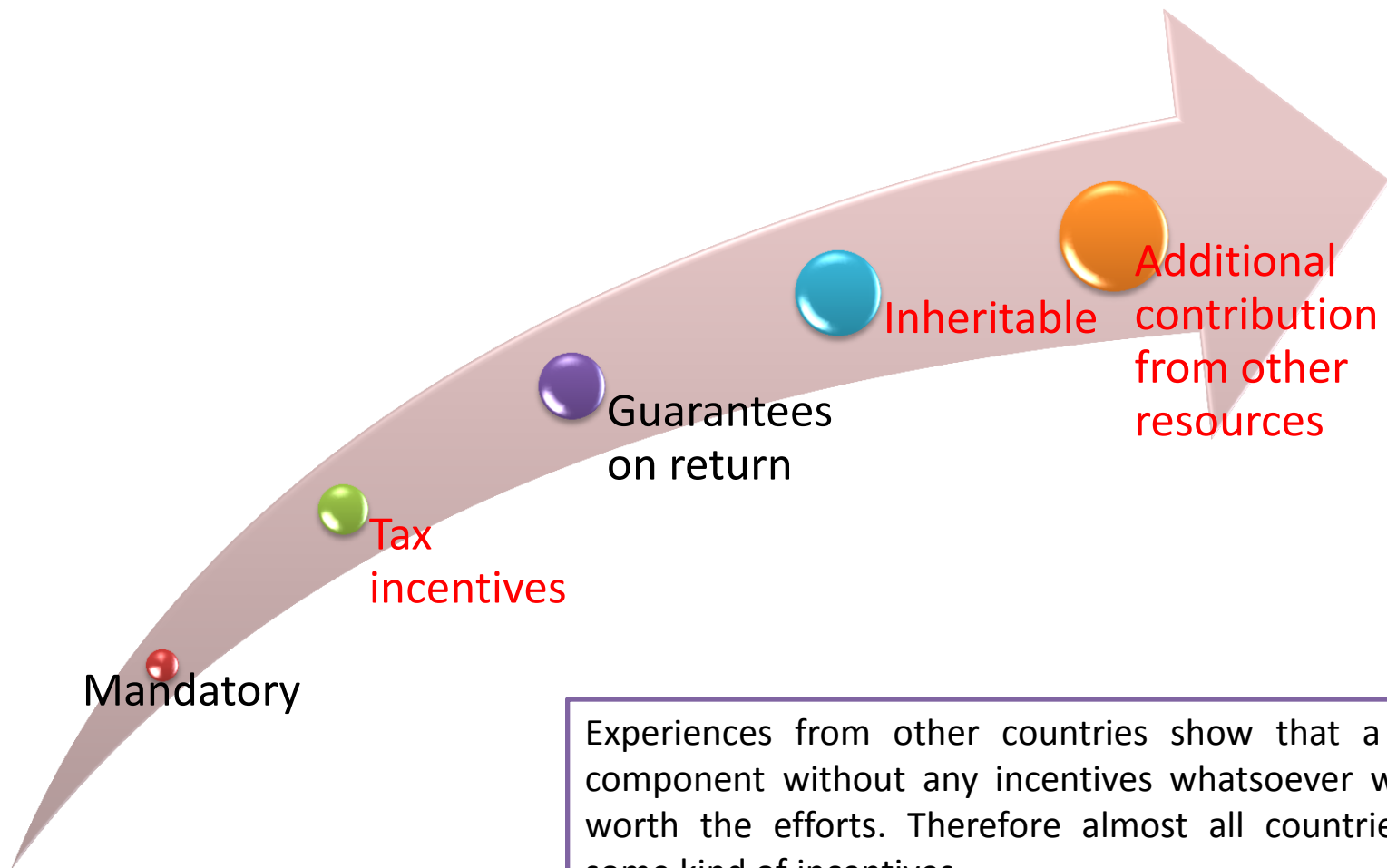
According international experience living standard in retirement – close to the living standard during employment

Introduction of voluntary funded component won't have vital influence for pension system stability in Azerbaijan

Recommendation - to choose such approach of voluntary funded component what can provide higher coverage and replacement rate

Higher replacement rate can be achieved by voluntary participation supported by others resources as well as longer contributions period

Incentives for joining



Experiences from other countries show that a voluntary component without any incentives whatsoever will not be worth the efforts. Therefore almost all countries provide some kind of incentives.

Pure DC scheme does not provide any guarantees to the pension plan participants in the form of guaranteed fixed returns or guarantees on the safety of principal



What is guaranteed?	Nominal principal (sum of contributions) Real principal Fixed return Minimal return Principal before or after fees Other
---------------------	---

Return over what period?	Annual return Return at retirement Return within investment period in particular pension plan Real return Other
--------------------------	---

Who provides guarantees?	Asset manager Independent 3 rd party State Other
--------------------------	--

```
graph TD; A[Pay-out of funded pension capital] --> B[To add the accrued funded pension capital to the non-funded pension capital and to calculate the old age pension in accordance with the Law on Labour Pensions]; A --> C[To buy life insurance policy];
```

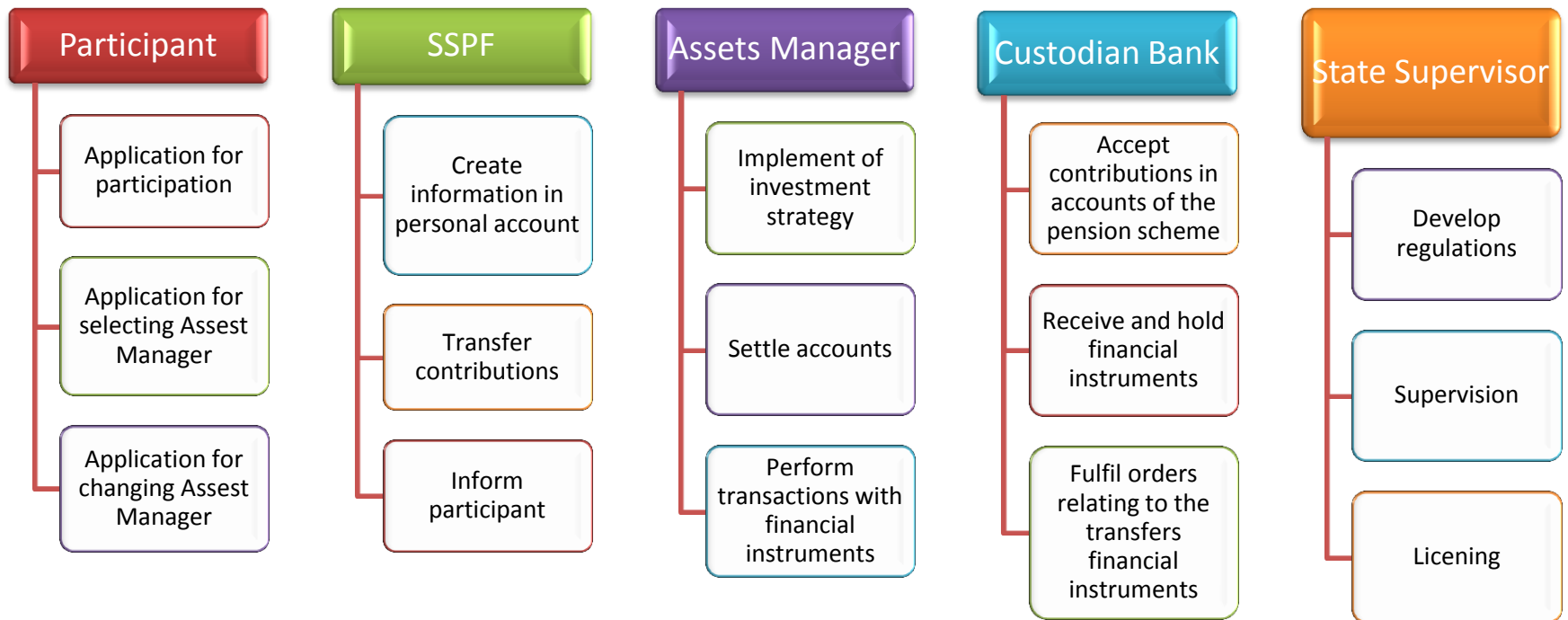
Pay-out of funded pension capital

To add the accrued funded pension capital to the non-funded pension capital and to calculate the **old age pension** in accordance with the Law on Labour Pensions

To buy life insurance policy

4. Operation of the funded pension component

Main competent authority



Individual accounting system in SPPF

Information about person

Information about participation

Information on contributions made

Information on the administration expenses

Information on the transfer of contributions to Assets Manager

Information on the transactions with the funded pension capital

SPPF shall ensure that the actual information is provided to each participant

Assets Managers

The fund of collecting the contributions and the assets management should be separated

Number of Assets Managers is not limited administratively

Do not suggest to regulate how many and what kind of pension plans asset manager should have

Only exception would be the requirement to all asset managers to have one conservative pension plan

Cash flow from SSPF to Assets Manager

Crucial role - well managed information, cash flow and cooperation of several institutions

Transfer of contributions to the respective pension plan account with the holding bank -after registering the contributions in the accounts of the scheme participants

Pension plan funds shall be expressed in the **pension plan shares**

Individual should be allowed to **move from one fund to the other**

Competence of SSPF

Monitoring of the pension system

Administration of individual accounts

Information of each individual

Conclusion of contracts with Assets Manager

Preparing a report regarding the operation of the funded component

Publication of funded component results

Transitional period

Recommended transitional period could be **five years**

For the first years assets can be **managed by the state** - Central Bank of Azerbaijan or/and State Oil Fund of Azerbaijan

System should start with investments in relatively **safe financial instruments**, like local government bonds and insured deposits

After transitional period assets management could be **opened for private Assets Managers**

Administration costs

Fee for assets management

Initially fee are relatively high

Fee ceiling

Fee cover by participants' contributions

During the first years fee can cover by resources of the institution budget or subsidy from the state budget

Start-up costs

- development of IT systems
- administration expenses
- public information campaign
- training of employees

Maintenance costs

- administration expenses
- client service

«Zero point»

All institutions providing the operation of the scheme **should develop** new IT systems, administrative procedures, train employees as well as ensure the operation of data registration and transfer systems, provide fast data transfer as well as a high level information security and protection.

5. Conclusion

Recomendation

Based to experts' calculations, international experience, demographical and economical situation in Azerbaijan the most appropriate approach **should be voluntary participation with state support**

However taking into account adopted the Concept "Of reforms of pension provision system in the Republic of Azerbaijan in 2014-2020" participation **could be voluntary simultaneously appointed incentive factors (like as tax advantages, inheritance)**

Precondition for success reform

Institutional framework – the most important

- A strong project team for implementation of reforms
- A common understanding of the objectives
- Cooperation with partners outside to SSPF
- Legislation base
- IT, relevant staff, creating accounting system

Financial framework

- Contribution rate, scope of participation
- State budget or other resources support
- Adequate financial market infrastructure, regulation and supervision
- Implementation year



THANK FOR YOUR ATTENTION!

Twinning Project contacts:

- +994 51 310 76 90
Agrita Groza Resident Twinning Adviser
- Email: twinning.baku@gmail.com
- Address: 80 H.Zardabi avenue, **8th floor**, AZ1122, Baku, Azerbaijan



Gesellschaft für
Versicherungswissenschaft
und -gestaltung e.V.

