DEVELOPING A FUNDED PENSION SYSTEM IN RUSSIA

International Evidence and Recommendations

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FOREWORD

The Russian Federation, like an increasing number of countries around the world, is undergoing a major systemic reform. In Russia, the reform was driven by the need to ease the country's transition to a market economy and deal with the acute poverty of Russian pensioners.

The pension reform in the Russian Federation was introduced and in 2002 resulted in a shift from a single, publicly managed distributive system to one supplemented by a mandatory, privately managed, funded component. As a result, the pension system in Russia today is made up of a pay-as-you-go (PAYG) financed pension that provides a basic, social safety-net pension and an earnings-related pension administrated via notional individual accounts (NDC). A mandatory, earning-related, funded, defined contribution (DC) complements the PAYG system as do other voluntary occupational and personal funded pension plans.

The scope of this study concentrates on the design and management of the funded pensions. Russian policymakers need to continue to tackle issues regarding the institutional design, accountability and transparency of the pension system which clearly affects the development of the funded pension systems as they mature. This report analyses and identifies key policy areas associated with administrative capacity and plan design, investment strategies, supervision, and the governance of public and private entities responsible for private pensions in order to reinforce the safeguarding of pension rights and the fair and adequate delivery of pensions in retirement.

The report draws upon the experiences of OECD and non-OECD countries in delivering funded and private pensions and how they have chosen to address the risks and challenges involved. Cross-country comparisons and international examples of good practice are a useful tool in analysing the different facets of reforms and provide a useful source of inspiration for further reforms. The report also refers to OECD guidelines and principles for private pension regulation.

The purpose of this report is to inform the Russian public about private and funded pensions in other countries and identify aspects of the Russian funded pension system that may need to be reformed. It is also intended to contribute to the policy discussion on funded pensions in Russia and support the policy dialogue between Russia and the OECD members by providing a basis for consistent measurement and monitoring of policy initiatives and regulatory reform assessment in the field of private and funded pensions.

The publication was prepared by Asees Ahuja and Juan Yermo from the OECD Financial Affairs Division, Insurance and Private Pensions Unit with input from consultants Greg McTaggart and Irina Tchoumatchenko. Konstantin Ugryumov from the National Association of Non-State Pension Funds in the Russian Federation, Rostislav Kokorev from the Ministry of Economic Development, Mikhail Dmitriev from the Center of Strategic Research of the Russian Federation and Evgeny Yakushev from Pension & Actuarial Consulting LLT provided useful comments and feedback.

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EXECUTIVE SUMMARY

The pension reform undertaken in Russia in 2002 was aimed at adjusting the system to the market economy and changing demographic trends and dealing with the problem of poverty in retirement. The system prior to the reform was a pay-as-you-go (PAYG), in essence a flat rate system. It was expensive in terms of contributions and inefficient in terms of providing adequate pensions. The former pension system, governed by the law "on Public Pensions in the Russian Federation" established in 1990, became more complex and diversified and many special arrangements were introduced for different professional categories, including a number of costly early retirement arrangements.

In 2002, the new state pension called the Labour Pension was introduced containing three parts. The first part is a basic flat rate pension financed separately on a PAYG basis up until January 1, 2010. Thereafter, it has been integrated into the earnings-related, insurance pension based on notional individual accounts, also known as notional defined contribution (NDC), which is financed by contributions on a PAYG basis. A mandatory, defined contribution, funded system has been introduced covering individuals born after 1967.There is also the possibility to save in voluntary private pension arrangements, most of which are employer-sponsored. In 2009, a co-financing scheme was launched to expand coverage of voluntary schemes and increase retirement savings. The state matches individual contributions made on a voluntary basis to the Russian state pension fund called the Pension Fund of the Russian Federation (PFR), on a rouble-for-rouble basis up to a ceiling and for a limited period. The scope of this study focuses on the funded and privately managed pension plans in Russia, both mandatory and voluntary. Its ultimate goal is to identify a set of policy proposals to strengthen the funded pension system in the Russian Federation and ensure that it serves effectively its complementary role in the country's retirement income system.

The design of the mandatory, funded defined contribution part of the pension system gives members a number of choices regarding the investment and management of their accumulated contributions. Members can choose to: (i) keep their pension savings invested and administered under the default state pension fund and managed Vnesheconombank (VEB) which is appointed as the state asset management company, (ii) have their savings administered by the PFR but have the assets managed by an external asset manager, or (iii) move their savings completely out of the state pension fund to a non-state pension fund (NPF) and private asset manager. Voluntary pension savings are also administered by NPFs.

The financial crisis and weak investment performance have put pressure on the private pensions industry around the world. A weakening rate of investment returns has led to waning confidence in private pension savings. After the experience in Argentina and Hungary where private pension funds have been taken over by the state, there is a need to buttress public trust in funded pension arrangements through policies that ensure value for money for pensioners and an adequate retirement income.

Russian pension funds have also been negatively affected by this environment, and the state-managed pension assets were not been able to deliver positive returns above inflation during the crisis years. New private pension providers in Russia need to adopt best practices in pension fund governance and strong fiduciary standards in managing their funds and investments. Regulations also need to be broadened, ensuring they cover different aspects of the prudential management of the pension funds and financial consumer protection, as stated in official OECD recommendations. The supervisory framework also needs to be revamped to ensure effective oversight of the pension funds.

In order to make use of international experiences in OECD and non-OECD countries in the administration, management, supervision and governance of private and funded pensions this study includes an analysis of international best practices and cross country analyses during this turbulent time but also as countries have been developing their private pension plans. Indeed, the Russian pension reform and the socioeconomic conditions under which it has been designed and implemented are quite similar to those of other transition economies. Comparisons of policy solutions and outcomes can therefore be useful. Comparisons with the experiences of countries that have a longer experience in regulating private and public pension funds and/or financial institutions in more developed financial and private pension markets is also advantageous.

These analyses are put in the context of the OECD classifications for private pensions and the OECD principles and guidelines on good governance, supervision and regulation for private and funded pensions. The OECD encourages countries that have funded DC pension schemes to make sure that they are coherent between the accumulation and payout phases, and with the overall pension system. In governance and supervision issues the OECD strives to aid countries in establishing a clear identification and separation of operational and oversight responsibilities in the governance of a pension fund. To the extent that a pension entity is established that owns a pension fund on behalf of members and beneficiaries, the legal form of this entity, its internal governance structure, and its main objectives should be clearly stated in official documents. If the pension fund is established as a separate account managed by financial institutions, the pension plan or contract between plan sponsors and beneficiaries and the financial institution should clearly state the responsibilities of the latter with respect to the management of the pension fund. As good pension fund supervision should be "risk-based", the division of responsibilities should also reflect the nature and extent of the risks posed by the fund. The OECD advocates transparency as key to gaining public confidence especially as the number of actors in the management of a plan increases.

The OECD has also produced a set of guidelines for investment strategies whereby a diversified risk portfolio taking into consideration the interest of participants is advocated. It has also recommended that costs and fees be minimised in order to maximise net returns.

Given the multi-tiered design of the pension system in Russia, several different governmental actors are involved in the design, administration and supervision of the system. While extensive and generally well-designed, regulation still has some significant gaps. Filling these gaps in line with OECD guidelines is essential for achieving a high level of public confidence in the system and in the industry. This is subsequently essential for the sustainability of the pension system and the commercial success of the pension fund industry. This is more so the case given the current volatility in financial markets.

An essential recommendation is to create sustainable and stable reforms in order to facilitate retirement planning. The accumulation of pension entitlements and certain design features, particularly pertaining to the payment of benefits need to be fully considered. The study recommends further action to increase transparency in pension fund governance and decision-making and strengthening regulation and the role of the supervisory body in the Russian Federation. It also suggests strengthening the protection of plan members especially in the event of a bankrupt or financially weak NPF. The need to reconsider the restrictiveness of investment regulations is also highlighted. Investment decisions should be made on the basis that they are in the best interests of participants. The study advocates development of a written investment policy and funds should be held accountable to members and the supervisor on the actual performance compared with this investment policy. The need for strengthened self-governance including a system of participant representation is also recommended. The design and administration of the payout of benefits should be fully planned as should the range of annuity, investment and guarantee products the PFR and NPFs may offer. Furthermore, retirement planning, risk control and individual choices need to be facilitated through efforts by the supervisory body and the NPFs in promoting financial education and creating awareness amongst the general public but also amongst actors in the private pension industry.

This study is structured in the following manner:

Chapter 1 looks at funded pension systems around the world and how they have developed over time. It describes the general approach to the OECD classification of pension plans and analyses this classification in terms of beneficial regulatory and supervisory framework and management and investment strategies. It also looks that the different responsibilities of the entities and actors involved in the plan.

Chapter 2 takes an in-depth look at the investment management of pension funds and draws upon the experiences in OECD and non-OECD countries. The chapter charts out the advantages and disadvantages of different types of investment strategies and financial products in different types of pension schemes. It also considers the role of governance, supervision, and state regulation of investment strategies and risk management.

Chapter 3 lays out the OECD guidelines for pensions fund governance in OECD countries and gives a comparative analysis of actual practices in different countries. The chapter addresses problems and challenges in pension fund governance as well as the similarities and differences in corporate governance of commercial organizations and pension funds.

Chapter 4 sets the scene for the Russian pension funds market and discusses the role of private pensions and their providers in shaping an adequate and sustainable pension system in the Russian Federation. This chapter identifies areas for improvement and offers recommendations related to the governance, regulation and supervision of private pensions in the Russian market.

The last chapter provides concluding remarks related to the main findings of the study.

KEY RECOMMENDATIONS TO THE RUSSIAN FEDERATION

Creating politically stable pension reforms to foster public confidence

Pension systems need to be reformed to ensure that they continue to meet the twin goals of benefit adequacy and financial sustainability. Once major reforms are implemented, a period of stability is needed in the system's general design to see through the reform and allow the different stakeholders to adapt to the changed structure and reap the benefits from it. Pension reforms should therefore be designed from a generational and long-term perspective. Successive changes to the pension system, parametric or systemic, should be avoided as they can cause public confidence to diminish and can adversely affect retirement savings.

Fluctuating contributions in different parts of the pension system in the Russian Federation make it difficult for individuals to plan and save for their retirement. People need to save enough consistently and for long enough periods in order to reap the gains from savings in an effective and cost-efficient manner. In this sense, shifting contributions from the funded, defined contribution (DC) scheme to the pay-as-you-go (PAYG), notional defined contribution (NDC) scheme after a relatively recent reform could create confusion and hinder public trust in the pension system. Furthermore, any such reform should be gradual and well-communicated so that participants can better plan for their retirement.

Ensuring a central role for the funded pension system

The government of the Russian Federation has proposed a reform where current participants in the mandatory funded scheme have the option to shift part of the 6% of contributions that currently goes into funded, DC scheme to the NDC scheme until January 2015. New entrants will be given this choice upon entering the scheme according to the proposal. Much of the risk diversification that could be obtained by having one mandatory's savings partly invested in the financial markets is eliminated for individuals that choose to opt out of the funded scheme. Individuals would be better served if they were given the possibility to choose to opt out of the NDC scheme and contribute 6% of their salary into the funded DC schemes beyond 2015. This type of choice needs to be coupled with the provision of fair information and communication to members so that they can make informed and rational choices. It is also recommended that an eventual shift from the funded DC scheme to the NDC scheme only applies to new contributions – leaving intact the current stock of savings in the funded system - in order to ensure that savers reap a long-term return on their past contributions.

The latest reform proposal would lead to financial gains in the NDC system in the short-term due to the injection of funds. These gains, however, are typically temporary. They will present a long-term increase in public spending on retirement benefits as liabilities in the NDC system will also increase, especially as demographic pressures intensify. The long term financial sustainability of the PAYG NDC system is better served by increasing the actual retirement age and promoting longer working lives. Furthermore, the payout of special pension privileges benefits should be better targeted to the neediest in order to reduce costs.

The OECD advocates a diversified and balanced pension system, with public and private, funded and unfunded pension provision, in order to balance adequacy and financial sustainability goals of the pension system in an ageing demography. Funded schemes also increase the formation of long term capital for domestic investments which will be affected if contributions are shifted from the funded DC scheme to the NDC scheme in the Russian Federation. In order to promote private pension savings there are advantages in applying mandatory or auto-enrolment schemes in terms of greater coverage, higher contributions and more progressive distribution amongst contributors in comparison to voluntary systems that rely solely on tax or financial incentives. The subsequent recommendations will focus on funded private pensions in the Russian Federation.

Improving investment diversification

With regards to investment management and asset allocation, the Russian Federation has particularly stringent investment regulations by international comparison in particular for the assets managed by the state-owned asset manager, VEB and to some extent also for Non-State Pension Funds (NPFs). The quantitative restrictions on the investment of assets in the mandatory pension system involve limiting investments in equities, foreign investments and other assets. Some of these restrictions can constrain the diversification of risks and the financing of productive private sector investment and should be reviewed.

Investment limits for pension funds could be loosened gradually over time, following a similar path as for insurers, and focusing initially on ensuring better access to different investment opportunities in the domestic market. This should allow for improved risk-adjusted performance of pension assets. Allowing for a higher degree of overseas investment would also ultimately help diversify risks and boost returns. At the same time, the prudent investor principle should be implemented, raising standards of governance and risk management in pension fund investment. The supervision of pension fund investment also needs to become more effective and risk-based.

The Russian Government's interest to allow investment in infrastructure should be fostered as they can provide long-run, stable and strong returns which are well suited to the long-term nature of retirement pension saving. There is, however, a need to properly structure the instruments for such investments and ensure that pension funds and asset managers develop the internal capacity to manage such investments. The decision to invest in such instruments should also be taken by pension fund boards with the best interest of members in mind. Governmental pressure on pension funds to invest in specific infrastructure projects should be avoided at all costs.

The design of investment strategies should also pay due regard to the age profile of members. Some degree of life styling of investments is necessary, reducing risk exposure as the member approaches retirement. Such strategies also require a reform of the return guarantee requirements so that the guarantee only applies on the accumulated savings at retirement.

Increasing efficiency: improving competition and reducing costs

Administration and investment costs, charges and fees in the Russian Federation are high by international comparison, and generally the pension funds do not disclose information about the charges and fees that are deducted from an individual's account. Costs and fees need to be kept under review and benchmarked both against the amount being paid and against the quality of the service being provided.

Despite there being a number of actors the Russian non-state pension fund sector is highly concentrated where a few of the largest funds hold the lion's share of assets and cater to a majority of the participants. Fostering open competition and mobility between funds could help achieve added gains in terms lower costs and charges and better returns. At the same time, competition will only deliver such results if members are properly informed and educated, which may be difficult to achieve in the Russian context. Hence, regulatory policies may be needed to create stronger incentives on NPFs and asset managers to improve their efficiency.

Enhancing transparency and disclosure on investments and benefits

Investment asset allocation strategies need to take into take into consideration how participants' pension benefits can be maximised per unit of contribution but not ignoring the need for controlling individual investment risks. The quality, accessibility and content of investment information currently provided by NFPs are varied. Legislation requires public disclosure on information regarding investment portfolios and returns in NPFs as well as individualised information to participants regarding the value and performance of their accumulations. There is, however little information provided on the investment objectives of NPFs, how they perform against these objectives or information to participants on what future benefits they may expect. NPFs should develop written statements of investment policy that are publicly available and the regulator or supervisor should develop a risk management template to assess the performance of funds annually. In this way the governing body can also control risk exposure in accordance with investment policies and risk management strategies.

The regulator needs to develop standard public information documents that funds should provide to both participants and other interested parties using standardised methodologies and assumptions. This will also facilitate the comparability between funds and individuals. Minimum information requirements should include individualised statements to participants showing not only the accrued value of their entitlements and current and accumulated returns but also clear benefit projections under prudent and standardised assumptions.

Establishing a cost effective payout phase that is coherent with the accumulation phase of the pension system

The accumulation and pay-out phase of the pension system need to be internally coherent. Typically, a mandatory DC system with few elements of individual choice - as is currently the case in the Russian system - should be coupled with a clearly designed annuitisation plan. Annuities provide protection against outliving one’s resources and could be promoted as defaults in the mandatory system for at least part of the accumulated savings. However, developing a well-regulated and efficient annuities market in Russia will take time. A programmed withdrawal (or gradual drawdown), should be subject to rules regarding maximum drawdowns to reduce exposure to longevity risk.

Over time, a fully functioning and competitive annuity market should be promoted which provides protection for inflation, longevity and interest rate risks. Pension funds should be eventually allowed to purchase annuity products from life insurance companies. Before then, it will be necessary to modernise the life insurance industry, and in particular ensure that mortality tables are up to date and that longevity risk assumptions take into account the expected future evolution of mortality. Regulators will need to play a proactive role ensuring that longevity and other risks are properly addressed by annuity providers. A basic protection of pension benefits against inflation is also recommended, but it will require the issuance of long-term, inflation-indexed bonds by the government in sufficiently high quantities.

Improving governance by increasing transparency, expertise and internal controls

It is essential that pension funds and their asset managers adopt the highest levels of integrity and professionalism in the way that they manage the assets under their control. In order to achieve this, the governing body and funds need to have the necessary expertise to both take decisions and to ask the right questions of those who provide advice and/or services. Where there is a lack of internal expertise, duties can be delegated, but to ensure the independence of certain external functions like audit or custody it is better in the long run to use independent organisations rather than affiliates to the fund or the asset manager. Whilst pension fund sponsors may see some short-term gain in appointing associates or senior company executives to the pension fund governing body, accountability can be best ensured by having also member-representatives and independent directors.

There is also a need to review the fiduciary obligations of the boards of pension foundations to make sure that decisions are made with the best interest of participants in mind. The legal structure of pension funds needs to be reviewed, as currently the named trustees are also often the beneficiaries of the fund. The sole legal beneficiaries of the pension fund should be the members and their dependents, to the extent that there are survivor benefits. The pension fund board and its employees should be subject to fiduciary duties and abide by a code of conduct. There should be a requirement to clearly identify and separate operational and oversight responsibilities and to ensure that conflicts of interest are properly addressed and where possible averted. At the same time, regulations should establish appropriate procedures for adequate internal decision making and controls. Internal controls should cover all basic organisational and administrative procedures and costs and should be subject to review by the responsible supervisory authority. The National Association of Non-State Pension Funds (NAPF) should work towards developing standards that comply with OECD guidelines, in particular the guidelines for pension fund governance and the OECD-IOPS good practices for pension funds' risk management systems. The NAPF should set up self-regulatory initiatives to encourage NFPs to adhere to these standards.

Streamlining supervision and introducing risk-based supervision to improve public control

The supervision of pension funds need to be clearly regulated so that the supervisor is granted the necessary powers, resources, responsibilities and subject to proper accountability to ensure an effective and efficient oversight of the funded pension system. There are a large number of regulatory and supervisory bodies and if these are badly coordinated this can erode public control and stump the growth of private pensions. A coordinated regulator under the Central Bank of Russia can be advantageous in terms of greater independence and effectiveness of supervision. At the same time, these developments need to be monitored, especially with regards to the need to build up competence in the area of pension fund supervision and the delegation of supervisory duties to other regulatory bodies. Due consideration should also be given to establishing an integrated and comprehensive supervision over the whole funded pension system, including the public sector entities managing pension assets (PFR and VEB). Currently, the supervisor is only responsible for the NPFs and private assets managers.

The appointed supervisory body needs to be the institution that the population can turn to in any case of injustice or wrongdoing by NPFs or any intermediaries in order to strengthen consumer protection. A procedure should be established to consider complaints about a NPF that does not include using the courts system as a first resort. The procedure should be expeditious and transparent, be easily understood and have only reasonable or no cost to the individual claimant. Procedures and supervisory mechanisms related to transferring accrued benefits in the case of a potential bankruptcy of a NPF or asset manager should also be reviewed to provide maximum participant protection.

The supervisor also needs to strengthen the quality of controls on risks, costs and investments. The possibility of introducing a form of risk-based supervision over private pension funds should be considered. Such methods of supervision can ensure a more efficient deployment of limited supervisory resources and ensure a more effective assessment of the financial sustainability of private pension funds under different financial market and general economic scenarios.

Fostering public confidence through financial education and public awareness

Government and industry have a shared responsibility in developing strategies to encourage savings in private pension provision by all those who may otherwise have insufficient retirement income. An important part of this is maintaining public confidence in the private pension schemes. A key aspect that needs to be considered in the Russian Federation is fostering an understanding of the main concepts of saving in a funded DC scheme and what risks this entails for individuals. This is also vital if rational choice is to prevail as investment and longevity risks are transferred to the individual.

The Russian Federation is currently implementing guidelines developed by the OECD and the International Network for Financial Education on how to develop a national strategy for financial education. The NAPF and the supervisor need to be actively involved in promoting financial literacy. The NAPF directly or in association with a national university could develop a course for training for the staff of NPF's in order to attain higher levels of knowledge and responsibility within the industry.

Transparency and clear communication coupled with a better understanding of financial concepts can also be an important preventive against abuse but can also be an important marketing tool in enhancing interest in private retirement saving. The NAPF and the government could collaborate in providing collective and standardised information from the different parts of the pension system would also help to create an understanding of the entirety of a person's retirement income and facilitate the individual retirement savings decision. Furthermore, pension funds should provide standardised information on performance, costs, charges and fees, asset allocation and investment strategies and goals. This type of information helps create competition, increases transparency and consequently the public confidence in the private funded pension schemes. A national pension communication campaign will also be essential for informing the public about major changes in the pension system, such as the reform to be implemented in 2014 which will allow workers to choose between the NDC and DC systems.

1. PENSION PLAN DESIGN AND CLASSIFICATION

1.1 Introduction

This chapter illustrates the general approach to the design of funded pensions in accordance with the OECD classification of private pensions. This classification was developed in order to provide a common basis for the review of pension system, where having an understanding of the overall structure and operation of pensions is essential including both private and public pensions.

Typically speaking, pension provision through private pension arrangements can take the form of mandatory or voluntary arrangements. They could be linked to an employment relationship, making them occupational pension plans, or they may be based on contracts between individuals and private pension providers, making them personal pension plans. Moreover, pension provision can be achieved through either defined contribution (DC) or defined benefit (DB) arrangements. DC plans are plans under which the plan sponsor pays fixed contributions and has no legal or constructive obligation to pay further contributions to an ongoing plan in the event of unfavourable plan experience, while DB plans are plans other than defined contributions plans, generally classified into one of three main types, “traditional”, “mixed” and “hybrid” plans. The term private is used to refer to funded and book-reserved pension systems.

Most countries limit the integration of pension plans only into pension funds, as the financial vehicle of the pension plan. But an increasing number countries, now consider pension insurance contracts as the financial vehicle for pension plans. Insurance contracts specify pension plan contributions to an insurance undertaking in exchange for which the pension plan benefits will be paid when the members reach a specified retirement age or on earlier exit of members from the plan. The shift towards DC plans has led to an increase in the use of insurance contracts. This is due to the advantages and experiences the insurance industry has converting accumulated contributions in DC schemes into annuities.

Different types of pension plans require different approaches to supervision, regulation and scheme management. The plan sponsors’ and beneficiaries’ risk bearing and responsibilities differ, for example, in DB and DC plans or if the plan in employer sponsored or not. In an occupational plan the employer has responsibilities to ensure payments into the plan and ensure that the assets from the plan are separate from that of the business. In a DB scheme the employer also has responsibilities related to information, fulfilling solvency, insolvency and investment regulations as does the plan manager. In DC plans some of these risks, like the investment and financial risk is borne by the individual.

The OECD encourages a risk based management and supervision of pension plans. This requires supervisors to review the manner in which pension funds are identifying and controlling risks and carry out an assessment of the financial and operational factors in place to minimise and mitigate those risks. This process then allows the supervisory authority to direct its resources towards the issues and entities which pose the greatest threat. The pension supervisory authority establishes objectives and regulation for pension plans. They can through these then identify, prioritise the risks faced by individual funds and the pension industry that bear on the pension supervisory authority`s objectives and take necessary action. This system allows for a more reliable early warning system especially when markets are volatile, as financial instruments and systems become more complex and when supervisory resources are not extensive enough.

Administration and management costs and fees are an issue of growing concern that the supervisory and governing body needs to address. In DB schemes since increasing costs may lead to the need to increase employer contributions and in DC schemes since they will lead to reduced benefits. This can in the long run lead to participants abandoning the fund and transferring their accrual to another fund.

1.2 Pension Terminology

The OECD has developed a classification of private pensions that has been approved by the governments of member countries. This classification is presented here to facilitate the understanding of the report.[1]

Public vs. private pension plans

Public pension plans are typically social security and similar statutory programmes administered by the general government (that is central, state, and local governments, as well as other public sector bodies such as social security institutions). Public pension plans have been traditionally PAYG-financed, but some OECD countries have partial funding of public pension liabilities or have replaced these plans by private pension plans.

A *private pension plan* is a pension plan administered by an institution other than general government. Private pension plans may be administered directly by a private sector employer acting as the plan sponsor, a private pension fund or a private sector provider. Private pension plans may complement or substitute for public pension plans. In some countries, these may include plans for public sector workers.

Occupational vs. personal pension plans

Access to *occupational pension plans* is linked to an employment or professional relationship between the plan member and the entity that establishes the plan (the plan sponsor). Occupational plans may be established by employers or groups thereof (e.g. industry associations) and labour or professional associations, jointly or separately. The plan may be administered directly by the plan sponsor or by an independent entity (a pension fund or a financial institution acting as pension provider). In the latter case, the plan sponsor may still have oversight responsibilities over the operation of the plan.

In *mandatory occupational pension plans* participation is mandatory for employers. Employers are obliged by law to participate in a pension plan. Employers must set up (and make contributions to) occupational pension plans which employees will normally be required to join. Where employers are obliged to offer an occupational pension plan, but the employees' membership is on a voluntary basis, these plans are also considered mandatory.

In *voluntary occupational pension plans*, however, the establishment of these plans is voluntary for employers (including those in which there is automatic enrolment as part of an employment contract or where the law requires employees to join plans set up on a voluntary basis by their employers). In some countries, employers can on a voluntary basis establish occupational plans that provide benefits that replace at least partly those of the social security system. These plans are classified as voluntary, even though employers must continue sponsoring these plans in order to be exempted (at least partly) from social security contributions.

Access to *personal pension plans* does not have to be linked to an employment relationship. The plans are established and administered directly by a pension fund or a financial institution acting as pension provider without any intervention of employers. Individuals independently purchase and select material aspects of the arrangements. The employer may nonetheless make contributions to personal pension plans. Some personal plans may have restricted membership.

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[1] OECD (2005)

Mandatory personal pension plans are personal plans that individuals must join or which are eligible to receive mandatory pension contributions. Individuals may be required to make pension contributions to a pension plan of their choice – normally within a certain range of choices – or to a specific pension plan.

In *voluntary personal pension plans* individuals are not obliged to participate in a pension plan. They are not required to make pension contributions to a pension plan. Voluntary personal plans include those plans that individuals must join if they choose to replace part of their social security benefits with those from personal pension plans.

DB vs. DC occupational pension plans (plan sponsor's perspective)

A DC occupational pension plan is one under which the plan sponsor pays fixed contributions and has no legal or constructive obligation to pay further contributions to an ongoing plan in the event of unfavourable plan experience.

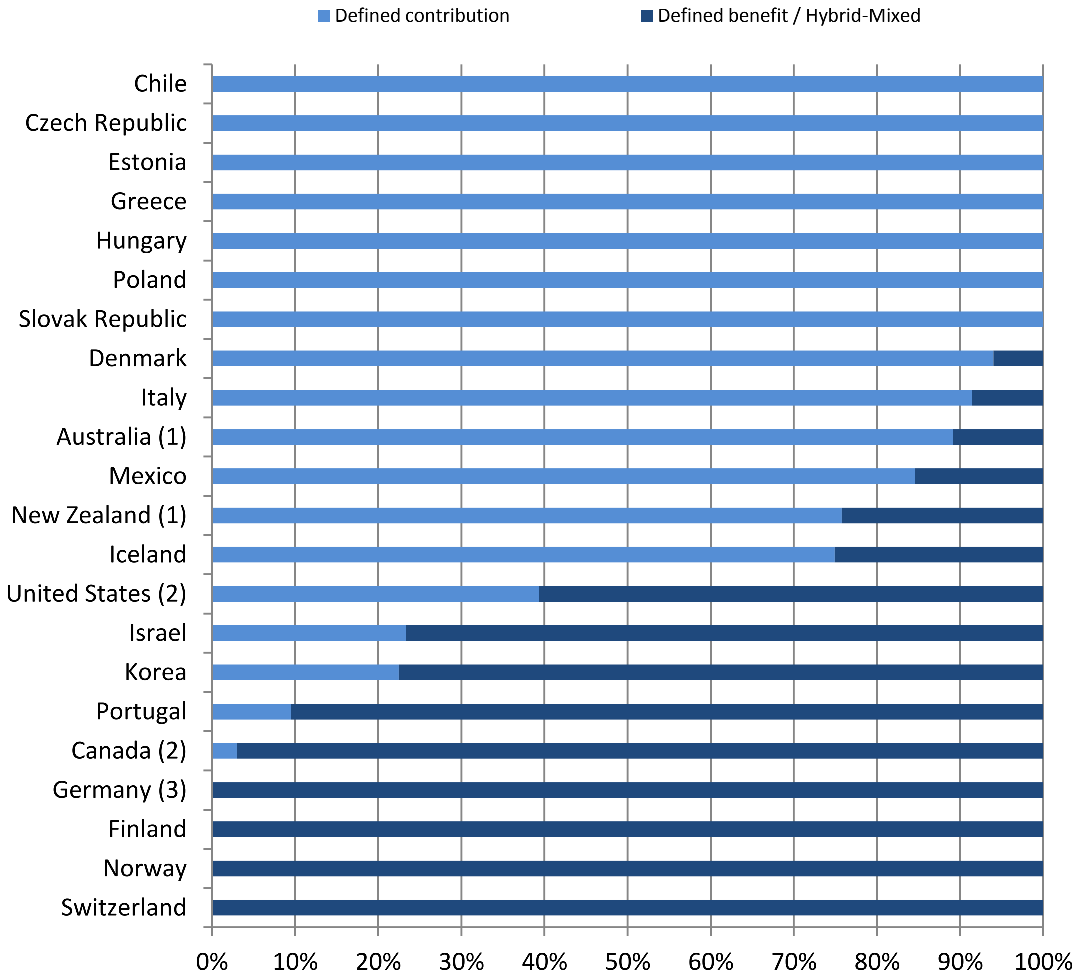
A DB occupational pension plans can generally be classified into one of three main types, "traditional", "mixed" and "hybrid" plans. A *"Traditional" DB plan* is where benefits are linked through a formula to the members' wages or salaries, length of employment, or other factors.

In a *"Hybrid" DB plan* benefits depend on a rate of return credited to contributions, where this rate of return is either specified in the plan rules, independently of the actual return on any supporting assets (e.g. fixed, indexed to a market benchmark, tied to salary or profit growth, etc.), or is calculated with reference to the actual return of any supporting assets and a minimum return guarantee specified in the plan rules.

"Mixed" DB plans have two separate DB and DC components but which are treated as part of the same plan.

Figure 1. Relative shares of DB and DC pension fund assets in selected OECD countries, 2011

As a percentage of total assets



1. Data refer to June.

2. Data refer to occupational plans only.

3. Pension plans in Germany can actually be traditional DB plans or hybrid DB plans, but the split between the two categories is not available.

Source: OECD Global Pension Statistics.

Protected vs. unprotected pension plans (pension fund/provider's perspective)

An *unprotected pension plan* can be a personal pension plan or occupational DC pension plan where the pension plan/fund itself or the pension provider does not offer any investment return or benefit guarantees or promises covering the whole plan/fund whiles a *protected personal pension plan or occupational DC pension plan* does. The guarantees or promises may be offered by the pension plan/fund itself or the plan provider (e.g. deferred annuity, guaranteed rate of return).

Funding of pension plans

Funded pension plans are occupational or personal pension plans that accumulate dedicated assets to cover the plan's liabilities. These assets are assigned by law or contract to the pension plan. Their use is restricted to the payment of pension plan benefits.

In *book reserved pension plans* sums entered in the balance sheet of the plan sponsor as reserves or provisions for occupational pension plan benefits. Some assets may be held in separate accounts for the purpose of financing benefits, but are not legally or contractually pension plan assets. Most OECD countries do not allow this method of financing. Those that do usually require these plans to be insured against bankruptcy of the plan sponsor through insolvency guaranty arrangement.
Unfunded pension plans are financed directly from contributions from the plan sponsor or provider and/or the plan participant. Unfunded pension plans are said to be paid on a current disbursement method (also known as the pay-as-you-go, PAYG, method). Unfunded plans may still have associated reserves to cover immediate expenses or smooth contributions within given time periods. Most OECD countries do not allow unfunded private pension plans.

1.3 Illustrating the main differences between pension plans and insurance products

In the OECD classification a *pension fund/plan* is the pool of assets forming an independent legal entity that is bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the pension fund. Pension funds take the form of either a special purpose entity with legal personality (such as a trust, foundation, or corporate entity) or a legally separated fund without legal personality managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.

Pension insurance contracts specify pension plan contributions to an insurance undertaking in exchange for which the pension plan benefits will be paid when the members reach a specified retirement age or on earlier exit of members from the plan. Most countries limit the integration of pension plans only into pension funds, as the financial vehicle of the pension plan. Other countries also consider the pension insurance contract as the financial vehicle for pension plans.

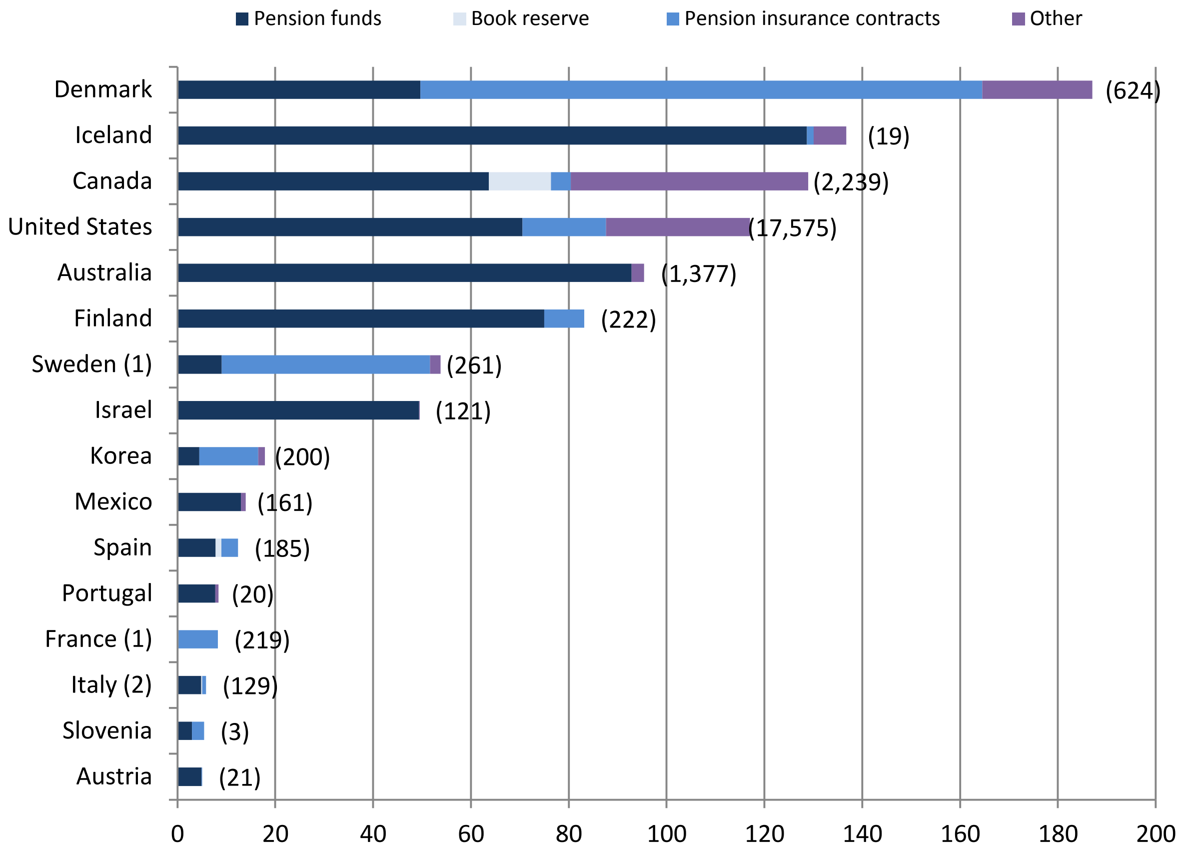
The traditional difference between a pension plan and a pension product provided by an insurance company was the requirement for a pension contributor to be an employee of the employer participating in a pension fund. The employer's participation could either be in a corporate pension plan established by that employer or an organisation of which that employer was a subsidiary or into a multi-employer plan (or professional pension scheme in CIS (Commonwealth of Independent States) countries) where there was a common link between the employers participating in the scheme for example the type of industry or geographic location. Whilst participation in a corporate pension plan could either be on a DB or a DC basis, it was almost unheard for insurance pension products to be other than defined contribution.

The insurance industry in most countries does provide a product that can be made similar to a DB scheme. This is usually on an individual basis as opposed to a company wide basis. This is what is called a deferred annuity. Effectively under a deferred annuity the contributor decides either how much he can afford as a contribution or says how much he would like to receive as a regular monthly payment at retirement. In this case, the insurance company will make certain assumptions about the return on the investment and from that is able to tell the contributor how much needs to be paid each month. Normally, this contribution will be indexed to inflation to preserve the value of the annuity. The contributor may have to either pay more to get the sum they want or accept a lower monthly amount at retirement.

Pension funds are the main financing vehicle for private pension plans in Israel and represent more than 90% of total assets in countries such as Australia, Austria, Finland, Iceland, Mexico and Portugal. On the other hand, in Denmark, France, Korea and Sweden, pension insurance contracts account for the largest shares of aggregate private pension assets. Denmark's private pension system was the largest in relation to its economy at nearly 190% of GDP, followed by those of Iceland (137%), Canada (129%) and the United States (117%).

Figure 2. Private pension assets by type of financing vehicle, 2011

As a percentage of GDP and in absolute terms (USD billion)



Note: Countries where private pension plans are financed exclusively by autonomous pension funds include Chile, the Czech Republic, Japan, and the Slovak Republic.
1. Data refer to 2010.
2. Technical provisions were considered as a proxy for the total assets of book reserve schemes.

Source: OECD Global Pension Statistics.

In terms of pension accumulation products there is great debate about the advantages and disadvantages of each type of pension provider – an employer sponsored pension plan or a plan provided by in many cases by insurance companies. In this latter category, accumulation plans established by banks and investment management companies can also be included.

Those who favour employer sponsored schemes will stress the fact that the controlling body of such a plan is the Trustee (совет in Russian). This trustee is often representative of both parties making contributions – employers and employees – and will jointly take decisions regarding the investment strategy, the choice of asset manager, the choice of administrator be and the price of will be for these services. They will argue the opposite about pension products provided by financial services organisation and that the cost of the services provided is actually profit for the provider and not necessarily designed to provide best quality of service and best return on contributions.

Insurance companies tend to dominate the market for the conversion of the amount standing to the contributor's credit in a DC scheme when he or she reaches retirement age. In most countries there is either a requirement, or a strong incentive, to convert this accumulation into regular payments called annuities. There are many different types of annuities – period certain, guaranteed or life- long with the latter having a number of variations fixed or escalating, for the life of the pensioner only of for the life of both the pensioner and his/her spouse.

Annuities are experiencing similar problems to pension schemes in that increased life expectancy and low rates of investment return are significantly reducing the values of annuities. In the UK if you had £100,000 in your pension accumulation and retired at age 65 at the start of the 1990s, you would have received a guaranteed income of £15,640 a year for life. Twenty years on, a 65-year old man retiring with the same accumulation will secure an income of just £5,800 a year or nearly 2/3 less. [2]

Similarly in the US the average rate for a 10 year multi-year guarantee annuity in May 2002 was 5.62% whilst the rate for May 2012 is 2.29%.[3]

In some cases, there have been moves to open up the annuity market. In many cases, pension fund contributors did not know that they had the option to buy an annuity from a body other than the one that ran their pension fund. Open markets for annuities are more common now. There is now more flexibility in deciding at what stage a person takes out an annuity with some countries allowing a phased withdrawal of funds from a pension fund without the need to formally commit to an annuity.

Most corporate DC pension funds will require a person reaching retirement age to take out an annuity from an insurance company. Some pension funds will pay annuities directly from the pension fund itself. The type of annuity will be much more restricted in these circumstances. Such an annuity will be a fixed period, either with no indexation or a fixed indexation. This means that the longevity risk to the fund will be minimised.

An increasing role for an insurance product that is becoming more widely used, especially in the UK, is the use by DB pension scheme of pension buy-outs. This is a process by which a pension scheme pays an insurance company to take over responsibility for paying its members' benefits. Each pension scheme member gets an individual policy with the insurance company securing and paying their benefits. All links with the former sponsor and trustees are replaced by that insurance policy.

This type of arrangement has been around since the mid-1980s. Until 2004, the market for this product was around £1 to £2 billion a year. In 2008, the demand surged to £8 billion in the year. Estimates for 2012 were a potential market of £10 billion.

To date, this product has mainly been of interest to UK pension funds but recently there have been statements that the market could extend easily to Canada, the US, and the Netherlands – most countries where DB schemes have been operating for some time. [4]

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[2] Source: http://www.telegraph.co.uk/finance/personalfinance/pensions/9044601/How-to-beat-the-annuity-rate-crisis.html

[3] Source:

http://www.annuityratewatch.com/rates/myga_historical_rates.cfm?theYear=2012&fixedRateYears=10&doRefresh=Redraw+Chart

1.4 Main characteristics and parameters of funded pension plans

Scheme design and membership

Pension funds have changed quite significantly over the last couple of decades. Pension plans were extremely limited in terms of flexibility of design. The plan design was simply based on a fixed relation between paid contributions and the benefit. If the contributions could not be paid then the contributor was not entitled to be a scheme member. In DC schemes everybody had the same investment portfolio regardless of whether they were a month from retirement or had only just joined the scheme. Due to the absence of a specific pension promise, it has been easiest for DC schemes to change. None the less there are some changes occurring in respect of DB schemes.

The biggest change in DC schemes has been in respect of who can be a scheme member. Traditionally, membership of a pension scheme was almost only by invitation. For example, blue collar staff could be excluded from scheme membership. In some countries, a woman had to cease to be a pension fund member if she got married.

Today it is effectively illegal for an employer to dictate who can contribute to a scheme in this way. In many countries (e.g. US or UK) there is still no compulsion for an employer to make a contribution to a voluntary supplementary scheme but if the employer does decide to make a contribution then in most countries he has to be willing to make a contribution for all employees. Additionally, if the employer offers a pension fund contribution then he has to offer the same rate of contribution or benefit to all the employees although this is not the case in all countries. There are still many countries where employers will make much greater contributions either in monetary or percentage terms for senior executives, often not to a company pension fund but the executives own personal pension fund.

As a consequence of opening up scheme membership, flexibility under the rules of participation can be observed. In DC schemes there are now some instances whereby everybody can participate in the scheme without the need for the worker themselves to contribute. If the worker themselves do contribute then there is often a choice in the rate of contributions they can pay and the opportunity to change that rate (usually annually). There is a formula whereby the amount paid in by the contributor is matched by the employer, sometimes one for one, sometimes to a higher ratio. Contributors can even, if their personal circumstances require it, temporarily stop contributing and restart at a later date. In this that case, they can increase the contribution rate to make up for the period when no contributions were made.

One of the drawbacks of a DC scheme compared to a DB scheme relates to the benefit paid in the event that the contributor cannot work on account of a disability or in the worst scenario dies. A downside of DC schemes is that the benefit is completely dependent upon the sum of contributions plus investment income. If a person is, for example, disabled at a young age there will be little pension benefit for them in a DC scheme whereas in a DB scheme the disability benefit will be based on the number of years of contributory service they person would have had. So today, we are seeing group life policies attached to DC schemes which will pay a lump sum insurance benefit in addition to the pension accumulation if a DC contributor is disabled or dies.

DB schemes had been built with very traditional work practices in mind. A key issue here has been the broadening of eligibility for membership. It was difficult, for instance, for a woman to take time off work to look after family to continue to be a member of a DB scheme. It was similarly difficult for a person who wanted to, or because of the employment market, was forced to work part-time to also

[4] Monk (2009)

continue to participate in the scheme as they could not afford the contributions. This could involuntarily force such individuals out of a DB scheme.

DB schemes are, however, becoming more participant friendly through increasingly flexible solutions. Pension fund membership more readily reflects changed employment circumstances. The ABP Pension Fund (a compulsory private scheme for government workers in the Netherlands) is one of the biggest pension funds by asset value in the world. It is typical of new thinking on DB schemes. It has many options that participants can choose from. There is for instance a flexible retirement age from 60 to 70 years and there is an option to reduce the number of hours worked, and receive a part-time pension to supplement the lost income. ABP also allows its members to increase or decrease their contribution rate according to their circumstances with the benefit they receive being adjusted accordingly.

Another characteristic of DB schemes, regardless of if they are compulsory supplementary schemes or voluntary supplementary schemes, has been the fact that they often allowed retirement a number of years before the age at which the person can receive his or her pension from the compulsory base pension system. In some cases it was not uncommon for 10 years prior to State retirement age to be the age at which a person could receive a benefit from a supplementary scheme. Increasingly the option for early retirement is being taken out of these schemes. Five years before state provided pension retirement age is becoming more prevalent as the age at which a person can now receive a benefit and increasingly there are discussions about further increasing the retirement age, particularly now with 67 becoming a common age for a person to be able to receive a full benefit under the statutory PAYG pension system.

Investment choice in DC schemes

Traditionally, the investment policy for a DC scheme was based on one size fits all – what was referred to as a balanced portfolio. It paid no attention to the different risks associated with the different members of the fund. Younger members can afford a greater percentage in equities since they have longer to recover any losses whereas for those close to retirement it is much harder recover from any losses, therefore needing much more of their account invested in cash and bonds. Recent developments show a move towards offering contributors investment choices with regards to their contributions. Now, most DC schemes will allow investor choice. The most extreme is the compulsory supplementary funded plan in Sweden where there are more than 800 funds to choose from. [5]

In the US, there is a tendency to offer a large number of choices into which contributions can be invested whereas in other countries funds typically may only offer three choices – one with a very low level of equities for those close to retirement, one with about 50% invested in equities to those say 10 to 20 years to retirement and one with a high level of equities for those who are very young. These are often called lifestyle funds. One variant of the lifestyle funds is an automatic rebalancing of the contributor's pension account as they get older. This is automatically done by the pension administrator once the contributor reaches a pre-determined age. If there is no automatic rebalancing then the contributor has to actively make this choice.

1.5 Sponsoring employer's responsibilities in different types of pension plans

Generally speaking, there are a number of legal obligations governing the relationship between the employee, the trust and the employer:

- The employer is bound, by legal obligations. These can include the rules of the trust deed (пенсионная схема in CIS countries) in any relevant national pension legislation or any relevant

[5] Source: The Swedish Pensions Agency

national industrial agreement or any individual contract of employment, for example, the payment of pension contributions.

- All trustees, including those nominated by the employer, must act in the interests of all the scheme's beneficiaries – both contributors and in final salary schemes, pensioners.

- The employer has a duty to notify the pension supervisor if there is any reason to think that there are any problems or wrongdoings occurring in the scheme and that the wrongdoing is important to the supervisor.

- The employer is responsible for ensuring that any employee contributions deducted from pay reach the pension fund within any prescribed period and that the employer contribution (if any) arrives when it is due.

- The employer must ensure that the assets of the pension fund are kept totally separate from those of the business.

- Any investment of the assets of the fund in the employer or a related business must not exceed the limit prescribed in the legislation.

- The employer must ensure that employees are informed and consulted on developments that affect the pension fund.

- Trustees must be assisted in the performance of their duties, usually through specialist pension advisors, and trustees representing employees must be given paid time off to undertake those duties and any necessary training.

These key provisions apply regardless whether the scheme is DB or DC. The primary difference between the sponsoring employer's obligations will be written in the Trust Deed. In a DC scheme the Trust Deed will prescribe that once the employer has deducted in the case of employee and paid in the case of themselves monthly contributions no further liability rests with the employer. However, in a DB scheme the employer's liability does not end with the payment of contributions. The employer's liability will only cease when there are no longer any beneficiaries under the Trust Deed i.e. there are no longer any pensioners alive or the liability has been transferred to a third party e.g. there has been a buy-out.

Many of the obligations above will not fall upon the employer if the contributions are being paid to a multi-employer pension plan or to a pension plan established by a financial services organisation. Under such a scenario the employer has not established the trust under which the scheme operates and as such only has obligations in respect of contributions under legislation, if applicable, industrial agreement(s) or the deed of adherence (pension contract in CIS countries) signed by the employer.

1.6 Plan members' rights in different pension plan types

Plan members have a basic entitlement that a participating employer will honour all of the obligations mentioned in the previous section. They also have an entitlement that the trustee will act in their best interests, and not in the best of interest of the employer or with any vested commercial interest in the case of insurance company schemes.

The OECD has produced guidelines for the protection of rights of members and beneficiaries in occupational pension plans.[6]

Access to plan participation, equal treatment and entitlements under the pension plan

Employees should have non-discriminatory access to a private pension plan established by their employer. Specifically, regulation should aim at avoiding exclusions from plan participation that are based on non-economic criteria, such as age, gender, marital status or nationality. Regulation of voluntary and supplementary pension plans also should aim towards similarly broad access, although the extent of such access may take into account factors including the voluntary nature of the arrangement, the unique needs of the employer establishing the pension plan and the adequacy of other pension benefits. Employees should be equally treated under the plan rules with respect to portability rights (transferring accrued benefits upon changing employment), disclosure requirements, governance and redress mechanisms, and other rights associated with the plan. They should be protected from retaliatory actions and threats of retaliation with respect to pension benefits and the exercising of their rights under a pension plan, for example they should be protected from the employer terminating their employment so as to prevent them receiving an accrued benefit under the pension plan. Similarly, if they exercise their rights under a pension plan, including but not limited to their filing of a claim or appeal or their initiation of administrative or judicial action, they should be protected from retaliatory action, such as termination of employment, suspension, discipline, fine or any other type of discrimination

Benefit accrual and vesting rights;

It is a generally accepted principle that there should be no retrospective changes to benefit entitlements in a DB scheme unless this is agreed to by the majority of scheme participants. Future entitlements could be changed for example by reducing benefits, changing the contribution rate or increasing the age at which a benefit becomes payable.

Vesting can apply in both defined and DB schemes although it is more generally associated with DB schemes. It is the percentage of the employer contributions that the employee receives in the event that he or she ceases to be a fund member. Under every circumstance the contributions made by the individual must be returned to him/her. Increasingly schemes are moving towards being fully vested i.e. a scheme participant who ceases to be a participant will be required to transfer their full entitlement to another pension fund or leave their entitlement in the existing fund. This has to be the case in compulsory base schemes where legislation prescribes a minimum contribution to be paid by the employer.

In the case of voluntary schemes, there is still the possibility for some part of the employer contribution not to be refunded. For example, in the UK, the current rules stipulate that employees that leave a trust-based pension scheme with between three months and two years of pensionable service may not receive full benefits, and so trustees may give them the choice of a short service refund or a transfer of the fund to a new scheme. While a transfer includes all employee and employer contributions, the refund includes only the employee contributions, with the employer contributions refunded back to the scheme.

What is permitted will depend upon the fund rules. Research on behalf of the UK government showed that in DC schemes if the employee left in the first three months of pensionable service he or she was refunded only their employee contributions. If they left between three first months and first two years of pensionable service they were offered a choice between a refund of their own contributions or a transfer of both their own employee and the employer's contributions to a different pension scheme. A minority of participating employers allowed full vesting rights or permitted a transfer from the first day of joining the

[6] OECD (2010)

scheme. Many DB schemes in the UK are now closed to new participants but generally the same full vesting provision after 2 years applies.

Since 2002, the ERISA Pension Legislation in the US has prescribed two basic vesting schedules for optional employee participation with employer contributions. Under the three-year schedule, the employer's contributions are 100% vested after three years of service in the plan whereas the six-year graduated schedule allows workers to become 20% vested after two years and to vest at a rate of 20% each year thereafter until they are 100% vested after six years of service. If plan requires automatic employee enrolment and compulsory employer contributions, then those contributions vest fully after 2 years. This is the minimum requirement - plans may have faster vesting schedules.

In the US, in a DB plan, an employer can require that employees have 5 years of service in order to become 100% vested in the employer funded benefits. Employers also can choose a graduated vesting schedule, which requires an employee to work 7 years in order to be 100% vested, but provides at least 20% vesting after 3 years, 40% after 4 years, 60% after 5 years, and 80% after 6 years of service. Plans may provide different schedules having more generous vesting schedules.[7]

A further principle in this area is that accrued benefits should vest immediately or after a period of employment with the employer sponsoring the plan that is reasonable in light of average employee tenure, although a "reasonable period" is not specifically defined. It is, however, important from the member's viewpoint that the rules to determine the accrual of entitlements and benefits are clearly specified.

The remaining guidelines in this area include practices that substantially undermine or deprive benefit accrual and vesting rights should not be permitted, vested benefits of individuals who have ended employment with an employer should be protected and not subject to forfeiture, regardless of the reason for severance except in the limited case of dismissals resulting from clearly defined cases of breach of criminal or civil law, vested benefits should be protected from the creditors of the plan sponsor and plan service provider should be protected when the plan sponsor or a plan service provider changes ownership or files for bankruptcy.

Pension portability (ability to transfer benefits to another plan) and rights of early leavers

Individuals changing jobs should be able, upon request, to move the value of their vested account balance in a DC plan from their former employer's pension plan either to the plan of their current employer (where permitted) or to a similar, tax-protected environment provided by an alternative financial instrument or institution. There should be a timely execution of the request to transfer the value of their vested benefit accruals.

Where feasible, a similar portability right also should be available to members of defined benefit. In calculating their vested benefit the actuarial and interest rate assumptions to value the individual's vested benefit should be fair and reasonable. These assumptions should be made readily available to the person transferring from one plan to another.

Portability rights should be available to members of a pension plan when they leave an employer, regardless of the reason for the separation and should not be inhibited by unreasonable charges or fees. Members and beneficiaries should be informed of the presence of any such charges or fees.

Individuals should not be required to exercise their portability rights and, generally, should be permitted to leave their vested benefits in the pension plan of their former employer.

[7]Source: United States Department of Labor

Disclosure and availability of information

Members and beneficiaries, both actual and potential, should have a legal right to ready access or disclosure to basic information about the pension plan, including adequate information regarding their rights of access, anticipated contribution and/or benefit accrual rates, vesting schedules, other rights and obligations, investment policy, the names and ways to contact service providers and processes or procedures for making a claim.

Plan documents, annual accounts, annual financial and actuarial reports, if not automatically disclosed, should be made readily available to plan members (and to beneficiaries where relevant) for copying for no more than reasonable charge or fee. Members and beneficiaries should be notified in timely fashion if required employer and member contributions have not been made to the pension plan. In the UK, contributions must reach the pension fund administrator by the 19th day of the next month (if not received within 90 days the breach must be reported to the supervisor). In the US, under no circumstances may contributions be forwarded later than the 15th business day following the month of being deducted. Failure to do so invokes penalty interest.

Timely, individualised benefit statements should be provided to each plan member and to beneficiaries, if they exist. The information included on the benefit statement and the frequency of its delivery depends on the type of pension plan. The information should allow the participant to identify current benefit accruals or account balances and the extent to which the accruals or account balances are vested.

For pension plans with individual accounts, the information should include the date and value of contributions made to the account, investment performance and earnings and/or losses. For member-directed accounts, a record of all transactions (purchases and sales) occurring in the member’s account during the relevant reporting period should be provided.

Individuals should be provided adequate and timely information about the rules associated with the portability of their vested benefit accruals, especially where the transfer of these assets may entail a loss of certain benefits or rights that were associated with the pension plan in which the benefit originated.

Disclosure materials should be written in a manner expected to be readily understood by members and beneficiaries. Consideration should be given to adequate forms of delivering information having regard to the confidentiality - mail, delivery at the workplace, e-mail or websites are possible options.

Amendments or changes to rules that significantly impact members and beneficiaries, their entitlements, or their benefits should be disclosed to them punctually and in comprehensible manner.

Additional rights in the where members can choose where contributions will be invested

Where members direct their own investments in an occupational pension plan, they have the right to a number and diversity of investment choices sufficient to permit them to construct an appropriate investment portfolio in light of their own individual circumstances and in the context of the particular pension programme.

They should be able to access complete information regarding investment choices that is standardised and readily comparable. At a minimum, this should include disclosure of all charges, fees and expenses associated with each investment choice, as well as portfolio composition and historical investment performance data.

They have the right to timely and fair execution of their investment decisions and to written confirmation of these transactions. The right (or responsibility) to make and execute investment decisions should not be inhibited by unreasonable charges or fees.

Those who are required to manage their own individual accounts should be provided sufficient opportunity to acquire the financial skills or education and other assistance that they need in order to make appropriate investment decisions about their pension plans.

Entitlement process and rights of redress

Members and beneficiaries and those claiming such status shall be entitled to a fair process or procedure in which their entitlements, rights and benefits under the pension plan may be claimed or asserted. The claim process or procedure should be expeditious and transparent. It should be easily understand and have only reasonable or no cost to the individual claimant.

The process should include independent administrative or judicial recourse if initial claims of rights or benefits are denied by the pension plan administrator, fiduciary, or employer. This process should provide for adequate remedial measures to redress the loss of rights or benefits suffered by the member or beneficiary whose claim has been found to be valid.

For example, in Australia, every pension fund must have a publicly advised complaints officer to whom a complaint can be made and then, having been through this process, a complainant can then present his complaint through the legal process at the Pension Claims Tribunal. In the US, complaints can be lodged with the Department of Labor, and in the UK, the Pensions Advisory Service handles disputes in the first instance which then can followed up with the Pensions Ombudsman.

1.7 Pension plan management: objectives, responsibilities and functions

The term pension plan management can be applied to two aspects of the operation of pension funds. Firstly the day to day scheme administration (transaction processing and recording), and secondly the investment of the assets.

Scheme administration

In its simplest form pension scheme administration can be broken down into 5 primary components; enrolling participants in the scheme, collecting contributions and remitting them in accordance with trustee or individual participant instructions, maintaining the database of individual’s scheme entitlements, communicating with participants and facilitating the payment of benefits.

It is important that whilst the controlling body of the pension fund can delegate the administration of the scheme to a third party (usually staff employed directly by the fund or to a company specialising in pension administration, it cannot pass off the ultimate responsibility and accountability for the administration to a third-party. Therefore, the ultimate responsible for the efficiency and effectiveness lies with the controlling body.

The overall objectives of the pension fund’s administration should be:

- to accurately maintain all scheme records, making those records available to scheme members and beneficiaries on an as required basis;

- to provide a timely, accurate and helpful service to actual and potential members of the scheme and their employer(s);

- to collect and pay, timely and correctly, sums due under the scheme and to arrange for their proper disbursement, accounting and budgeting;

- to publish timely and accurate information about changes to scheme policies and regulations;

- to provide value for money in delivering cost effective service;

- to lodge all necessary statutory documents on behalf of the controlling body with appropriate government bodies;

- to liaise with all bodies providing services to the scheme including the auditor, asset managers(s), custodian, lawyer etc.;

- and to provide appropriate advice to the controlling body about their pensions responsibilities/obligations.

Increasingly technology is becoming the driving force of ensuring both timely and accurate maintenance of data and communication with scheme participants and beneficiaries as well as other service providers. Controlling bodies have increasingly become aware of the cost of administration services.

This has seen a trend away from the scheme sponsor undertaking the scheme administration to employing specialist administration companies on term contracts, commonly of between 3 to 5 years, chosen after a competitive tender often referred to as "out-sourcing or third party administration".

As stated previously, in the decision about unbundled (where is service provider is separate) and bundled products (where all services are provided by the one company), the amount either paid by the employer in corporate pension funds or by the individual, particularly in DC schemes) has increasingly come under focus due to higher employer costs and/or reduced account balances on account of costs.

It is now common for the scheme controlling body and the scheme administrator to develop benchmarks to determine the standard of service delivery being provided to scheme members. These standards will vary slightly depending upon whether the scheme is DB or DC – particularly if the latter offers individual participant choice in where contributions will be invested.

A more recent development, as in Australia, is to rate individual schemes whereby the scheme as a whole, including the various aspects of its administration, is assessed by an independent organisation[8].

Investment of the assets

The basic objectives of investing the assets of a DB pension scheme differ significantly to that of a DC scheme. These are, therefore, addressed separately in Chapter 2. However, the responsibilities and functions of the asset management companies are the same for both plan designs. In this section, we will also look at the role of the custodian whose role is also the same for both types of schemes.

The asset management companies are given discretion on how they actually invest the assets within the overall investment strategy. However, they must always stay within the guidelines given to them by the controlling body.

[8] Source: Super Ratings, http://www.superratings.com.au

The role of the custodian is key in both types of schemes. To a large extent, the custodian is the eyes and ears of all those with an interest in the fund, not unlike a daily auditor as opposed to an annual auditor. For the controlling body and the scheme participants, the custodian's task is to ensure that every asset belonging to the fund is both invested and is invested in accordance the investment declaration. Where the custodian detects breaches of the investment declaration it will act to rectify those breaches. In some countries, the asset manager chooses the actual stocks to be bought and the custodian physically does this. In some countries, the asset manager engages brokers to physically do the buying and selling (trading). Regardless of the model the custodian has the final say in what is bought and sold as to ensure the ruling body's strategy is implemented. The custodian is also responsible for holding all the proofs of purchase on behalf of the controlling body (share and bond certificates) and for that all dividends payable to the fund are collected. In some jurisdictions, where investment earnings of pension funds are not subject to taxation, the custodian is also responsible for ensuring that any tax refunds due are received by the fund.

Investments in DB schemes

There appear to be slight differences between strategies currently adopted in the USA which focus on managing the risk/reward of investing pension assets, to those of Europe where the focus is more on maintaining solvency or keeping the deficit under control.

It is the controlling bodies' responsibility to take the decision on what investment strategy to adopt, regardless of what type of fund it is. Western Europe is now very much characterised by controlling bodies taking professional advice using a mathematical model to match assets and liabilities. In many countries that have recently developed their funded pension systems there is still a reluctance to pay for professional investment advice. The chosen investment strategy is implemented by the chosen asset management companies. In most Western DB schemes it is rare for there to be one asset management company. More often there are specialist asset management companies in the various portfolios dealing with, for example, national and international equities, national and international bonds.

Particularly in the area of equities, pension funds have become significant shareholders in companies around the world. These shareholdings bring with them both rights and obligations which the pension fund needs to exercise and fulfil. These are discussed later in the section on corporate governance.

Investments in DC schemes

DC schemes have a different approach to investing their assets. Since the benefit at retirement for such members in the sum of the accrued contributions plus accrued return on the contributions, the investment philosophy here is one of maximising return whilst minimising risk. Some may argue that it is easier to invest the assets of a DC scheme since assets do not need to be matched with liabilities. But countervailing this is that the returns are closely watched, sometimes with too much focus is on short-term returns. Poor returns can lead to participants transferring to other funds, which has a double effect on the service providers who are rewarded on the basis of contributions and/or total funds under management.

1.8 Main regulatory and supervisory approaches to private pension plans

The pros and cons of modifying the structure of the agencies that supervise the financial system are of interest to policymakers. It is an issue that has been widely discussed in policy notes and academic papers in recent decades, and began to be discussed in the late eighties when Norway, Denmark and Sweden were establishing a single supervisory authority in their countries.[9] The discussion heated up in the late 1990s

[9] See Quintyn and Taylor (2002) for arguments in favour of independence, its dimensions, and the way to achieve them, as well as the institutional arrangements needed to make independence work in practice.

when the United Kingdom created the Financial Services Authority (FSA) and continued in the first half of this decade as many developed and developing countries moved towards more integrated structures.[10]

Today, the discussion seems to have reached a consensus regarding the need to supervise the regulated components of financial groups to take into account the different prudential requirements of each sector and the different risks to which each is exposed, but without losing sight of the group as a whole, including the parent. Indeed, it is partly this need to ensure that a group-wide assessment and management of risk is achieved that has led some countries to restructure their supervisory systems to deal with financial groups in an integrated fashion. However, no single model has been adopted and many countries continue to rely more or less on functional oversight regimes with separate rules and separate supervisors for the banking, insurance, and securities sectors. Regimes range from disaggregated structures to single regulators with statutory authority, with various mixtures in between. Given the wide range of regimes in practice, it is safe to conclude that there is no single model to organize supervision which can be considered "optimal" in all cases.

In this section, two aspects of regulation of private pension plans will be discussed. The first is the regulatory body's structure and the second is the approach taken by supervisors to supervising private pension funds.[11]

Regulatory body's structure

When the first pension supervisors began to appear, there were a plethora of responsible agencies. In many countries, a pension fund had to be approved by the tax agency to be able to receive its tax concessions and, as such, the Tax Office became responsible for pension regulation. In others, the Ministry of Finance was responsible for insurance so it also became responsible for pensions. In Russia, the first inspectorate of non-state pension funds was part of the then Ministry of Labour and Social Protection. Across all this there was debate about the role of the regulator of investment products.

As DC pension schemes grew, particularly through the development of personal pension products offered by financial service providers, the separation of insurance products from pension products became less distinct. Added to this, banks and asset management companies also became involved in selling pension products, leading to greater debate about the need for one supervisor to cover all "financial services products".

During the period immediately following the move away from planned to market economies many donors, both bilateral and multilateral, provided much technical assistance in the capital markets area including pension, insurance and regulatory reform. Typically, the first reform saw the regulation of non-bank financial institutions (insurance, pensions, credit unions, leasing companies etc) brought under the one supervisor.

The issue of scarce resources and the blurred distinction over the roles of banks as owners of insurance companies, asset management companies and providers of pension products brought about the next major step – what is referred to as the "unified regulator" whereby all financial services products came under the purvey of a single supervisor.

[10] In the past 30 years, Australia, Austria, Canada, Colombia, Denmark, Estonia, Finland, Germany, Hungary, Iceland, Ireland, Japan, Latvia, Malta, Netherlands, Nicaragua, Norway, Peru, Singapore, South Africa, South Korea, Sweden, Switzerland, and the United Kingdom among others have established integrated agencies, which oversee various combinations of the banking, insurance, pension and securities sectors.

[11] IOPS (2007)

Most countries around the world are going down this path. Some have not followed this model. For instance, Mexico has a mandatory DC system (although participation levels are very low) and there is a stand-alone pension supervisor not aligned with other financial services supervisors. The US has kept the regulation of pension funds as the responsibility of the Department of Labour (MHSD is the Russian equivalent). The UK has a dual model. The Pensions Regulator regulates work based pensions (voluntary or compulsory schemes with employer contributions in this paper) whilst the Financial Services Authority looks after all other types of pensions and other financial services products.

The approach to supervising pension plans

The OECD's work on efficient and effective financial regulation and supervision highlights and reinforces the avenues where a number of key risk exposures in the financial system lie. [12] These include:

- Multiple functions in the financial system: The financial system involves a number of key functions, such as the provision of payment mechanisms, financial intermediation, management and transfer of risks, exchange and pricing of financial assets, and clearing and settlement of financial obligations.

- Multiplicity of products, institutions, systems, markets, and participants: The operation of the financial systems involves different types of products, institutions, systems and markets, each involving different types of participants, all of which may evolve and change in form and purpose over time. This has been particularly evident with the pension sector, in a number of jurisdictions, due to various changes in government policy and the continual development and maturing of the sector itself.

- Linkages with other sectors of the economy and households: The financial system is closely interconnected with the real economy and individual households given its role in providing funds for investment, and vehicles for savings and investment; in this respect the pension sector plays a crucial role.

- International linkages: The financial system is international in nature, spanning countries and regions, with integrated financial markets, exchanges, and clearing and settlement systems, cross-border supply of financial products and services, and globally active financial groups and conglomerates. Many pension fund products invest globally and as such are exposed to the effects of such linkages.

- Rapid evolution and innovation: Technological advances, market liberalisation, competition, regulatory and legal reforms, and globalisation have served to accelerate change in the financial system. The pension sector has equally evolved rapidly due to these advancements together with the progression in government social policy direction which also plays a significant role.

A Pension Supervisor's role is to ensure that under all reasonable circumstances, a supervised pension fund can honour its promises. As stated in the section concerning the funding of private pension plans, the most common approach taken to the supervision of pension plans is to adopt a "risk-based" approach.

Risk based supervision (RBS) requires supervisors to review the manner in which, in this case, pensions funds are identifying and controlling risks. It requires supervisors to assess system and individual fund risk and to respond with the supervisor's own processes and interventions in line with the assessment. This, in turn, allows supervisors to allocate resources to the pension funds with the greatest risk and areas

[12] OECD (2010)

within individual pension funds that are high risk. RBS involves supervisors assessing four factors: inherent risk, controls, residual risk and additional support.

The reasons for moving to risk based supervision will vary from country to country and to a large extent depend upon the dominant type of pension fund in the country.

Across almost all countries the primary reasons for introducing RBS were that

- the means of investing pension fund assets were becoming more complex;

- the capital markets were becoming both more international and more complex;

- supervisors needed better trained and qualified staff at times when resources available to them were becoming more scarce;

- and the integration of non-banking products with banking products leads to a change of approach when regulatory bodies were merged into one.

Additional reasons for the introduction of RBS that may have been scheme or country specific included:

- a policy of reducing the risk of underfunding or insolvency of DB plans (or DC plans with guarantees) due to sudden and adverse price movements

- the search for efficiency gains, especially from improvements in the risk/reward trade-off in DC schemes

When examining supervision, and particularly risk-based supervision, there are three main parties to the process.

The first is the pension fund and the actors that take and implement decisions on behalf of participants. The trustee has the overall responsibility for decisions such as the investment strategy including the level of risk that will be taken and about the possibility of negative returns. In addition to the trustee, we have the scheme administrator that is responsible for ensuring that there are appropriate internal controls to guard against fraud or theft of the fund's assets.

Secondly, the supervisor plays a key role developing and applying regulations. These regulations will usually prescribe the minimum standards that need to be applied. The supervisor needs the appropriate tools to be able to assess risk and needs the appropriate authority to enforce the minimum standards and demand that breaches be rectified. The supervisor may also need to call upon other powers, for instance, disclosure laws which will ensure that information needed as part of the risk assessment process is available.

The third group is market participants. They will feed into the regulatory process other "formal or informal" information. Formal information can come from the actuary carrying out the actuarial review, from ratings agencies who will assign risks to individual companies and to governments, for example in respect of bond issues. Equally important are the scheme members themselves reporting delays in benefit payments or crediting of contributions. Such information will often signal to the supervisor that there is a potential breach in the management of the plan.

Whilst Risk Based Supervision has spread across many OECD countries and non-OECD countries that are members of the European Union, the approach taken under Risk Based Supervision will not necessary be able to be applied in all countries.

Pension funds that have a legal structure based on trust law, with its fiduciary responsibilities, statutory obligations and legal precedents founded upon case law, are more easily aligned with Risk Based Supervision as opposed to those pension funds in former Soviet countries where there is no concept of trust and the regulatory structure applied to pension funds is the civil code and the concept that pension funds are not-for-profit organisations.

The second issue relates to the market. If we take the market for non-state pension funds in Russia, the majority of these funds are local funds, established by Russian companies with services being provided by Russian service providers. It is harder to adopt Risk Based Supervision in this climate than in a country like Croatia where non-state pension funds are predominantly established by multi-national players.

A final point is whether the benefit of establishing a Risk Based Supervision model outweighs the cost of establishing this model. In most countries where Risk Based Supervision has been established, the supervisor is able to raise a levy on market participants that can be directly ascribed to meeting the costs of regulation. In other countries, even if there is the capacity to raise a levy, that levy is directly ascribed to the State Budget with no guarantee that the finding will find its way to the Supervisor.

During the crisis, many pension funds experienced market and investment risks which quickly spilled over into liquidity and contagion/counterparty risks (where alternative investments and/ or derivatives were involved). Pension funds operating in the current post financial crisis environment have noted that interrelated risk exposures such as market risk, counterparty risk and liquidity risk are considered to be their top three concerns. [13]

The consequences of the blurring effect of such risks and their effect on supervision and its effectiveness are therefore relevant. The lessons stemming from the recent crises are that in going forward, regulators and supervisors will have to pay more attention to background risks and systemic risks, as well as build in mechanisms for learning from past failures and near misses.[14]

1.9 Addressing fees and costs in pension fund systems

The efficiency of private pension systems can be judged by looking at the total operating costs in relation to assets managed. The total operating costs of private pension systems include all costs of administration and investment management involved in the process of transforming pension contributions into retirement benefits.[15] This is, however, just one measure of the efficiency of the private pension system. Judging a pension fund's efficiency solely on the basis of administration costs ignores, particularly in the case of DC scheme, and even in the case of DB schemes, the return from investing the contributions. A scheme that has very low administration costs may not necessarily even reach the benchmark investment return.

There is also an argument about economies of scale – i.e. the larger the number of participants, the greater the assets and therefore the more likely the cost of administration will be lower. For example research by Bikker and De Dreu on Dutch DB pension funds supports this argument.

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[13] Neilson, F., Costabile, A. and Short, J. (2011)

[14] OECD (2012)

[15] OECD (2011)

Administration costs need to be kept under review and benchmarked both against the amount being paid and against the quality of the service being provided. In terms of administrative efficiency only being measured in terms of administrative costs being a proportion of the fund's assets, the amount spent on administration is not the only measure of administrative efficiency. Particularly in DC schemes there may be a significant proportion of the fund's members who are inactive members i.e. they do not have contributions made on their behalf. This may be because they are out of the workforce or have moved overseas. But a large proportion of inactive members can be women who are on career breaks either looking after their own children or looking after elderly parents. An administration charge model based on both contributions received and the value of the individual account balance is the most common approach to trying to accurately account for the costs incurred in administering a pension fund.

The governing body of either type of pension fund needs to be acutely aware of the cost of administration. The Dutch Financial Services Regulator (the Financial Markets Authority) reported in April 2011 that "a cost reduction of 0.25 percentage points will result in 7.5 % more collective pension assets over a period of forty years". Put more bluntly - each increase in administration costs of 0.25% of assets reduces an individual's account balance in DC scheme by 7.5%. [16]

But equally in a DB scheme each increase in administration costs will add to the amount needed to finance fund benefits – either by way of needing higher investment returns or by requiring higher contributions by the sponsoring employer and/or fund participants.

However, due to the great national diversity of systems and fee charging methods, it is extremely difficult to compare such fees and charges internationally. The OECD has carried out exercises to model costs and fees on a unified basis for private defined contributions schemes, known as the charge ratio, which allows for a standardized international comparison.[17] Though such standardized results should be treated with caution, some trends can be identified:

- Voluntary systems tend to have higher charge ratios (due to marketing costs etc.) as in Turkey, the Czech Republic and Serbia.
- In some systems where there is a small number of providers show relatively lower charge ratios.
- Charge ratios decline over time, making older pension systems generally less expensive. The higher charges in Serbia and Turkey, for example, may continue to decline as the plans mature.
- Regulations, particularly those limiting asset based fees, can reduce costs in pension systems, but opportunity costs (of potentially higher returns) may be sacrificed.
- Regulations imposing minimum guarantees imply higher charge ratios.
- High contribution and wage rates deliver higher final balances and therefore lower charge ratios.

1.10 Tax treatment of pension plans

There are three components to a funded pension scheme:

1. The contributions employers and/or employees make

[16] AFM (2011)

[17] Stewart and Hernandez (2008)

2. The investment income and capital gains that are earned from investing the contributions

3. The benefit that the participant receives when he or she ceases to be a fund member

Convention uses the letters "E" (exempt) and "T" (taxed) when we talk about the taxation of the three components mentioned above. Obviously the most beneficial regime from the participant's perspective is one where there is absolutely no tax on any component (EEE). This is a very rare occurrence as governments almost universally want some share of the financial activity. The EEE model occurs in many CIS and post-communist countries in the compulsory social security pension scheme, as the contributions are deducted before tax is calculated, and the benefit is paid tax-free. At the other end of the spectrum TTT is also very rare since the majority of governments offer some incentive for citizens to save for their own retirement.

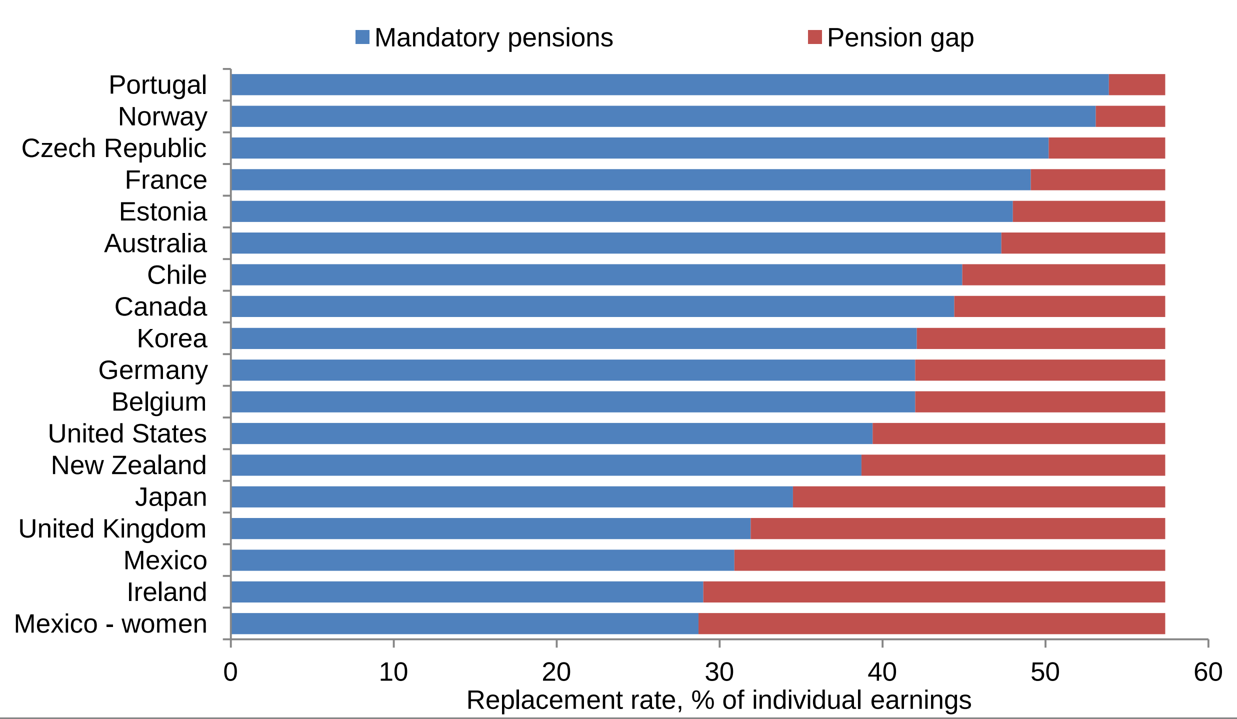
The benefit a participant will receive from their pension scheme will be higher if only one element of the three components is taxed than if two or more elements are taxed. There will be no difference in the end result if contributions are taxed or benefits are taxed, provided the rate is the same in both cases. There will also be no difference in the end result if contributions and investment income are taxed compared to investment income and benefits being taxed (again if there is no different rate applicable).

There are many models adopted by countries around the world. The literature on taxing pensions refers to the EET model as the "classical expenditure tax" since any revenue for the government is deferred until the person retires. The TEE model is referred to as the "pre-paid expenditure tax" since revenue is received immediately and not at retirement.

A lot of debate focuses on providing tax incentives to increase pension contributions. Looking into the amount of previous wages replaced by mandatory pension plans, both PAYG financed or funded, suggests that there may be a need for additional retirement savings in voluntary funded pension plans to complement and diversify retirement income. The pension gap measures how much people would have to contribute to voluntary, private pensions to lift overall replacement rates from the national, mandatory level to the average for OECD countries. there is a large "pension gap" in a dozen OECD countries, with net replacement rates from mandatory schemes of less than 60%. In most of these countries private pensions are voluntary and rarely cover more than half of the workforce. A greater role for private pensions in these countries is inevitable to fill this pension gap. Even if further increases in retirement ages are implemented, private pension provision should be promoted to allow workers to draw on their savings in old age, complementing their working income and public pension benefits. This can be particularly attractive for those seeking flexible working conditions after a certain age or a phased retirement.[18]

[18] OECD (2012)

Figure 3. The pension gap - Gross replacement rate for an average earner from mandatory pension schemes and difference from OECD average replacement rate



Note: For simplicity and comparability, the calculations assume that people with voluntary pensions have a defined-contribution plan, where the value of the benefit depends on contributions and investment returns. The modelling makes the same general assumptions as with the calculations for the other indicators. In particular it assumes an annual real return of 3.5% on pension savings, net of administrative charges.

Source: OECD pension models; OECD Earnings Distribution Database.

Governments throughout the OECD are highly active in designing and implementing policies to encourage private pension savings. Contributions to voluntary DC pension plans enjoy tax advantages in most OECD countries in order to promote savings for retirement. However, in most countries these tax advantages take the form of a deduction on the income tax base (i.e. the amount of income subject to income tax that it is used to determine the tax rate). In countries where there is a flat rate of income tax the question is simpler. Should the Government subsidise those in the workforce who can make pension contributions or should it use these tax incentives to increase base pensions and/or social assistance at the expense of those who are working.

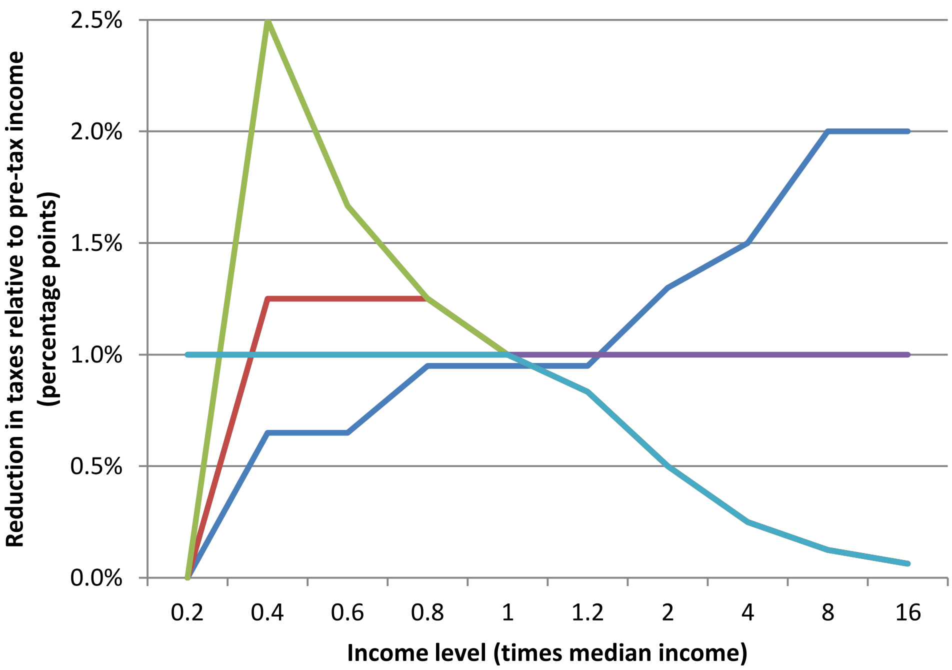
The situation gets more complicated where there is not a flat income tax but a marginal income tax where the rate increases as the person's wage increases. Tax deductions provide incentives that increase with income as it reduces marginal tax rates. Measuring tax incentives as the change in tax payments relative to pre-tax income stemming from each of the different forms of introducing tax incentives, a tax deduction provides higher incentives to save to higher income earners and it may be of little or no value for workers with low income.

For instance, in the UK the higher rate of taxation (40%) applies to all income in excess of £34,370. This has a significant impact upon the value of pension contributions. A person who is on the lower rate of taxation and who is able to make pension contributions will have their contribution increased by their marginal tax rate of 20% - so a person on £30,000 who makes a contribution of £3,000 (10%) will in fact have £3,600 credit to their account. Whereas a person on £60,000 with a marginal tax rate of 40% and who also pays in £3,000 will in fact be credited with £4,200. There was a lot of discussion over this issue prior to the last budget but the situation was not changed.

There can also be distributional aspects to take into account in the pay-out phase. Public sector workers in the UK (compulsory supplementary scheme members) can receive a tax-free lump sum upon retirement. Depending upon when they became scheme members they can either receive a lump sum of three times their annual pension or convert 25% of their pension into a lump sum. If we take a public sector worker on a wage of £20,000 per year who has been a scheme member for 30 years they will receive a pension of £7,500 or a lump sum of £22,500. If the person is a senior civil servant with a wage of £80,000 and who also was a scheme member for 30 years their pension will be £30,000 a year together with a lump sum of £90,000. This tax advantage is obviously of greater value to higher paid workers.

Given that enrolment and retirement savings generally increase with income, an incentive structure skewed toward higher income may be far from the best way to increase participation and contributions to private pension plans. Tax deductions provide incentives that increase with income as it reduces marginal tax rates. An alternative way of introducing tax incentives that change inversely with income is to use tax credits. Tax credits entail that after calculating taxable income and applying the tax rates relative to the income brackets to determine the tax due, one can apply a deduction to the tax due. This deduction can be a fixed amount equal for all income levels or a percentage of contributions with a cap. Targeting the low paid requires a third type of incentive, in the form of a government subsidy or matching contribution into the individual's retirement savings account. Matching contributions enable certain groups to be targeted. The figure below measures tax incentives as the change in tax payments relative to pre-tax income from the different types of incentive structures mentioned above.

Figure 4. Incentives of tax deductions, tax credits and matching contributions by income



Note: The tax incentives are designed such that, given the tax brackets, the reduction in taxes relative to pre-tax income is the same for the person with the median income.

Source: OECD Calculations

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2. INVESTMENT MANAGEMENT OF PENSION FUNDS

2.1 Introduction

This chapter looks at the issue of investing the assets of pension funds. The practical aspect of investment activity is highlighted in the chapter by looking at the investment strategies and asset allocations OECD pension funds – both DB and DC defined contribution. This analysis shows that they have widely spread portfolios with significant proportions of the fund's assets invested both overseas and in alternative investments.

Different investment strategies are necessary for each DB and DC schemes. Generally speaking, DB schemes are maturing meaning that greater emphasis is being placed upon matching the assets of the fund with its liabilities. Very few countries are now investing with the objective of reducing the employer's immediate cost through decreased contributions. The focus is more on ensuring that there is no long-term blow-out of costs. On the other hand, the assets of DC schemes are increasing significantly and will continue to do so. More countries are including DC arrangements as part, if not a significant part, of their public pension scheme.

The question of investing assets overseas is politically sensitive in some countries, particularly those where there is a belief that pension reform can be a driver of economic growth and a stimulus for the development of the capital markets. For example, pension funds can be an important vehicle for investing in infrastructure, property and real estate whether this is through direct investment by the fund itself or through specially established vehicles such as real estate investment trusts (REITS) or infrastructure funds run by private asset managers. Pension funds assets can be used to provide residential property. Either the fund can itself be the developer and take what is known as the developer's profit (often the greatest amount of profit) or by providing mortgage finance, preferably through a third party to avoid pitfalls if a fund participant falls into arrears and repossession needs to be made.

The use of alternative investments and derivatives provides opportunities for pension funds to enjoy investment returns that they may not otherwise have made through traditional investment activities. Historically, however, there are also significant risks associated with these investments. Any governing board that decides to go down the path of using alternative investments and derivatives needs to clearly understand the implications of such a strategy and have appropriate monitoring mechanisms in place to ensure a functional and timely early warning system.

Whilst investment in private equity has suffered from adverse publicity, this type of investment warrants serious consideration by a pension fund. The ability for a private entrepreneur to secure a capital injection without seeking listing on a registered stock exchange can be a source of valuable finance to the entrepreneur and high rewards to the pension fund. Proper due diligence is the key.

A similar argument applies in respect of commodity investments. This type of investment is sensible from a pension investment perspective, but recent press articles about the role of financial organisations in driving up the price of staple foods, and leading to increased food poverty, makes the management of this type of investment vehicle problematic. The Governing Body of a pension fund needs to carry out proper due diligence before entering into this area of investment.

2.2 Why the interest in pension fund investment?

Funded pensions are a growing trend

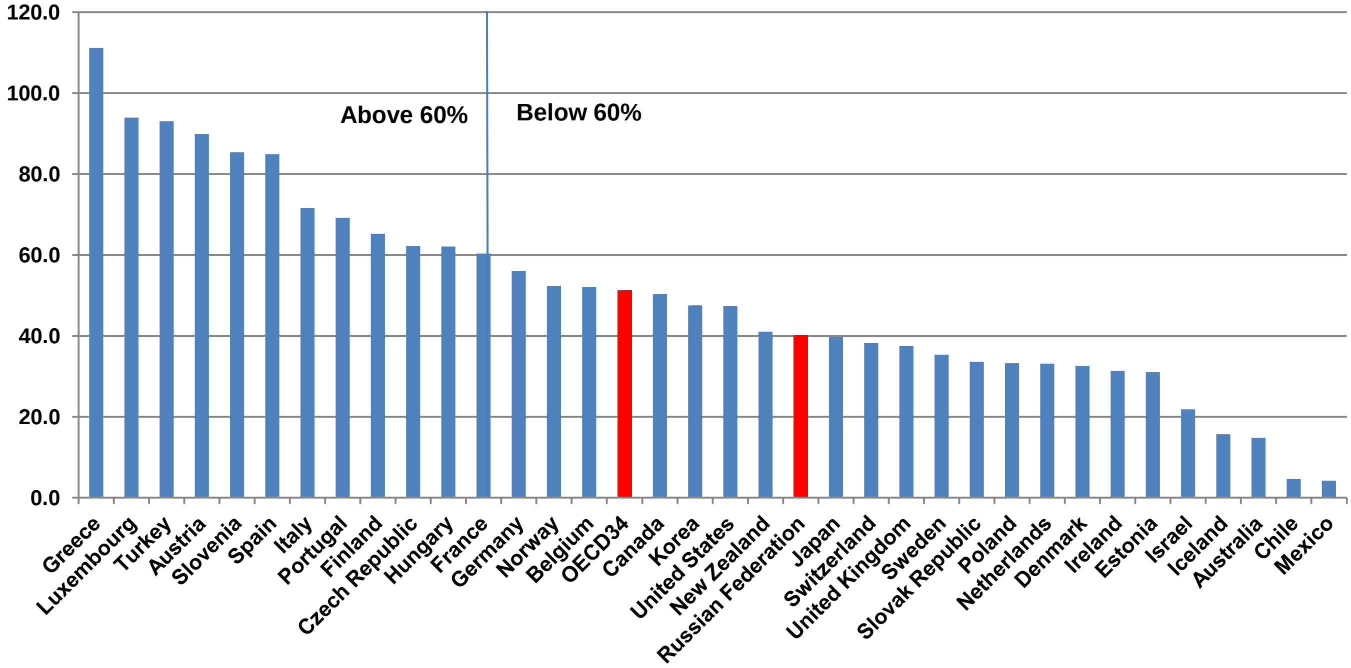
Pension systems in the OECD have evolved markedly over the last twenty years. While no two pension reforms are exactly alike, they have all generally included the following features:

- Lower public (PAYG-financed) pension benefits achieved via (i) discretionary changes in benefit formulas or (ii) an introduction of automatic adjustment mechanisms in PAYG pensions;
- Higher retirement ages;
- Further development of funded pension arrangements, in some cases including the introduction of mandatory funded pension arrangements.

Over these last decades, and as a result of various reforms, the structure of the retirement income system is more diversified in most OECD countries, with an increasing role for funded systems and a decreasing smaller role for the PAYG system (as a proportion of the total benefits offered)

As of today, in 22 out of the 34 OECD countries, the PAYG pension system will provide a benefit to workers entering the workforce that will be below 60% of their final salary if they retire at the normal retirement age after a full career. This net (after taxes) replacement rate will be below 40%.

Figure 5. Net pension replacement rates from public pension systems for average earners



Note: The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
Source: OECD (2011), Pensions at a Glance 2011

PAYG pensions are complemented in 14 of the 34 OECD countries by mandatory, funded pension arrangements, which all or most employees must join or "quasi-mandatory" arrangements, which require enrolment into specific pension arrangements as a result of collective bargaining at either the industry or national level. The Czech Republic is also expected to join this group with a new mandatory DC system, bringing the total number of countries with mandatory or quasi-mandatory funded pension arrangements to 15.

While most countries have moved towards multi-tier pension systems, combining PAYG and funded systems, some countries in Central and Eastern Europe have partially reversed the original reforms that introduced the mandatory funded component. Two other OECD countries, Hungary and the Slovak Republic, used to have mandatory private pension systems but have recently changed enrolment rules, with a dramatic effect on coverage, especially in Hungary. In this country, the government decided to effectively close down the mandatory private pension system at the end of 2010.

In twenty other OECD countries, funded pension systems are voluntary, that is, employers decide on a voluntary basis whether to establish pension plans for their employees. Three countries, Italy (2007), New Zealand (2007) and the United Kingdom (2012) have made enrolment into funded pensions automatic, but offer employees the possibility of opting out. These auto-enrolment systems rely on individual inertia to raise coverage levels. In particular, the New Zealand Kiwisaver has raised coverage levels from less than 10% of the working age population to more than 55%.

Overall, there is a clear trend towards combining PAYG and funded pension systems and for the latter to be increasingly of a mandatory nature and DC. In about two thirds of OECD countries, the average worker has to rely on funded pension systems to complement a public pension benefit of less than 60% of their final salary.

Funded pensions impact on national savings, financial markets and the national economy

There has been much theoretical and empirical research as to the impact of funded pension systems on household and national savings. The empirical research is largely inconclusive except for mandatory funded system which in general can be shown to contribute to higher national savings rates.[19]

Funded pension systems can also contribute to economic growth through other means. Funded systems can reduce employment distortions and savings disincentives caused by social security contributions. They can also provide much needed funds for critical, long-term investments such as infrastructure and can raise the efficiency and level of financial intermediation, improving growth prospects.

Three basic channels of the impact of funded pensions on financial development can be distinguished:

- Direct changes in savings and the size and composition of the financial system as a result of a move of mandatory pension contributions from a PAYG to a funded system. Pension reform can affect the savings rate of the economy and hence change the level of financial intermediation.

- Direct effects on financial intermediation are also to be expected. If the transition from a PAYG to a funded system takes place through the issuing of public debt, market capitalisation will grow and the maturity of public debt maturity could increase. The development of a public debt market could in turn foster the growth of the market for private securities.

[19] López Murphy and Musalem (2004), Kune (2010)

- Changes in the efficiency and composition of financial intermediation as a result of the emergence of pension funds and other institutional investors. Some improvements in the operation of the financial system may result from regulatory reform and the operation of pension funds and other institutional investors that participate in the new funded system.

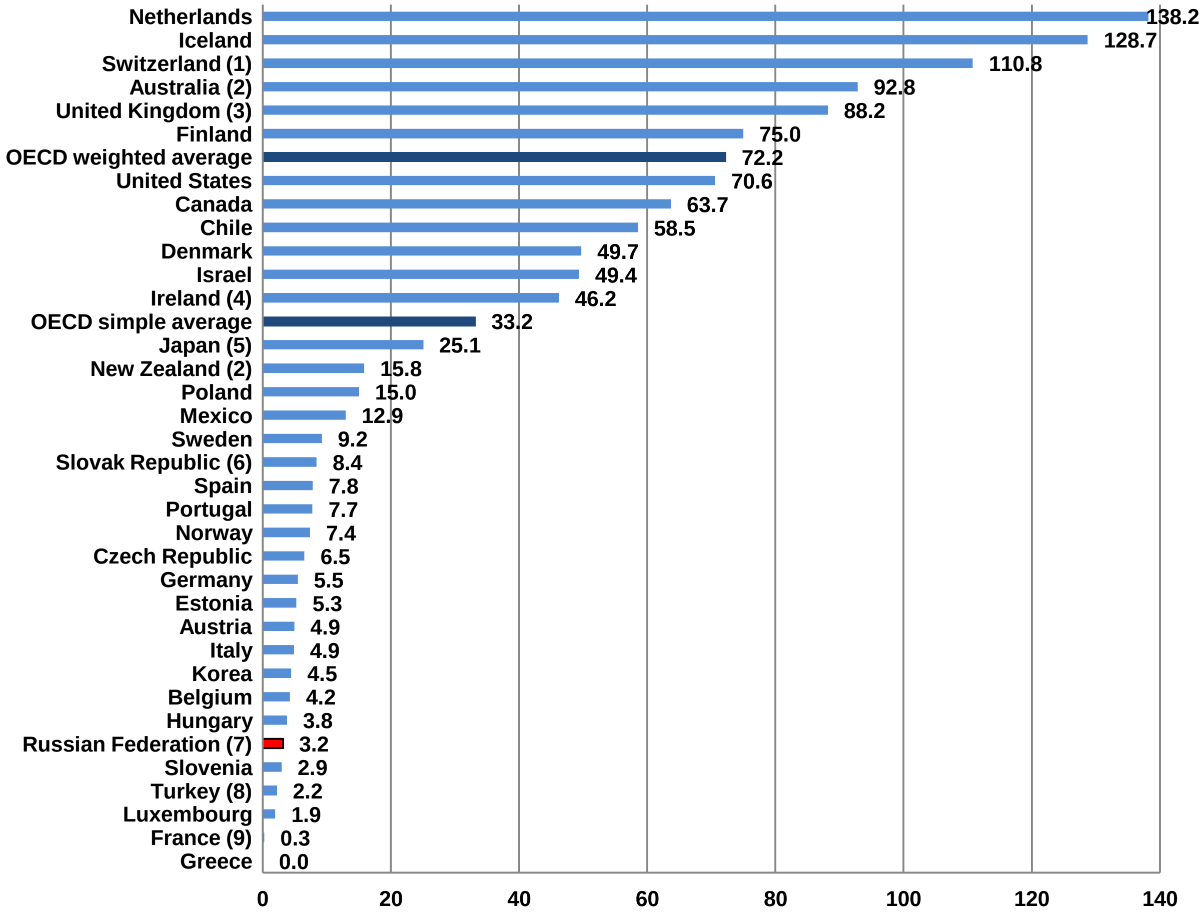
Pension funds and other institutional investors can have secondary effects on the composition of the financial system by, for example, lengthening the maturity of company and household financing. They may also increase the efficiency of financial intermediation, by, for example, increasing the liquidity of capital markets and serving to counterbalance the power exercised by banks.[20] They may therefore contribute to a better allocation of resources and improved economic performance.

Davis (2002) finds a significant direct effect of the share of equities held by pension funds and life insurance companies on growth in multi-factor productivity in 16 OECD countries. Davis and Hu (2004) using a dataset covering 38 countries also find a direct positive link between pension assets and the growth of output per worker. Both papers argue that an important aspect of the financial development channel is an enhancement of corporate governance. Even firms unaffected by shareholder activism, they conclude, have natural incentives to improve their performance so as to avoid the threat from pension fund activism in the future.

The impact of pension funds in the financial system depends on the volume of assets managed by these institutions. As shown in Figure 6, the largest pension fund sectors in relation to GDP can be found in countries such as Iceland and the Netherlands. Typically, the Russian pension fund sector comes in the lower half of the chart, with assets that represent less than 4% of annual GDP.

[20] Allen and Gale (2000)

Figure 6. Importance of pension funds relative to the size of the economy in OECD countries, 2011



1. Data refer to the first trend calculations for the year 2011.

2. Data refer to the end of June 2011.

3. The figure for total assets at the end of 2011 is an early estimate based on the 2010 level of assets and the flow of transactions in 2011. It does not take into account value changes. A 2011 final estimate will be available in January 2013.

4. Source: IAPF Pension Investment Survey.

5. Source: Bank of Japan.

6. Data refer only to pension funds supervised by the Securities Market Agency of Slovenia.

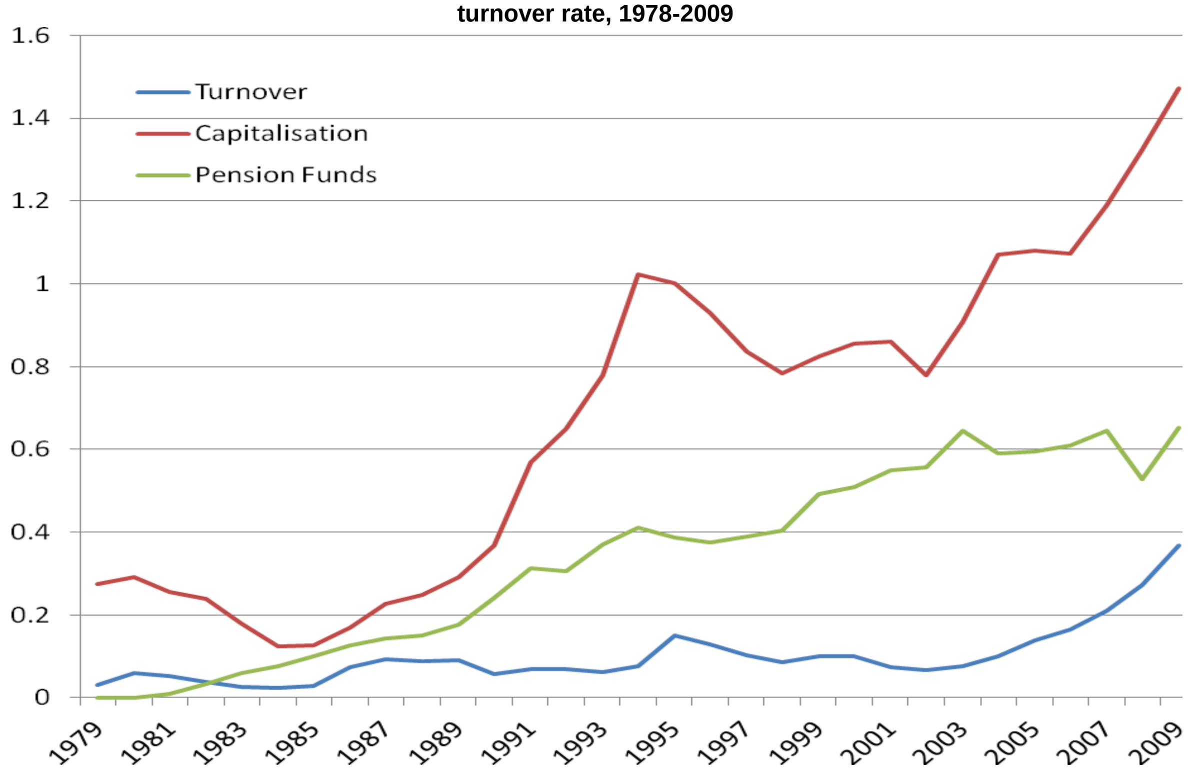
7. Data for occupational pension plans refer to 2010.

8. Data refer to PERCO plans as of June 2011 (source: AFG)

Source: OECD Global Pension Statistics.

Through their investments, pension funds can contribute to capital market development, boosting both stock and bond markets. One of the clearest examples of the strong relationship between pension funds and stock markets is Chile, where a mandatory pension fund system was established in 1981. As it can be seen in Figure 7, the growth of pension funds has been accompanied with a rapid increase in stock market capitalization and more recently a jump in turnover rates.

Figure 7. Chile: pension fund assets to GDP ratio, stock market capitalization to GDP ratio and stock market turnover rate, 1978-2009



Source: Superintendencia de Pensiones, World Bank Financial Sector Database

2.3 Regulating pension fund investments in OECD countries

The International Organisation of Pension Supervisors (IOPS) issued revised principles of private pension supervision in 2010. Those principles say that the objectives of private pension supervision focus on protecting the interests of pension fund members and beneficiaries, by promoting the stability, security and good governance of pension funds. Pension supervision involves the oversight of pension institutions and the enforcement of, promotion of, adherence to and compliance with regulation relating to the structure and operation of pension funds and plans, with the goal of promoting a well functioning pensions sector. In addition, achieving stability within the pension sector is an important part of securing the stability of the financial system as whole (as investments made by pension funds have a major impact on the real economy in many countries). [21]

Under the trust law concept, pension fund assets are held in trust for the beneficiaries. The trustee is responsible for determining the investment strategy and overseeing the activities of those organisations appointed to physically invest the assets.

The key issues in regulating pension investments from the regulator's perspective are protecting members and reducing the likelihood of a fund defaulting. Increasingly, the approach taken by regulators is forward-looking, primarily risk-based, consultative, consistent and in line with international best practice. This approach also recognises that management and boards of supervised institutions are primarily responsible for financial soundness.

[21] IOPS (2010)

OECD countries that have implemented risk based supervision include The Netherlands, Denmark, Australia, Mexico, Canada, Germany, the UK, Hungary, Chile and Ireland. Those countries which have not, or because of their legal system are not able to, apply risk-based supervision will continue with compliance based supervision. The differences between the two are highlighted in the box below.

Risk-based approach	Compliance-based approach
• Supervisors use judgement to assess risk and quality of management	• Point in time focus • Overlooks major risk areas • No early warning system
• Compliance checks done by audit etc, removes duplication of work	• Duplicates work of auditors etc
• Supervisor can benchmark institutions and assess overall industry	• Difficult to get meaningful comparisons
• Attention directed to emerging problems	• Penalises past breaches of rules

DB and DC schemes have different objectives in investing their assets. Regulators need to acknowledge this and develop supervisory practices that reflect the differences between schemes.

The investment strategy of a DC scheme must address the participants' needs up to the day they convert their accumulation to a lump sum or regular monthly payment. The investment of the funds used to purchase an annuity is neither an issue for the participants nor (usually) for the fund into which their contributions were paid. The focus in the pay-out phase often moves from that part of the supervisor responsible for pension funds to that part of the supervisor responsible for insurance products since most annuities are provided by insurance companies.

In DB schemes, the pension supervisor does not need to distinguish between the period when the person is making contributions and the period when the person is receiving their regular payment (pension). Contributions are paid into the pension fund which will add to the assets available for the benefits to be paid out. The problem for DB schemes comes when the fund has more pensioners than contributors (a mature fund) as the investment strategy that the scheme sponsor may like to adopt in respect of the contributions being paid in, has to be tempered by the need to pay out many pensions, the cash-flow for which could be significantly impacted if the market turns down and the fund is heavily invested for instance in equities. One problem that needs to be faced today pertains to the uncertainties of financial markets. Past investment performance alone cannot indicate future performance as there are so many factors impacting upon the returns a pension fund can/will achieve.

The issue of how to manage risk and supervise DC pensions has moved higher on the agenda. During the crisis some funds with large equity exposures experienced investment losses as large as 20-30%. This was catastrophic for those near retirement age as they had no opportunity to regain their losses. The losses also impacted on the population's opinion as to the value of pensions as part of a person's retirement planning.

The main difference between DC and other forms of pension arrangement is that individual members predominantly bear the risks inherent in the plan. These include investment risk and operational failures. Such risks are also present in DB pension plans, but with DB or insured products, there is another party (such as the plan sponsor or provider) to make up short-falls caused by investment losses and/or increased longevity. With DC plans, everything comes out of the accumulated account from which the individual member must fund his or her retirement.

In DB plans, the supervisory authority is there to ensure that the plan sponsor (usually the employer) funds the plan to the extent needed to ensure that the promised benefit will be provided. Investment risk, longevity risk, inflation etc. are all considered within the assessment of the solvency of the fund or plan. The supervisory approach will consequently focus on funding and solvency issues, looking at assumptions and often stress testing to assess whether benefit promises are likely to be met even under adverse circumstances.

With DC systems the focus has to be on processes rather than outcomes as benefits are not guaranteed. The role of the supervisor is to ensure that the pension fund is managed in a secure way, as if the members themselves were undertaking the task. The focus of the supervisor should be on the risks which impact on the members of the fund and could involve them losing money. It is the member that pension supervisors should seek to protect, since they bear the risk. The focus in looking at risks is to ensure the fund achieves optimal outcomes for the member. These optimal outcomes would include appropriate investment decisions and the security of assets.

The most important risk borne by individual members of DC funds is investment risk which therefore becomes a prime activity of pension supervisors. The recent trend to offer individual decisions about investments is important, but at the same time puts an added emphasis on providing understandable information since few individuals have the knowledge and capacity to absorb the information and make long-term rational choices. This has been offset, to some extent, by the introduction of compulsory lifestyle funds to automatically adjust the asset allocation as the participant grows older.

In many countries DC schemes are providing pension fund members with a choice of investments. This poses issues regarding the focal point of the supervisor. Focus on the default fund, when an active choice is not made, would have the greatest impact. This is because, as experience shows, the bulk of members, and thereby assets, are diverted in the default funds. Focus on the choice funds, on the other hand, is also necessary as these funds often face risks in terms of a lack of member investment knowledge and more risky investments.

According to the state of the capital markets around the world, governments may or may not impose restrictions upon where the assets of a pension fund can be invested. Generally, there will be a restriction on what percentage of the assets can be invested in the shares of the sponsor or in any one particular issuer. There may be prohibitions on certain types of assets that may be purchased, for example futures, commodities or even restrictions on which shares can be purchased for example shares may need to be listed on a particular stock exchange.

The majority of legislatures around the world do not impose any other restrictions upon where the assets of a private pension fund can be invested.

2.4 Designing and implementing investment policies

There is a distinction in the design and implementation of the investment policy according to the type of plan design. A DC scheme will differ from a DB scheme since the objectives of the two are different as mentioned in the previous section.

DB schemes

The major complicating factor relating to the investment of a DB scheme's assets is the need to match them to the liabilities. An issue is that from a fund perspective there is almost an open liability for the fund particularly where reversionary benefits are payable to those who were financially dependent upon deceased beneficiary. An increasing number of DB funds are looking to reduce their long-term exposure through the use of buy-outs, for example. This allows some of the long-term risk to be removed from the pension fund's liabilities by transferring that cost across to a third party.

The main investment objective is to ensure that over the long-term, and after allowing for all future income, there will always be enough money to meet the cost of the payments to be made. The investment of the assets of the scheme should be consistent with funding a defined level of benefits within an acceptable level of risk, while trying to minimise the cash cost to the employer over the long-term, having regard to the funding requirements prescribed by legislation and an acceptable level of risk of significant cash injections being required from the employer.

As part of achieving the scheme's objective, the governing body periodically sets a target for the total real investment return (from both capital appreciation and investment income) on the assets of the scheme. Given the ongoing commitment of the employer to the scheme, a degree of investment risk can be taken in the expectation of generating higher returns. This risk is constrained by diversifying across different classes of investment and a range of investment managers. In setting the appropriate level of investment risk the governing body considers a range of factors, including the impact and probability of a significant fall in the value of the assets, the financial strength or covenant of the employer and the financial strength of the plan. Investment risk is monitored on an ongoing basis and reviewed by the governing body regularly.

Targets set for the strategic allocation of assets between different classes of investment reflect the governing body's view on the appropriate balance to be struck between returns and risk, and on the extent to which the assets should be distributed so as to meet liabilities. Investments are made on the expectation that greater long-term returns will be achieved through a prudent exposure to real assets, including equities and property. The investments should be highly diversified by asset class, geographical area, sector and industry

DC schemes

For a DC scheme the investment declaration will be different from that of a DB scheme. Typically, the governing body sets as the overarching investment objective of the fund. The investment objective provides a clear and measurable target that seeks to preserve and grow members' capital in both nominal and real terms over the long term.

In order to achieve this objective the governing body has to have:

- established effective and efficient investment policies and processes
- a rigorous approach to risk management and risk budgeting
- a rigorous approach to the management of investment costs.

As a first step, regulators and policymakers to consider a target retirement income from DC plans. In order to identify such a target, regulators and policy makers need to consider both choice and risk variables, including the amount of contributions, retirement ages, contribution periods, labour market conditions, returns on investment and life expectancy. The governing body will typically establish a set of guiding principles to provide an objective and transparent framework for consistent decision making. These principles act as a guide to enable effective delivery of all investment functions.

Investment beliefs typically include that:

- understanding scheme member characteristics, circumstances and attitudes is essential to developing and maintaining an appropriate investment strategy;
- as long-term investors, incorporating environmental, social and governance (ESG) factors within the investment process is in the best interests of members;
- taking investment risk is usually rewarded in the long term;
- diversification is the key tool for managing risk and return;
- risk-derived asset allocation is the biggest determinant of long-term performance;
- analysis of both economic conditions and market regimes should be used to drive strategic decisions;
- passive management – where available – generally delivers better net value for money than active stock selection;

These investment beliefs are usually subject to an evidence-based review at least every three years. DC schemes will have a varying allocation between return-seeking and income-seeking assets through time. This is known as the 'glide path'. It is split into three phases: the foundation phase, the growth phase and the consolidation phase.

The foundation phase refers to the early years of a member's working life when a savings habit is being built. The objective for this phase is to preserve the value of contributions in real terms. In the foundation years, the proportion of return-seeking assets (which tend to be more volatile) is lower than in the growth phase. The magnitude and range of the risk budget in this period reflect the belief that it is important to build members' confidence and encourage a savings habit in the early years. Therefore, the asset allocation is likely to be more cautious, without ruling out the ability to capitalise on investment opportunities. Typically, the foundation period lasts around five years and this varies according to the investment opportunities available – the transition from foundation to growth is intended to be smooth rather than a step change in risk profile.

The growth phase is where the maximum growth in assets is being targeted through asset classes which are expected to grow in value relative to inflation quicker than other investments. The objective for this phase is to deliver inflation plus a certain percentage over the long term. In the growth phase, the governing body invests in a range of asset classes, with a strong bias towards return-seeking assets in order to maximise the value of the members' investments in real terms. Volatility in this phase is likely to be higher than in the other phases, although this volatility can be managed by careful diversification and dynamic asset allocation.

The consolidation phase prepares a member's asset allocation for retirement. The primary objective of the consolidation phase is to manage the risks associated with converting a member's accumulated savings into a retirement income. Investments are progressively switched out of return-seeking assets. In the consolidation phase, the asset allocation is aiming primarily to manage the pension conversion risk (for the initial years of many schemes this will be cash and in the longer term this will be the purchase of an annuity and a cash lump sum), although the Trustee will offer fund choices which allow members to target different decisions.

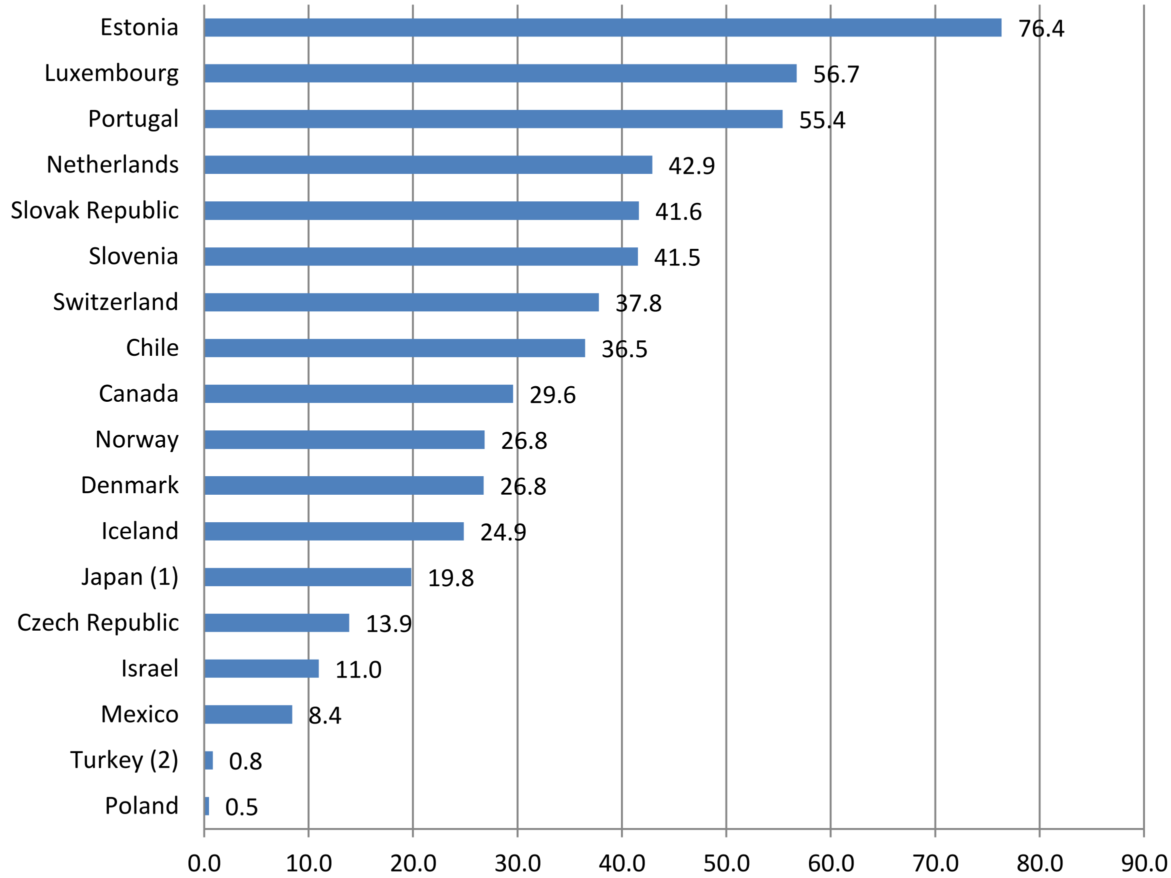
2.5 Specific challenges related to foreign investment

Many pension funds in OECD countries have a significant proportion of their assets invested overseas. During 2011, pension funds in many countries also shifted their geographical allocation to reduce exposure to countries deemed to be risky. This was the case for instance in Slovakia where pension fund exposure to debt from the European periphery fell by 3 percentage points, to 4.5%. The flight to safety also translated into a drop in foreign exposure among pension funds. This has been particularly marked in countries like Chile, Denmark, the Netherlands and the Slovak Republic, which experienced drops in assets invested abroad ranging from 8 to 10 percentage points between 2010 and 2011. [22]

Foreign investment in entities located abroad (including investment in local currencies) tends to be greater in countries that belong to the euro area. As shown in figure 8, of the OECD sample surveyed, Estonia, Luxembourg and Portugal have the most internationally diversified pension fund portfolios, with respectively 76.4%, 56.7% and 55.4% of total assets issued by entities located abroad, and the share of assets issued by entities located abroad has increased since 2001 in both Estonia and Portugal. Other countries with high investment in foreign-based entities include the Netherlands (42.9% of total investment), the Slovak Republic (41.6%), Slovenia (41.5%) and Switzerland (37.8%). On the other hand, five out of the eighteen countries for which such information was available invest relatively little in foreign assets or securities denominated in foreign currencies (less than 15% of total assets).

[22] OECD (2012)

Figure 8. Foreign investment of pension funds in selected OECD countries, 2011
As a percentage of total assets



1. Source: Bank of Japan.

2. Data refer only to personal pension plans.

Source: OECD Global Pension Statistics.

For pension funds in emerging markets the issue is more complex. There are both political arguments and pension theory arguments that need to be addressed in respect of overseas investment by pension funds in emerging countries.

The primary political argument that needs addressing is the demand for local investment. Investing internally within the country should lead to economic growth which, in turn, should lead to more jobs and consequently to more consumption. This also results in subsequent increases in government revenue. This is all the more politically attractive where there are significant deficits in the state pension funds financing the PAYG system especially where budget transfers are required. Internal investment by pension funds should ultimately lead to a reduction in the deficit in the PAYG pension scheme.

Overseas investment can create some problems in respect of the fund's corporate governance principles and in particular conflicts of interest in pension funds. Whilst corporate governance tends to focus on issues internal to pension funds, overseas investment introduces an external conflict of interest. The role of the pension fund governing body is primarily to maximize the return on the contributions of those participating in the fund. If that can be done by investing internally within the country, then that is fine. However, if the returns available by investing internally are less optimal than those available from investing internationally the conflict of interest arises.

In some countries the state of the capital markets, particularly in emerging market countries, may dictate whether or not there is a significant amount of pension fund assets invested overseas. Legislature partially solves this dilemma, in some cases, by imposing limits upon the percentage of pension fund assets that can be invested overseas. The limit may be upon the percentage of funds assets that may be invested in any particular asset class or alternatively the limit may be upon the grade of investment or the stock exchange where the shares are traded.

The 2010 OECD Survey of Investment Regulation of Pension Funds examines restrictions on overseas investment of OECD countries and non-OECD countries[23]. The survey shows that in the vast majority of countries there are no restrictions on overseas investment. South American countries tend to have more restrictions than other countries. In Chile, maximum 80% of all investments can be overseas depending upon the type of fund the participant chooses. In Colombia, the corresponding figure is 40%, 20 % in Mexico whereas in Brazil it is only 2 to 3%.

In some EU countries there is a restriction. Slovakia only allows for investment in EU countries. Finland allows 10% to be invested outside the EU but then only in OECD countries. Portugal has a 15% restriction and Hungary had 20%. In South Africa there is a 20% restriction and Korea has 30%.

One of the key principles of investing pension fund assets is to ensure that there is a diversity of the portfolio. An extension of that argument is that the risk is further spread by holding some assets in countries other than that where the pension fund operates. If the assets are held in only one country and that country's economy under-performs then pension fund participants will suffer more than if the fund's assets were spread over a number of countries.

However, when a pension fund starts to invest its assets outside of its home country the question of currency risk enters into the equation. Countries in the Euro zone can spread their investments without the currency risk. For other countries there is always the risk that when assets are repatriated that the exchange rate compared to when the assets were purchased has moved negatively and the fund therefore takes a loss. Davis (2002) argues that the improvement in the risk-return position from diversification more than compensates for the additional element of volatility arising from currency movements. He noted the arguments for a sizeable exposure to international assets apply best to a portfolio that such as in DC pension funds.

Globalization and deregulation have steadily reduced the average costs of international trading of portfolio assets, to the extent that most asset managers report that costs are no longer major obstacles to investment in foreign assets. Nevertheless, the transaction costs of international asset trades are often higher than the costs of domestic asset trades. There may be extra costs associated with registering in, or otherwise gaining access to, a foreign market. In addition, foreign currency transactions typically require payment of a commission. Such costs raise the required return threshold of a foreign portfolio investment. And for emerging markets there may be a need to appoint a sub-custodian responsible for carrying out trades in international markets. [24]

Aversion to currency risk continues to be an important reason for investing in the domestic market particularly with regard to bond investments, according to a number of market participants. While currency risk can generally be hedged, the availability of longer-term hedges may be limited. Moreover, covered

[23] www.oecd.org/dataoecd/53/43/44679793.pdf

[24] IMF (2005)

interest parity implies that the cost of a full duration-matched hedge on a foreign fixed-income investment is likely to offset the expected gain from the investment.[25]

Kariastanto (2011) analyses some Asian experiences. He quotes Dreasen and Laeven (2006) as finding that international portfolio diversification will benefit investors and that investors from developing countries would receive more benefits than those in developed countries. Segot and Lucey (2007) argue that international diversification in small markets such as those in the Middle East and North Africa could also bring benefits to international investors. In the case of pension funds in Asian countries, Pfau (2009) finds that international diversification could improve the sustainability Pakistan's pension fund by simultaneously increasing expected returns and lowering investment risks. Kumara and Pfau (2010) suggest that international diversification in Sri Lanka, which has an underdeveloped bond market and whose pension assets are bigger than its stock market capitalization, could better serve pension fund participants with risk attitudes ranging from aggressive too conservative.[26]

2.6 Implications of capital market development for pension fund investment and regulation

The general impression is that the development of the pension system with its attendant pension funds will impact the development of a country's capital markets. Borsch-Supan et al. (2005) support the argument. A beneficial side effect of pension reform is that it will lead to higher economic growth, by increased saving rates and more efficient capital markets, which could partly compensate for the transition burden of money from an unfunded system to a funded system. Besides that, higher growth would alleviate problems associated with population aging.

Aging is one of the main motives to reform pension systems. Funding of pensions might increase economic growth rates by increasing the aggregate saving rate, by the development of capital markets, by reducing labour market distortions, and by improving corporate governance[27.]

This theory is questioned by Meng and Pfau in their October 2010 work "The Role of Pension Funds in Capital Market Development". They contend that for their overall sample of countries, pension fund financial assets have positive impacts on stock market depth and liquidity as well as private bond market depth. However, in the study, the sample countries are split into two groups according to their level of financial development.[28] The impacts are only significant for countries with high financial development. Pension funds do not impact capital market development in the countries with a low level of financial development.

This research shows that countries with different levels of financial development have different financial market climates that can directly impact the role and performance of pension funds. Differences include pension fund investment regulations, market efficiency, transparency, the legal framework, market activities, and macroeconomic and financial conditions. The investment behaviour and asset allocation of pension funds in the two types of markets are different, suggesting that countries with low financial development must do more to create conditions for their pension funds to positively impact capital market

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[25] IMF (2005)

[26]Kariastanto (2011)

[27]Borsch-Supan et al. (2005)

[28] Argentina, Austria, Belgium, Chile, Colombia, Czech Republic, Denmark, Hungary, Israel, Mexico, Norway, Peru, Poland, Portugal, Sri Lanka and Thailand are considered to have low financial development. Australia, Canada, Finland, Germany, Italy, Japan, Korea, Malaysia, Netherlands, Singapore, South Africa, Spain, Sweden, Switzerland, United Kingdom and United States are considered to have high financial development.

development. The findings suggest that as a whole, the countries with low financial development are not doing enough to take advantage of their pension funds. Research suggests that pension assets in many countries are used to finance government deficits or to reward the politically connected or create inefficient investment projects without impacting the country's development or growth. Investment options in low financial development countries are often riskier, which can otherwise deter pension fund investments that could stimulate financial markets.[29]

Vittas (2004) argues that for pension funds to have a positive impact on capital market development they need to reach sufficient size, their regulations must allow for a variety of investments and not otherwise prohibit investments in equities, and optimal investments must be pursued.

Zandberg and Spierdijk (2010) claim that they cannot find a link between the funding of pensions and economic growth. This might be due to a weaker link between funding and saving than commonly is found, which could be caused by the fact that pension funds invest a significant amount of their assets abroad. Data on the fraction of assets that pension funds invest abroad would be of considerable help to find explanations for the absence of an effect of funding on growth. Implications of their results are that the costs from a transition toward a funded system cannot be born partly by higher economic growth rates during the transition. All in all, they think that there might be good reasons to switch from a PAYG to a funded pension system. However, in their study they cannot find evidence that higher economic growth rates as one of them.[30]

An interesting area to explore would be whether there would be a larger impact of pension funds on the development of the capital markets if there were significant restrictions on investing pension fund assets abroad. In this climate, some literature argues that pension funds and other institutional investors generate long-term contractual savings and stimulate the development of securities markets. They can act as a countervailing force to existing commercial and investment banks, stimulate financial innovation, exert pressure for greater market integrity and modernized trading facilities, strengthen corporate governance, and encourage more robust financial regulation. The most important precondition is a strong and lasting commitment of the authorities to maintain macro-financial stability, to foster a small core of solvent and efficient banks and insurance companies, and to create an effective regulatory and supervisory agency. Opening the domestic banking and insurance markets to foreign participation can easily fulfil the second requirement.

Pension funds are neither necessary nor sufficient for capital market development. Other forces, such as advances in technology, deregulation, privatization, foreign direct investment, and especially regional and global integration, may be equally important. If pension funds are subject to conducive regulation, adopt optimizing policies, operate in a pluralistic structure, and if they reach critical mass, pension funds can have a large impact on both capital market development and economic growth. Pension funds are critical players in “symbiotic” finance, the simultaneous and mutually reinforcing presence of many important elements of modern financial systems. They can support the development of factoring, leasing and venture capital companies, all of which specialize in the financing of new and expanding small firms. Financial innovation, technology and globalization allow developing countries to adopt new instruments faster, although institution building is a long-term process.[31]

It is argued that Chile’s capital market has benefitted enormously from pension reform. One of the reasons for success in Chile is that since its inception in the 1990s, it has been championed by a high level

[29] Meng C. and Pfau W (2010)

[30] Zanberg E and Spierdjik L (2010)

[31] Vittas (2004)

committee from the Ministry of Finance established to promote a sound development the capital market by inter alia identifying market needs and facilitating the development of instruments pension funds to invest, e.g. domestic infrastructure (highways, ports, etc). They have also taken action against abuses by market players through corporate governance laws and strengthening supervisory capacity. In countries where the impact has not been as great as in Chile the problem can be the lack of political interest once the legislation has been passed.[32]

In the case of Chile, opinion is almost unanimous that pension reform had a positive impact on capital markets. Most studies conclude that the growth of pension funds helped to increase the size of the markets; encouraged the authorities to improve regulations; promoted market transparency; and fostered better corporate governance practices. As pension funds began to be invested in financial assets, the level of trading in local capital markets expanded and new funding possibilities emerged. In particular, the accumulation of pension funds encouraged demand for long-term financial instruments, thereby creating the conditions for the development of that specific market. In fact, this seems to be an important part of the explanation for the growth of long-term bond markets in the last couple of decades. In turn, the growing size of the capital market generated incentives for financial innovation, because it facilitated the development of new institutions such as custodians, centralized clearing mechanisms, and electronic trading systems that, given the high levels of investment required, are unlikely to emerge in smaller markets.

Pension fund demand for financial instruments has also been a force driving regulators to introduce changes in the laws and regulations specific to the capital market. These changes include the modification of the tax system as it applies to the issuance and acquisition of financial instruments; improvements in trading mechanisms (“stock exchanges”); the development of a legal framework for the risk rating industry and for custodial institutions; and changes in other regulations that provide protection for investors.

The growing participation of pension funds in local capital markets has been accompanied by a gradual but steady increase in the quality and timeliness of the information available to investors. This can be explained by the demand that arises from the pension funds themselves for better financial information and, also, by the interest of the various issuers in meeting the requirements imposed by the pension funds as a condition for investing in the securities they plan to issue. The participation of pension funds as shareholders or bondholders has also helped to improve the corporate governance standards of the companies in which they invest.[33]

This is a combined result of the direct demands made by the pension funds on the managers and controllers of such companies and of a decision on the part of the issuers themselves to create conditions that would encourage pension fund managers to invest in their companies. At the same time, the development of pension funds seems to have been an important force behind the creation and improvement of regulations aimed at minimizing the risk of conflicts of interest and strengthening the rights of minority shareholders and the holders of debt instruments issued by the companies.

Finally, the accumulation of pension funds in Chile had another two potentially positive effects (though these are still unproven): a decrease in the cost of capital, and improvements in the quality of investment decisions. One reason capital costs could fall is that the greater size of the market makes it possible to reduce the average issuance costs of financial instruments. In addition, as noted above, the pension funds (and the life insurance companies that sell life annuities) are long-term investors that may demand lower liquidity rewards for their investments. Moreover, as compared with other investors, pension fund administrators may be prepared to tolerate greater short-term volatility in the returns on their

[32] Worldbank (2011), http://www.apapr.ro/images/stories/materiale/COMUNICATE/2011/BERD/wb%20rudolph.pdf

[33] Iglesias, 2000; and Lefort, 2007

investments. On the other hand, improvements in the quality of investment decisions can also be expected, since as professional and specialized investors, pension fund managers have developed capacities in collecting and analyzing market information.[34]

Another country where pensions are regarded positively in respect of capital market development is Australia. In Australia, higher national saving in recent years reflects the maturing of the compulsory superannuation (pension) system introduced in the mid-1980s and a rise in household saving, particularly following the global financial crisis. The Government's increase in the superannuation guarantee (from 9 to 12%) and structural changes in household saving behaviour mean that high levels of saving will likely be maintained over coming years.

In the Australian experience, the superannuation is an increasing source of financing to the rest of the economy, which has helped to reduce financing risks. By contributing to higher national saving, the superannuation also increases national income either through higher investment or by earning more investment income for Australians.

Since 2008 there has been a substantial shift in superannuation funds' asset acquisition away from foreign equities and debt securities towards domestic equities. Around 50 per cent of net equity financing for both banks and non-financial corporations over this period has come from superannuation funds. Holdings of domestic deposits by superannuation funds have also increased since the early-2000s. This has helped Australian banks and non-financial firms shift toward safer forms of financing in an environment where debt financing is less readily available and is seen as more risky than prior to the financial crisis. This was particularly important when global debt markets were impaired during the crisis years.[35]

However, the process of transforming the capital markets can take time. Poland implemented its pension reform in 1999 and today has assets of 224 bn. Zloty or $US 66bn. Despite the reform beginning in 1999, the percentage of the funds invested in government bonds is very high. The maximum percentage which can be invested in domestic equities is 45% so only 2/3 of the maximum percentage available to be invested in shares can be invested in shares. The transition away from shares seems to be also confirmed by the Warsaw Stock Exchange data which show that pension funds accounted for 21% of the equity turnover by institutional investors in the first half of 2011, while the respective figure for the second half was only 19%.[36]

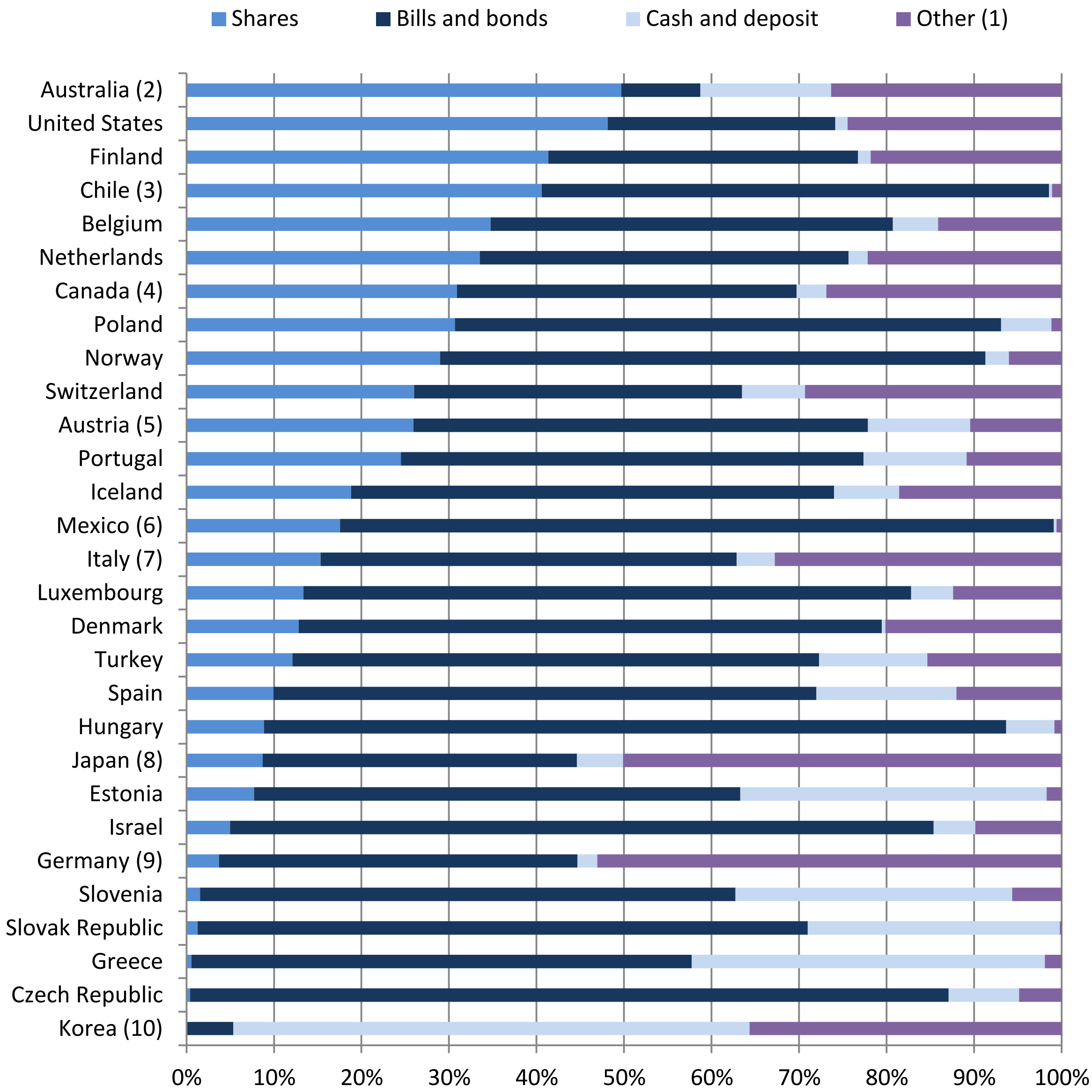
[34]Iglesias-Palau, A. (2009)

[35]Australian Government (2012)

[36] Source: Polish Ministry of Social Policy, 2011

Figure 9. Pension fund asset allocation for selected investment categories in selected OECD countries, 2011

As a percent of total investment



Note: The GPS database provides information about investments in Collective Investment Schemes and the look-through Collective Investment Schemes in cash and deposits, bills and bonds, shares and other. When the look-through was not provided by the countries, estimates were made assuming that mutual funds' investment allocation in cash and deposits, bills and bonds, shares and other was the same as pension funds' direct investments in these categories. Therefore, asset allocation data in this figure include both direct investment in shares, bills and bonds and indirect investment through Collective Investment Schemes.

1. The "Other" category includes loans, land and buildings, unallocated insurance contracts, hedge funds, private equity funds, structured products, other mutual funds (i.e. not invested in cash, bills and bonds, shares or land and buildings) and other investments.

2. Source: Australian Bureau of Statistics. The high value for the "Other" category is driven mainly by net equity of pension life office reserves (15% of total investment).

3. Other investments include market or fair value of derivatives held.

4. The high value for the "Other" category is driven mainly by other mutual funds (14% of total investment).
5. Other investments include derivatives at market value and outstanding accounts against plan sponsors.

6. Other investments include foreign issued by entities located abroad.

7. The high value for the "Other" category is driven mainly by unallocated insurance contracts (22% of total investment).

8. Source: Bank of Japan. The high value for the "Other" category is driven mainly by accounts payable and receivable (25% of total investment) and outward investments in securities (20% of total investment).

9. The high value for the "Other" category is driven mainly by other mutual funds (18% of total investment).

10. The high value for the "Other" category is driven mainly by unallocated insurance contracts (31% of total investment).

Source: OECD Global Pension Statistics.

2.7 Pension fund investment in alternative investments and derivatives

In December 2011 the OECD and IOPS together revised the "Good Practices on Pension Funds' Use of Alternative Investments and Derivatives". These were developed in view of the increasing use of alternative investments and derivatives by pension funds and the opportunities and risk they present to the security and safety of retirement benefits. The good practices are addressed to both pension funds and the public authorities responsible for their regulation and supervision. The financial and economic crisis of 2008/2009 heightened the concern of pension regulatory and supervisory authorities regarding pension funds' use of alternative investments and derivatives. Though suffering less of a direct impact from the financial crisis in general and from such instruments in particular than other financial sectors, pension fund regulators and supervisors raised concerns that the pension funds which they oversee did not understand the products they were investing in, or have the necessary risk management systems to cope with them.[37]

They encourage the establishment of robust and efficient risk-management policies and techniques to measure risks associated with this activity, the implementation of appropriate internal governance processes and risk control procedures, the conduct of due diligence investigation when assigning such investments to external asset managers and the promotion of open communication with shareholders on the results and costs of the use of alternative investments and derivatives. They also provide guidance with respect to specific legal/regulatory measures and supervisory policies to efficiently limit and monitor the risks of these instruments.

There is no clear-cut definition of what constitutes an alternative investment. The concept is of a dynamic and ever-evolving nature, and closely linked to the development of financial markets. In practice, alternative investments are characterised by properties that distinguish them from traditional investments (stocks, bonds, cash or property), such as: the application of innovative financial products and derivatives; the use of extensive leverage; illiquidity of underlying investments; a greater reliance on the skill of the manager and the absence of a meaningful performance benchmark.

A non-exhaustive list of commonly agreed types of alternative investments would typically include: derivatives, hedge funds; private equity; structured products and securitised real estate investments. The different characteristics of alternative investments have implications for their risk profile. Key issues that are typically more relevant for alternative investments and that may need to be addressed in a pension fund's risk management are: liquidity risk; integrity risk; operational risk; limited transparency; valuation weaknesses; control issues and conflicts of interest.

Derivatives

Derivatives are financial contracts whose price is determined by the value of an underlying asset, commodity, rate, index or event. The basic types of derivative contracts are forwards, futures, options, swaps, and swaptions (an option on a swap). They can be classified along three main criteria. Some derivatives, like standardised futures and options, can be traded on an exchange like any other financial asset, while others, for example like swaps, are traded on the over-the-counter market.

[37] OECD (2010)

A second classification concerns their degree of complexity. Basic types are known as plain vanilla products. The more complicated derivative structures, which are always traded on the over-the-counter market, are known as exotic derivatives. These tend to be option-based contracts. Classification can also be according to the type of underlying asset (e.g., equity derivatives, foreign exchange derivatives, interest rate derivatives, commodity derivatives or credit derivatives).

One of the concerns about pension funds use of derivatives concerns the complexity of the product. Pension funds have been using derivatives, initially in the form of call and put options, since the mid-1970s, without significant problems. But since the development of the futures markets, derivatives have become ever more complex.

The use of derivatives is tempting. Call options provide a way for pension funds to earn extra income when the stock market is moving sideways. Put options provide a way to buy insurance against a sudden drop in a stock's price. Stock index futures provide a way for pension fund managers to move significant amounts of assets into the market or out of the market quickly without causing significant changes in stock market prices.

They can be used for various purposes by long-term investors such as pension funds as a substitute for direct investment in the underlying asset (because of liquidity, market timing, tax or other reasons), risk control or hedging, duration control and general portfolio/exposure management (such as the duration of their fixed income portfolio).

However, they can also be used for other purposes, including speculation[38] and leveraging of portfolios, which can come into conflict with the basic objectives of a pension fund. While derivatives and, more generally, leveraging can have return-enhancing properties on investment portfolios, their use for this purpose can also expose pension funds to major losses in adverse scenarios as the multiplier effect of leveraging on returns reverses.

Two additional major risks with the use of derivatives are market transparency and counterparty risk. This is particularly evident in the case of over the counter derivatives, where there is no central exchange to collate and disseminate pricing information and to act as an intermediary to ensure adequate posting of capital and collateral. For these reasons, regulations in most jurisdictions restrict pension funds' use of derivatives (e.g. allowing them to be used for hedging purposes but not for speculation).

Leveraging

Leveraging is the use of various financial instruments or borrowed capital, such as margins, to increase the potential return of an investment. The most common form of leveraging is a mortgage where we use borrowed capital to buy our house. Gearing has the same meaning in the UK.[39]

Some pension fund managers are considering using leverage to increase pension fund assets. One strategy would shift funds out of the usual stock allocation of just over 50% and into a new allocation of supposedly safe fixed income assets. Managers would then lever up this allocation, borrowing say $3 for every dollar of the fund's money to buy more assets and thereby turbo-charge returns.

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[38] Speculation is taken to mean transactions involving unusual and considerable levels of risk which intend to take advantage of short-term market moves for commensurate levels of gain (as opposed to investments which are normally longer-term transactions based on fundamental analysis).

[39] Source: www.investopedia.com

Yet recent events in Europe suggest borrowing to buy even highly rated sovereign bonds is riskier than it looks, and with leverage, any losses make a bigger hole in the underlying fund. Moreover, if pension funds go this way, they will be more vulnerable to rising interest rates, which would bring bond values down and funding costs up.

The use of leveraging is in many countries part of the process of private equity or hedge funds. There needs to be some limit to the extent that a fund can be leveraged.[40]

Hedge Funds

A hedge fund is not a readily defined asset class. However, it is generally accepted that all hedge funds aim to make positive returns in all market environments, usually expressed as a target (for example inflation plus a percentage or a cash sum plus a percentage). They are designed to achieve returns which are not necessarily correlated with the returns on equities and are able to use techniques such as shorting, the practice, by fund managers, of selling assets which are not owned but borrowed. This is done on the expectation that the value of those assets will decrease and that they can be bought back later at a lower price and returned to the original owner. The fund manager's profit is the difference between the selling price and the subsequent reduced purchase price. Shorting is not generally available to traditional funds.

Hedge funds depend heavily on the skill of individual managers to exploit small anomalies across the market including equities and bonds (and their derivatives), commodities and much more exotic investment opportunities. It can be very difficult for trustees to assess the skill of individual managers and their ability to carry out these tasks. The costs of investing in hedge funds are high, They can, for example, amount to a 2% annual management charge and a charge of 20% of the increase in the value of assets under management is common (up to 40% is not unusual).

The Governing Body should note that in the event of a downturn and a reduction in the value of the assets, there will be no clawback of management charges. The minimum investment in hedge funds in the UK is typically £1m. Most pension schemes that invest in hedge funds limit their investment to a small proportion of their equity portfolio, but a very small number have invested much more heavily than this.

Hedge funds can be used to diversify the existing assets that the pension scheme holds. In a rising equity market hedge funds may underperform equities, but they are expected to protect investors when equities fall in value. Where hedge funds are used to diversify a bond portfolio, the targeted returns are likely to be lower than they would be if they were used to diversify an equity portfolio (e.g. cash + 4%). This may mean that the manager is less likely to take undue risks.

Hedge funds are perceived as being high risk. The degree of risk in a particular hedge fund will depend in part on the extent of leverage employed. However some funds may be less volatile and less risky than equities. But there is a high tail risk which means that there is a small chance of a very large loss for those who invest directly in a hedge fund. Hence, pension funds would typically invest in hedge funds via a fund of funds approach, where the impact of one failure is likely to be small.

In the event of severe market shock some hedge funds have proved to be as vulnerable as any other asset. In these cases diversification of the portfolio has not been achieved.

Private equity

Private equity can be divided into two main classes – venture capital and non-venture capital.

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[40] Source: www.breakingviews.com

The types of venture capital investment include:

- Start-up: provides finance for companies to develop products and their initial marketing. The product is not yet sold commercially.

- Other early stage: Financing companies that have completed product development stage and require further funds to start commercial sales prior to generating profits.

- Expansion: Provided to grow and expand an established company or to rescue/turn around a company

- Refinancing bank debt: Replace existing liabilities with a mixture of debt and equity providing a more flexible financing package.

- Secondary purchase: Purchase existing shares in a company from another venture capital firm or from other shareholders.

Types of non-venture capital investment include:

- Management buy-out (MBO): Funds let current operating management acquire an existing product line or business. Institutional buy-outs (IBOs), Public to Privates and similar financings are also included

- Management buy-in (MBI): Funds provided to enable an external manager or group of managers to buy into an established company

- Public to Private: Purchase of equity of publicly listed companies, which are then delisted to become private companies again. Private equity capital is provided to finance development of the private company, with a view to subsequent listing or trade sale.

There are three ways in which pension funds might typically invest in private equity – through a limited partnership, through a fund-of-funds or through an investment trust.

Limited partnership

A limited partnership is the most common way that pension funds invest in private equity. The limited partnership retains ownership and management in the company and is managed by an independent management company, the general partner (GP). Broadly speaking the GP is a 'fund manager'. It retains liability for the actions of the partnership. In turn, investors within these funds are known as limited partners (LPs). A limited partnership has a limited life- span of perhaps 10 or 12 years. Investors might be expected to commit capital to the fund over period of 3 to 5 years, with revenues from sales distributed throughout the life of the fund.

Such funds will usually start to return cash to investors after three to five years. If one of the companies in which the fund is invested is floated, investors are sometimes offered the shares in the company. However, typically the shares are held within the fund until finally sold by the private equity manager.

The advantages of the Limited Partnership approach depend upon its tax treatment. In many countries income and capital gains flow through the partnership untaxed. Capital gains are shared between the limited partner investors and the general partner private equity manager giving the latter strong incentives to invest for absolute capital growth over a defined period, to the benefit of the former. However, limited partnerships may be regarded as illiquid as participation is not publicly tradable.

Fund of funds

A fund of funds is a structure for sharing investment across several private equity funds. The fund of funds is managed by a team of professionals, offering investors a diversified portfolio of companies. These professionals manage the relationships with the various underlying funds, organize the review of valuations, provide information and back office services for the funds.

A key advantage of investing via a fund-of-funds is that it is a diversified way to gain exposure to private equity. On the other hand the extra level of management also results in extra fees, which eat into returns. The general view is that investing via a fund-of-funds represents a longer-term commitment.

Investment trust

The key advantages of investing via an investment trust are that the fees are relatively low, and the investment is more liquid than other forms of exposure to private equity. However it may also be the case that returns are more closely correlated with the public market. Although trusts are an investment vehicle, they are structured as public companies, whose shares are traded on the stock market and are thus available for members of the public to purchase. In addition, shares in a particular trust might trade at discount to the value of the assets held within it.

Direct investments

Trustees might also consider direct investments. However, it should be noted that this is a far more complex, and committed, way to invest in unquoted companies. It is probably only suitable for the largest pension funds which have sufficient in-house expertise to undertake the commitment and exercise effective oversight.

Pension schemes which invest in private equity may confine their investment to a small proportion of their equity portfolio. There is also likely to be a high minimum level of investment in comparison with equities (about £5 million in the UK). **T**he typical costs of private equity funds are a 2% management fee and a charge of 20% of the increase in the value of the assets under management. These relatively high costs, along with the minimum investment required, may constitute a disincentive for small schemes. Trustees should note that in the event of a downturn and a reduction in the value of the assets, there will be no claw back of management charges.

Private equity investment funds provide no regular income, and are not liquid. Capital gains (or losses) are only realised after a considerable period of time when the underlying companies are sold or floated on the stock exchange. Commentators reflect that in the recent past, when large sums of money have been allocated to private equity investment, it has had the effect of increasing the asking price for companies and potentially reducing returns. Private equity activity depends upon access to funds in the marketplace and any fear of a reduction in access to funds puts private equity investment at risk. A further problem has become apparent in the wake of a sharp fall in equity values. The value of companies owned by private equity firms has also been downgraded which has had the effect of increasing the correlation between the returns on shares in public companies and holdings in private equity.

Commodities

Unlike many other alternative asset classes, commodities have a low minimum investment amount, in the UK typically £1 million.

Commodities are physical resources such as gas, oil, gold, livestock and produce. However, pension schemes do not buy actual commodities. Investment in commodities is via derivatives, (for example coffee futures) and pension schemes are likely to invest in commodities via pooled funds.

Commodity returns, historically, have been volatile. They have also tended to be negatively correlated with returns on equity markets, although some would argue this might not always be the case. Commodity funds are usually passively managed and track an index. Commodity managers generally deal with a basket of commodities, rather than individual ones. Typically, charges are around 0.75% of the funds under their management, a much lower management fee than the trustees would have to pay for other alternative asset classes.

Infrastructure ventures

The OECD general definition of infrastructure is the system of public works in a country, state or region, including roads, utility lines and public buildings. Infrastructure is typically used for performing long term capital activities which provide essential services to the public.

The symmetry between a country's infrastructure investment task and national retirement savings are obvious. Investments in a country's national retirement savings plan need the type of long-run, stable and strong returns which infrastructure assets usually provide. Yet to date, finding the structure to reconcile this match has eluded most country's policymakers.

Delivering on this structure would deliver significant benefits to a country. Infrastructure investment has a well-established link to productivity gains. It has been conservatively estimated that each dollar of infrastructure investment boosts economic activity by between $1.00 and $1.60. The estimated GDP multipliers from infrastructure investment measures range as high as $1.80.[41] Failure to make significant progress towards bridging the infrastructure gap could prove costly in terms of slower economic growth and loss of international competitiveness. Economic infrastructure drives competitiveness and supports economic growth by increasing private and public sector productivity, reducing business costs, diversifying means of production and creating jobs.

During the 1990s and 2000s, the relatively high volatility of traditional investment classes (equities, cash, bonds and real estate) coupled with a desire to better match liability exposures to asset holdings, drove the initial focus of pension funds on alternative asset classes, including infrastructure. The driving principle of this shift in investment focus was to provide protection against market and interest rate volatility and inflation. This has been achieved through the identification of new sources of return and a better diversification of investment.

Infrastructure investments are expected to produce predictable and stable cash flows over the long term. Infrastructure assets normally operate in an environment of limited competition as a result of natural monopolies, government regulation or concessions. Investments are usually capital intensive and include a tangible asset that must be operated and maintained over the long term.

Pension Fund investment in infrastructure seems to be a reasonable proposition given the potentially good match of interests. Pension funds are increasingly looking at infrastructure investment (however investment is still limited). Infrastructure investments are attractive to institutional investors such as pension funds as they can assist with liability driven investments and provide duration hedging. Infrastructure projects are long term investments that could match the long duration of pension liabilities.

[41] IMF (2010)

In addition infrastructure assets linked to inflation could hedge pension funds' liability sensitivity to inflation.[42]

Pension funds are increasingly looking at infrastructure to diversify their portfolios, due to the low correlation of infrastructure with traditional asset classes. Since listed infrastructure tends to move in line with broader market trends, it is a common held view that investing in unlisted infrastructure although illiquid can be beneficial to ensure proper diversification. In principle, the long-term investment horizon of pension funds and other institutional investors should make them natural investors in less liquid, long-term assets such as infrastructure.

Despite these reasons for increased interest, so far institutional investment in infrastructure has been quite limited overall. It has been estimated that less than 1% of pension funds worldwide are invested in infrastructure projects, excluding indirect investment in infrastructure via the equity of listed utility companies and infrastructure companies.[43]

International pension funds have subsequently developed considerable investment allocations to infrastructure assets. Five large Canadian Pension Funds have a target that at least 10% of their assets will be invested in infrastructure. Of them the Ontario Municipal Employees Retirement System has the highest target of 15%. At the end of December 2011 it had approximately C$9 billion invested in approximately 20+ investments that have a total enterprise value of approximately C$50 billion out of a total fund value of C$55.1 billion in net investment assets. However, there is debate about the role of infrastructure investment by pension funds. This concerns DC alternatives that can be blamed for being less interested in infrastructure investments because they tend to have a more short term approach. Conversely, in Australia the biggest investors in infrastructure are the defined contribution, multi-employer funds jointly established by employer associations and trade unions. The average asset allocation of Australian funds in infrastructure was nearly 10% in 2009.[44] The UK Government is encouraging pension funds to invest in infrastructure through its national infrastructure plan. This initiative has been supported by the self-regulatory organisation for occupational pension funds – the NAPF.

Infrastructure investments cover a wide spectrum of projects – from economic infrastructure such as transport, to social projects such as hospitals – and involve different forms of financing. Data explaining the size, risk, return and correlations of this diverse asset class is therefore limited, which may be making pension fund investors cautious. Given investing in such assets also involves new types of investment vehicles and risk for pension funds to manage – such as exposure to leverage, legal and ownership issues, environmental risks as well as regulatory and political challenges – caution may well be justified.

However, if governments wish to help infrastructure developers tap into potentially important sources of financing such as pension funds, certain steps could be taken:

- Enhance the investment environment
- Decide on the utility and nature of potential private sector involvement

[42] Since the benefits of active employees are typically linked to their wages and retiree benefits are increased in line with some portion of price inflation by many plan sponsors.

[43] OECD (2011)

[44] Source: Infrastructure Partnerships Australia

- Provide a sound institutional and regulatory environment for infrastructure investment, including facilitating access to capital markets through the phasing out of unnecessary obstacles to capital movements and restrictions on access to local markets

- Ensure public and institutional support for the project and choice of financing

- Make the co-operation between the public and private sectors work by promoting transparency and appropriate contractual arrangements

- Promote private partners‘ responsible business conduct‘

- Remove regulatory barriers

- Promote the prudent person standard of investment

- Remove unnecessary or overly restrictive quantitative investment limits (asset category ceilings, prohibitions on investing in unlisted, overseas assets etc.)

- Support stronger efforts in independent data collection and objective information provision in the field of infrastructure investment

- Recommend upgrade of national and supra-national statistical data collection with a view to better capture infrastructure (and other alternative asset classes)

- Promote higher transparency standards in private equity vehicles and direct investments

- Recommend the establishment of international guidelines for performance and risk measurement of infrastructure (and other alternative) investments

- Encourage the study of more advanced risk analysis beyond the traditional measures, including the specific risks of infrastructure

- Advice against a supervisory approach that creates false certainties in risk management

- Encourage improvements in knowledge and understanding of pension fund stakeholders and supervisors on infrastructure assets.

There are risks involved in infrastructure as an asset class. Because infrastructure investments are usually highly leveraged (up to 80% of infrastructure funds are borrowed), there is a small risk of a large loss. Infrastructure also carries the risk of regulatory intervention, in respect of the industries in question, for example rail regulation.

Regulation and supervision

There are 6 basic principles with regards to regulation and supervision of the investment strategy. Four of these principles are addressed to pension funds and their governing bodies – the other two primarily address the needs of supervisory authorities.

The four principles addressed at pension funds cover:

1. Investment policy & risk management strategy

2. Internal governance

3. Due diligence of external asset managers

4. Communication

Those addressed at supervisory authorities cover:

1. Regulation of pension funds' alternative investments and use of derivatives

2. Supervision of pension funds alternative investments and derivatives

In respect of investment policy and risk management strategy the guidelines say that the investment policy statement and risk management strategy need to explain whether, why, to what extent and how alternative investments and derivatives will be used. If used, the governing body must conduct adequate and proportional risk-management analyses. All significant risks relating to alternative investments and derivatives need to be measured and integrated into the risk management system with checks at regular intervals that diversification across the overall investment strategy is adequate and that undesirable concentration of risk in the portfolio as a result of alternative investments and the use of derivatives are avoided. The governing body should control its global position in underlying assets plus derivatives, monitor global results, and adjust their risk exposure in accordance with their investment policy and risk management strategy.

The governing body may use risk limits to control exposures to the various risks associated with derivative activities. These limits should be compatible with the investment purpose of the derivative, the nature of the pension fund's strategies, its risk measurement system, and its risk tolerance.

On internal governance, the governing board needs to ensure that it has sufficient understanding of the strategy and risk of its investment policy and adequate resources in place (both human and systems technology) before it decides to use alternative investments and derivatives. The governing body should have a clear selection process and written operational policies and procedures for implementing and exiting from the alternative investment and derivatives policy. This should cover the direct management of alternative investments or the selection of third-parties to do so on behalf of the pension fund. The fund's independent risk control and audit functions need to ensure compliance with the pension fund's policies on alternatives investments and derivatives usage and to report regularly to the pension fund's governing board. All individuals conducting, monitoring, controlling and auditing alternative investments and the use of derivatives should be suitably qualified and have appropriate levels of knowledge and experience in the specific matter.

When investing in collective alternative investment vehicles, the understanding of the pension fund's governing board needs to be supported by analysis at regular intervals of the risk profiles of the investment strategies and the capacities of the managers of the funds in which the pension fund has invested or intends to invest. Analysis should be based on timely and sufficient information about the funds and their managers so that an independent assessment can be made.

Due diligence needs to be applied before investing in alternative investments. The focus should be on the people, the processes and the performance of either the external manager to whom the pension fund gives a mandate, or the collective alternative investment fund in which the pension fund is planning to invest, with particular attention being paid to the valuation of assets and associated costs. The mandates given to external managers for alternative investments need to be based on adequate contract terms. Compliance with contract terms needs to be monitored regularly and systematically.

Pension funds need to be transparent in their communication with stakeholders about their policies regarding the use of alternative investments and derivatives and the objectives which they seek to achieve in this respect. They should report at least annually to members on their exposure to derivative positions and the actual and potential profits or losses related to these. They should disclose to members the fees and charges paid in relation to their alternative investments and whether they are being managed internally or externally.

From the regulator's perspective the legislation may include maximum levels of investment in alternative investments – either internally or externally managed - to the extent that they are consistent with and promote the prudential principles of security, profitability, and liquidity pursuant to which assets should be invested.

The legal provisions may include maximum potential loss limits or other risk limits on derivative activities and on the global position (underlying assets plus derivatives) as well as limits to a pension fund's exposure to counterparty risk through appropriate measures. There may also be a requirement for the use of an external, independent verification of valuation for non-listed, illiquid investments. The use of derivatives that involve the possibility of unlimited commitments and, more generally, the use of derivatives for speculative purposes should be prohibited.

The relevant authorities, not necessarily the supervisory authority, should collect specific data on pension funds' use of alternative investments and derivatives. The pension supervisory authority should provide guidance to pension funds on how they expect the risks relating to alternative investments and derivatives to be managed and the uses to which derivatives can be put. Supervisory oversight of pension funds' use of alternative investments and derivatives should be risk-based. Pension regulatory and supervisory authorities should ensure that they maintain a good understanding of alternative investments and derivatives[45]

Given the recent case of J.P. Morgan and its $2 billion loss despite reputedly having the best risk-management team, pension fund governing bodies should be wary of the hedging efforts of their asset managers. They should examine the whole range of derivatives used by their fund managers. The obvious places to look are hedge funds, enhanced managers and overlay managers. It is estimated that managers in these strategies oversee more than $500 billion.

The governing body of funds using derivatives should question its managers more closely about their use of derivatives. It should call in expert help to understand the strategies of the managers and the risks the strategies bring with them to the fund. It should also subject the risk-control strategies used by their managers to greater scrutiny and scepticism. It is apparent that risk-control models and strategies often are flawed and should not be relied upon too heavily.

Derivatives are a useful tool for pension funds. Used properly, they can enhance investment returns or reduce risk. Used without sufficient caution, or sufficient knowledge, they can create huge losses.[46]

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[45] Source: OECD and IOPS

[46] Source: Pensions and Investments, http://www.pionline.com/article/20120528/PRINTSUB/305289999

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3. THE FUNDAMENTALS OF PENSION FUND GOVERNANCE

3.1 Introduction

This chapter discusses the corporate governance which focuses upon the inner workings of a pension fund. These are internal principles as opposed to the external obligations imposed upon a pension for example by legislation or regulation. The corporate governance principles cover the ways in which a pension fund operates and the ways by which it interacts with the scheme's stakeholders including, contributors, beneficiaries, service providers, the supervisory authority and the wider community.

Corporate governance is an area, which has only just recently become an important focus of research by pension organisations. As pension funds grow as financial institutions and interact with a wider community, the importance of good corporate governance becomes more critical. Policymakers in many OECD countries have recently stepped up efforts to address perceived weaknesses in the governance of pension funds. In some cases, regulators have even enshrined governance best practices similar to the OECD guidelines in the country‘s pensions legislation. Industry associations have also taken the initiative in some countries and are driving a reform in governance practices, encouraging funds to improve their self-regulation through better governance practices.

According to the OECD Guidelines on Pension Funds, the governance of private pension plans and funds involves the managerial control of the organizations and how they are regulated, including the accountability of management and how they are supervised. The basic goal of pension fund governance regulation is to minimize the potential agency problems, or conflicts of interest, that can arise between the fund members and those responsible for the fund‘s management, and which can adversely affect the security of pension savings and promises and advocates transparency. Good Governance goes beyond this basic goal and aims at delivering high pension fund performance while keeping costs low for all stakeholders.

Good governance can have many positive side effects such as creating trust amongst all stakeholders, reducing the need for prescriptive regulation, and facilitating supervision. Good pension fund governance can also be conducive to more effective corporate governance of the companies that they invest in, as well-managed pension funds are more likely to seek value for their investments via a more active shareholder policy. Good governance also needs to be 'risk-based‘. For example, the more sophisticated the investment strategy the pension fund adopts, the stricter the governance oversight required; or the more complex the administrative arrangements of the plan, the tighter operational oversight needs to be.[47]

3.2 Organisation principles and main goals of pension fund governance in OECD countries

The OECD revised principles of pension fund corporate governance in cover governance structure and governance mechanisms. These two prime areas of activity are further broken down into 11 main points.[48]

Identification of responsibilities

There should be clear identification and separation of a pension fund's operational and oversight responsibilities. Where a pension entity is established to own the pension fund on behalf of participants its

[47] Stewart and Yermo (2008)

[48] OECD (2009)

legal form, internal governance structure and main objectives should be clearly stated in its statutes, by-laws, contract or trust instrument, or in documents associated with any of these. For funds created as a separate account managed by a financial institution, the pension plan or contract between plan participants and the financial institution should clearly state the financial institution's responsibilities for managing the pension fund. The OECD recommends good pension fund governance as being 'risk-based'. Therefore the division of responsibilities should reflect the nature and extent of the risks posed by the fund.

Governing body

A pension fund should have a governing body with the power and responsibility to administer the pension fund. It must ensure the adherence to the fund's governing document and protect the best interests of plan participants. The responsibilities of the governing body should be consistent with fund's principle objective of being a secure source of retirement income. The governing body can delegate activities to third party providers but it retains ultimate responsibility for the fund, even when delegating certain functions to external service providers. The governing body should retain the responsibility for monitoring and overseeing external service providers even where the governing body is a commercial institution.

Accountability

The governing body should be accountable to pension plan participants and the competent authorities (supervisory authority, tax authority, Ministry as appropriate). Accountability to plan members and beneficiaries can be promoted by giving participants, or their representatives, the right to appoint members of the governing body. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as benefit provider (especially in DB schemes). The governing body should be legally liable for any actions, which are inconsistent with the obligations imposed on it, including prudence. In DC plans, accountability should include rules to reduce or eliminate the governing body's liability provided they demonstrated good faith, usually done by taking appropriate professional advice.

Suitability

The fund documents (or over-riding legislation) should prescribe minimum standards on who can and can't be appointed to the governing body. This ensures a high level of integrity, competence, experience and professionalism in the governing the pension fund. The governing body should collectively have the necessary skills and knowledge to oversee all the fund's functions and to monitor those performs to whom tasks have been delegated. It should also seek to enhance its knowledge, where relevant, via appropriate training.

Delegation and expert advice

The governing body may rely on the support of sub-committees and may delegate functions to pension fund staff or external service providers. Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities. The governing body can be required to seek expert advice or appoint professionals to carry out certain functions. It should assess the advice received, including its quality and independence, and should verify that all its professional staff and external service providers have adequate qualifications and experience.

Auditor

An auditor, completely independent of the pension entity, governing body, and plan sponsor, should be appointed to carry out a periodic audit consistent with legislation/fund rules. The auditor should report promptly to the governing body and - if it does not take appropriate remedial action - to the supervisory authorities and other appropriate persons wherever it becomes aware of facts that put the Fund in breach of the Fund Rules or legislation or facts which may have a significant negative effect on the pension fund.

Actuary

The Governing Body of all DB plans financed via pension funds should appoint an actuary to review fund's financial standing. If an actuary, whilst undertaking this review realises, that the fund does not or is unlikely to comply with the appropriate statutory requirements he or she shall immediately inform the governing body (and the supervisory authority if required by legislation) of the issue(s). If the governing body does not take any appropriate remedial action, the supervisory authority and other appropriate persons should be informed without delay.

Custodian

Subject to the prevailing legislation, custody of pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund or by an independent custodian. Where an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.

Risk-based internal controls

There should be adequate internal controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, trust instrument or documents associated with any of these. They must comply with the legislation and instructions from the supervisory authority.

Controls should cover all basic organisational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, risk management procedures and compliance. There should be a code of conduct and a conflicts of interest policy for Governing Body members, staff of the pension entity and service providers with operational responsibilities. There should also be appropriate controls to promote the independence and impartiality of the decisions taken by the governing body, to ensure the confidentiality of sensitive information pertaining to the fund and to prevent the improper use of privileged or confidential information.

Reporting

Reporting channels between all the persons and entities involved in the governance of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.

Disclosure

The governing body should disclose relevant information to all parties (participants, plan sponsors (in DB schemes), supervisory authorities, auditors etc.) in a clear, accurate, and timely fashion.

It is important to note that the guidelines are generic and in certain countries the relevant pension legislation may go further than these guidelines. For example legislation may prescribe in more detail the qualifications and experience a person needs to be appointed to the governing body, for the governing body to seek professional advice where there is no member of the governing body with the appropriate experience and for organisations related to the pension fund sponsor or its asset manager not being able to be appointed as the custodian.

Quality and structure of the Governing Body

There have been were weaknesses in composition and suitability of persons on the governing Body and a lack of trustee/fiduciary knowledge and training for governing body members. The following suggestions for improving the composition of pension fund boards are drawn from

OECD guidelines and country experience[49]:

- Encourage employee/ member nominated representatives, taking into account the need for an appropriate mix of skills and accountability to plan members.
- Define 'fit and proper' criteria more accurately, extending it to the collective knowledge and experience of the board and calling for suitable training where specific experience or knowledge are not required prior to appointment to the board.
- Consider the costs and benefits of introducing licensing for trustee entities (boards and corporations).
- Allow, and encourage, the use of independent professional trustees.

One of the most difficult tasks of a governing board is to monitor its own performance. Self-assessment can help boards identify weaknesses in their monitoring and decision-making activities. In dual-board structures the management board is often assessed by the supervisory board. In the case of single boards, the assessment of the board can be carried out by another internal body, such an audit or similar committee which may include external professionals.

One potential problem with these oversight bodies is that they can lack sufficient strength or influence. One way to increase their powers may be to give them a 'whistle-blowing' responsibility, with the requirement to report any governance or other problems they detect to the relevant pension supervisory authorities. As a result of external assessments, the governing board may decide to pursue training or engage external independent experts to the board. Additional training is most likely required for boards where specific experience or knowledge requirements are not laid down by 'fit and proper' requirements (which is often the case in trust-based systems). International good practice suggests assessment and training may be improved in the following ways, which could be particularly beneficial to trust-based systems:

- Encourage self-assessment by boards
- Allow third-party monitoring and give such oversight bodies 'whistle blowing' powers
- Provide guidance on level and types of knowledge required by governing board members
- Encourage training of board members – not just on appointment but on a regular, on-going basis
- Provide free training (e.g. on-line)

[49] Stewart and Yermo (2008)

- Advise board members where training can be obtained

- Approve training courses

- Allow pension fund to pay for training of board members

- Encourage the use of experts to provide technical support, although stressing that board members should not rely on one source, and should have the knowledge to assess such advice adequately

Conflicts of interests may arise whenever the decisions of a board member concerning the pension fund are, or may be perceived to be, affected by a separate personal interest or a duty owed to another party, rather than that of the pension fund members and beneficiaries. Employer representatives are generally affected by conflicts whenever decisions have to be taken that affect the sponsoring employer. Employee representatives can also be affected by conflicts. For instance, they may place greater value on the wellbeing of members of similar age and gender as their own.

There may be a variety of ways to manage conflicts of interest, including use of a number of measures, or a combination of approaches – for example through the appointment of independent board members, establishing an executive sub-committee or board members withdrawing from a meeting. Some regulators (such as TPR in the United Kingdom, APRA in Australia) have the ultimate ability to work with or replace conflicted trustees, with similar powers recently being requested by the Financial Services Board in South Africa (avoiding lengthy court cases which were previously required in such circumstances). In cases of an acute conflict it may even be appropriate for a trustee to resign.

The management by trustees of conflicts of interest is integral to good scheme governance. Trustee boards should ensure that they have in place effective processes for identifying, monitoring and managing conflicts.

The following examples drawn from international good practice are suggestions for overcoming governance shortcomings stemming from conflicts of interest:

- Require a policy for identifying potential conflicts of interest and for dealing with them

- Require Governing Body members to notify compliance on an annual basis

- Disclose conflict of interests in minutes of Board meetings

- Governing body members with a conflict of interest should abstain from voting (resigning as a last resort)

- The supervisory authority should have the ability to appoint independent Governing Body members

DC plans present additional governance challenges arising from the involvement of individual members in some key decisions and the absence in such arrangements of a trustee or an equivalent governing body that represents exclusively the interest of plan members. In most DC plans, members face investment choices which they may not be well prepared to make. Conflicting interests are at the heart of many of the complaints often heard about DC plans, from high fees to unsuitable investments and poor performance. While improving members' financial education and enhancing disclosure can help overcome some of the more blatant cases of abuse, it is highly unlikely to eliminate the massive information gap between private pension providers and individual plan members.

Furthermore, there is potentially a role for employers and employee representatives in reviewing how contract-based schemes are working in practice via establishing DC management committees. The fiduciary responsibilities of sponsoring employers (in occupational plans) and providers (in personal plans) could also be clarified in order to ensure that the plans are managed with appropriate care and with the interest of the members in mind. In countries with highly concentrated pension fund markets, the pension fund supervisory authority can also play a central role in monitoring pension fund governance.

Given the growing importance of contract-based, DC pensions and personal pension arrangements, finding a solution to the additional challenges of DC governance (sometimes referred to as the governance vacuum) is an imperative task for employers and policymakers, especially in those countries where DC pension funds are mandatory. Some possible solutions would be to:

- Improve disclosure and communication to members (e.g. provide comparative performance and fee tables, personal pension statements, with estimated retirement income, comparison of asset allocation vs. peers etc.)

- Encourage collective governance structures to be put in place for contract-based DC schemes

- and give such oversight bodies 'whistle-blowing' powers

- Encourage governing boards to ensure that individual choices and default options are structured properly

- Where members take on risk, provisions should be made for their input into appointments and other decisions (either via representation on the governing body or at least via an approval process at the AGM)

- Ensure there is on-going monitoring of investment options and providers – either the plan sponsors (via the creation of an appropriate legal environment) , or potentially via an independent management committee

- Create the appropriate legal environment ('safe harbour rules') to allow sponsoring employers pension providers to fulfil fiduciary duties

- Strengthening the role of pension fund supervisory authority in monitoring private pension providers

- Improve communication to members (e.g. personal statements with estimated income and peer comparisons)

3.3 A comparative analysis of governance practices and regulations for pension funds

Challenges in pension fund governance

Despite increased understanding of the importance of good governance for pension funds some problems still remain. In recent years, pension fund governance issues have been exposed in the media. Some of the more serious cases of governance failures include issues surrounding the Swissfirst affair involving Pensionskassen in Switzerland (concerning problems with pension fund managers trading the same shares as the pension funds which employ them). These problems have prompted a governance review, whilst the ASIP (the schemes' representative body) is pushing for existing codes of practice to be adopted more widely and the government is said to be contemplating legislation.

In Hungary, where pension funds are established as not-for profit institutions, there is evidence that the governing body is generally ineffective in looking after the best interest of members. Most funds are established by financial institutions that find it easy to promote their candidates to the fund's supervisory board.

Some pension funds in the United States have also been the subject of governance problems, with directors of TIAA-CREF resigning in 2004 over conflict of interest issues, and problems also being experienced at some public pension funds (in San Diego, New Jersey and New York – referenced in

Clapman et al. (2007)). [50]Meanwhile issues in Greece have surrounded the pricing of public pension fund bond purchases, with the government reacting by issuing new rules regarding the selection of board members. [51]

Various studies and surveys have also identified general governance problems that affect broadly and deeply the pension fund industry. Ambachtsheer et al (2006) is part of a continuing investigation into pension fund governance which covers funds in Australia, Canada, New Zealand, the United Kingdom, and the United States, among other countries. The study found that governance practices were improving but that there were still many lingering problems.

A survey by Mercer (2006) of the governance of global retirement plans offered by multinational corporations found that sponsoring employers are very concerned about the lack of governance of their benefit plans in the different countries in which they operate. A lack of resources (including skills) and weak local engagement were found to be the most common challenges multinational corporations had in meeting their global pension governance goals.

A survey of the members of the International Organisation of Pension Supervisors (IOPS) to ascertain which governance issues they find the most challenging. [52] Initial results suggest that pension fund supervisors are particularly concerned with transparency and the disclosure of information to pension fund members, the competency and expertise of the governing body and internal controls. Incidents leading supervisors to increase their focus on governance include the rising complexity of the pension fund industry and rising demands on the competence of the governing body. Adjusting legislative requirements and increasing supervisor oversight were the most usual responses.

Country specific surveys include a report by Marr et al (2006) highlighting administrative problems in governance practices in the United Kingdom, claiming that 1 in 3 pension funds still have administrative problems (from using the wrong index level, or wrong salary to calculate pension benefits to allocating spouse benefits to the wrong account). The UK Pensions Regulator's (TPR) survey of UK pension fund governance Pensions Regulator (2007b)) found improvements in governance practices. For example, more trustees were undertaking training, scheme confidence in managing conflicts of interest had risen significantly and more trustees were examining the financial state of the plan sponsor. Yet despite these improvements it is clear there remains a need to improve the level of training provided, particularly to further reduce the proportion of schemes that do not undertake training. The disparity between DB and DC

[50] In the U.S., under principles of federalism, state and local government pension funds for the employees of state and local governments are exempted from many of the federal pension laws and are instead regulated by the state or local government entities themselves. A recent report by the Pew Center on the States (2007) indicates that pension plans for employees of state and local governments in the United States are approximately 85% funded, though funding levels vary widely from plan to plan.

[51] IPE 16th April 2007, Greece sets new pension governance rules', http://www.ipe.com/news/Greece_sets_new_pension_governance_rules_21831.php

[52] IOPS (2008)

was of particular concern, with a higher percentage of trustees of DB schemes undertaking training than trustees overseeing DC schemes. [53]

The survey also highlighted other challenges in areas such as risk management, internal controls and managing scheme administration. Governance of pension schemes has been a legislative and regulatory priority for many years and The Pensions Regulator‘s Medium Term Strategy (2008-2009) has identified improving governance of work-based pension schemes as a key priority.

In their governance discussion paper (Pensions Regulator 2007a) TPR also saw conflicts of interest as one of the major governance challenges. The duty of the trustee to act in the best interests of beneficiaries is imposed by the principles of trust law. Accordingly, all decisions made by trustees in regards to these areas should be unfettered and made first and foremost in the best interests of beneficiaries. Whilst conflicts are inevitable in many cases, the pertinent issue is that they are appropriately managed. The governance survey found the most common conflict to be the dual role held by a trustee as a director or finance director of the sponsoring company. The 2007 survey showed that since 2006 confidence in managing conflicts of interest has increased significantly but managing such conflicts will continue to be a challenge.

The Pensions Ombudsman in the United Kingdom, in the 2005 Annual Report, likewise comments that while the administration of pension schemes in the United Kingdom is improving work needs to be done to ensure that independent trustees are effectively regulated. The Ombudsman is concerned that those providing a professional service currently do not have the liability to provide redress if mistakes are made.

Clark (2006, 2007) has also surveyed the ability of pension fund trustees in the UK. In the 2006 paper looking at trustee competence, trustees' ability in solving problems relevant to their investment responsibilities is examined. The results show that trustees are more cautious with other peoples' money than their own, which may be an impact of the predominance of the prudent person rule in UK common law. The fact that trustees are not professionals has also led to concerns that trustees may lack the understanding to judge advice they receive from experts.

Clark (2007) notes a growing tension between representation and expertise in several fields, using UK pension fund governance and the USA mutual fund industries as examples. The evidence suggests that very few trustees have the competence and consistency of judgment to challenge the experts who are responsible for executing complex financial decisions. There is a clear association between trustee boards' understanding across key topics and their confidence levels in managing their schemes. The importance of guidance is evident, and The Pensions Regulator continues to use education as the means to change behaviour across schemes. Trustees are required to comply with 'trustee knowledge and understanding' (TKU) requirements and develop further their knowledge to ensure they are confident in dealing with the more complex aspects of running their schemes.

Cocco and Volpin (2005), looking at DB plans in the UK, found that pension plans of indebted companies with more `insiders‘ (i.e. also executive directors of the sponsoring company) on the trustee board invested more in equities, contributed less to the pension fund and had a higher dividend payout ratio. The conclusion drawn is that when finances get tough, conflicts of interest may arise and impartial trustees are needed on the board to make governance work. However, other explanations could be found – such as trustees who are also directors of the sponsoring company potentially having greater investment knowledge which would allow them to maximize returns and therefore lower funding demands for the sponsor.

[53] Source: Pensions Regulator

Two studies have specifically focused on the issue of the differences between the levels of DB and DC governance in the United Kingdom. A recent NAPF survey concluded that trustees were not doing enough to explain that there may well be better ways for members to deploy their funds. A Cass Business School report on "reluctant investors" points out that, with the exception of senior executives, it is unusual for employers to pay for face-to-face regulated investment advice (due to cost).[54] In its DC consultation work The Pensions Regulator has concluded that two of the areas where there are opportunities for improvements are with member understanding and member choices, and the Regulator has stated that it will issue guidance for trustees with the aim of raising standards in those areas. The guidance will be targeted primarily at trustees, encouraging them to take a more pro-active role in member education.[55]

In Ireland, the Pensions Board produced a review in 2006 of the trustee structure of governance.[56] The Irish report identified some weaknesses such as the small size of some schemes, wide variation in awareness and understanding of trustee responsibilities and conflicts of interest among trustees, particularly among employer nominated trustees of DB plans. In addition, the Pension Board's review found evidence that ongoing, quality trustee training was the exception rather than the rule.

Governance problems also affect countries that have mainly contract-based private pension arrangements, where pension funds take a contractual form. In most Central and European countries like Poland and Slovak Republic and Latin American countries, such as Mexico, mandatory pension funds are managed by financial institutions that are faced with potential conflicts of interest. Given the low level of education of the population and the generally low interest in pension matters, there is an incentive for pension fund managing companies to engage in costly marketing campaigns to attract membership. Such campaigns often provide little benefit in terms of improved investment performance but lead to high administration costs and fees paid by the plan members.

Governance reviews have also been carried out in some non-OECD countries with occupational pension systems. For example, Dias (2006) argues that in Brazil, sponsoring employers tend to dominate decision-making at pension funds, even though nominally the main decision-making body is the so-called deliberative council (a kind of supervisory board). There were also some instances in which the one-third member representation of members in the deliberative council were not being met.

Rusconi (2008) has reviewed pension fund governance in South Africa and has identified major knowledge gaps in trustee boards, weak board discipline, and conflicts of interest among consultants and asset managers that are going unaddressed, leading to a prevalence of active over passive management and higher fees than would otherwise be the case. Such conflicts reach even training programmes for trustees as these are mostly delivered or financed by asset managers and consulting firms.

In summary, several main challenges relating to pension fund governance remain, primarily in trust-based and contract-based pension systems. First, trustees and fiduciaries generally lack suitable knowledge, experience or training, which additionally hinders them from being able to understand and challenge advice they receive from outside experts. Second, conflicts of interest still remain, both within boards and in relation to independent, commercial trustees. Finally, the problem of how to ensure that suitable governance mechanisms are in place for contract-based DC schemes has also yet to be solved.

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[54] Byrne, Harrison, Blake (2007)

[55] Source: The Pensions Regulator

[56] Pensions Board (2006)

Recent policy and industry initiatives

Policymakers in many OECD countries have recently stepped up efforts to address perceived weaknesses in the governance of pension funds. In some cases, regulators have even enshrined governance best practices similar to the OECD guidelines in the country‘s pensions legislation. Industry associations have also taken the initiative in some countries and are driving a reform in governance practices, encouraging funds to improve their self-regulation through better governance practices.

Some countries have introduced governance regulations in recent years, sometimes taking the form of recommendations rather than strict requirements. The principles of good governance that have been developed follow broadly the OECD guidelines. These initiatives include the following:

- In Australia, the licensing of trustees was made mandatory in July 2006, a first among Anglo-Saxon countries. The assessment of ―fit-and-proper‖ requirements is an integral part of the licensing process.

- In Belgium, the CBFA released in May 2007 Circular CPP-2007-2-LIRP/WIBP on the governance of IORPs (the European Union term for pension funds).

- In Brazil, the regulator issued resolution #13 in January 2005, covering a set of guiding principles and regulations on pension fund governance.

- In Canada, CAPSA introduced a code of pension plan governance in 2004.

- In Denmark the Pensions Market Council‘s report on good governance in labour market pension funds contains a set of principles for the responsibilities of boards, their tasks, composition and working methods. The Danish FSA has also released detailed supervision with a description of board responsibilities.

- In Greece, the government issued new rules concerning the selection of board members of public pension funds.

- In Ireland, the Pensions Board is considering making the training of trustees compulsory.

- In the Netherlands, the DNB has announced that from January 2008 it will start assessing the Principles of Pension Fund Governance laid down in the Pension Act (and which were developed by the STAR labour foundation).

- In Portugal, the insurance and pension fund supervisory authority (ISP) issued new regulation (‘Norma Regulamentar no. 7/2007-R, de 17 de Maio‘, under Decree Law nr. 12/2006, of January 20th) on the governance structure of pension funds, addressing issues including the Pensions Ombudsman, Pension Fund Auditor, Appointed Actuary and Monitoring Committee of the Pension Scheme (’Comissão de Acompanhamento do Plano de Pensões‘).

- In South Africa, the FSB released in June 2007 Circular PF No.130 on “good governance of retirement funds”.

- In Switzerland, the Federal Agency for Social Insurance is considering the introduction of governance regulations. [57]

- In the United Kingdom, the 2004 Pensions Act requires trustees to have knowledge and understanding of the law relating to pensions and trusts, and other matters, and to be conversant with the scheme trust deed and rules and other material. The Pensions Regulator is responsible for ensuring that this requirement is met, and developed a framework for trustee knowledge and understanding (the TKU regime).[58]

The IORP Directive (2003/41/EC) of the European Commission also contains some requirements relating to the good governance of pension funds in the European Union. [59]

Pension fund industry associations have also been active in some countries in developing standards on pension fund governance:

- In Canada, the Common Front for Retirement Security was set up by 14 groups (including the CARP (Canada's Association for the Fifty Plus- Investor Protection Association), Royal Canadian Legion and several prominent seniors/pensioners groups etc.) representing 2 million people. The organisation's goal is to campaign for better governance of pensions, investments and retirement savings. This initiative follows on an earlier one by the Pension Investment Association of Canada (PIAC) in 1999 establishing a set of recommendations on pension plan governance.

- In the United Kingdom, the National Association of Pension Funds (NAPF) launched a review of the governance arrangements of pension schemes. A discussion paper was prepared to promote a debate on the important issue of pension scheme governance to effectively protect the interests of working people. A draft code on governance was submitted for public consultation, which covers among other issues, the obligations of the governing body, risk management, managing conflicts of interest, and internal controls.

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[57] This would strengthen the current 'self-regulation' approach which may not be working sufficiently rigorously, with one survey suggesting that less than half of the Swiss pension funds have adopted the industry-wide code. Reasons given include being subject to strict regulations elsewhere and costs. See 'Moving Governance up the Agenda', IPE December 2007.

[58] The Pensions Regulator has recently published the final module of its trustee toolkit, 'running your scheme', which focuses on governance. It has also produced a code of practice and scope guidance which interprets the requirement for trustees to have knowledge and understanding of the law relating to pensions and trusts. Earlier, the Myners Report on institutional investment placed a high level of importance on the need for trustees to be 'familiar with issues' when considering investment decisions. The report, with its number of investment principles, has become a voluntary code.

[59] For example, Article 9 states that these institutions effectively run by persons of good repute who must themselves have appropriate professional qualifications and experience or employ advisers with appropriate professional qualifications and experience; should have properly constituted rules regarding the functioning of any pension scheme operated by the institution have been implemented and members have been adequately informed of these rules; requires that all technical provisions are computed and certified by an actuary or, if not by an actuary, by another specialist in this field; and that the members are sufficiently informed of the conditions of the pension scheme, in particular concerning: (i) the rights and obligations of the parties involved in the pension scheme; (ii) the financial, technical and other risks associated with the pension scheme; (iii) the nature and distribution of those risks. In addition, Article 12 requires a written statement of investment-policy principles to be produced at least every 3 years (including as a minimum investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation).

- In the United States, best practice principles for the governance of US pension, endowment and charitable funds were released in 2007 by the Stanford Institutional Investors' Forum (SIIF) Committee on Fund Governance.[60]

Strengthening governance in occupational pension funds

Many of the problems in pension fund governance emerge from weaknesses in the governing board.

These can take several forms:

- The responsibilities of board members are not clearly defined: the board may lack a clear mission statement and may engage in operational duties which should be left to internal management staff or external service providers.

- Selection on the basis of representatives of stakeholders: in many countries board members are often selected on the basis of their status in a trade union or employer, rather than their specific knowledge or experience on pension issues.

- Lack of self-assessment, including training needs: governing boards rarely subject themselves to a thorough self-assessment review, to evaluate the extent to which their objectives are met and propose improvements to their decision-making methods.

- Conflicts of interest are not effectively identified and tackled: in many countries it is not required to have a code of conduct to manage conflicts of interest within pension funds.

Compounding these challenges is the problem of scale, which can be a major handicap for good governance. Small pension funds are unable to reap economies of scale and hence have high costs of administration. For example, a survey of pension funds in Ireland showed that management costs represented 3.64% of assets under management (AUM) in schemes with less than 50 members, but only 0.32% in schemes with more than 500 members (see Pensions Board (2006)). In the Netherlands, management costs for funds with less than 100 members were 0.59% of AUM and 0.07% in funds with more than 1m members. Similarly, costs were 1.23% of AUM in funds with less than 10 million euro in assets and 0.1% in funds with more than 10 billion euro (see Bikker and de Dreu (2006)).

Small funds are also likely to be backed by small employers, which may lack workers and even executives with relevant skills and experience to sit in the governing board. While training may help mitigate this weakness, it is unlikely that a small fund will be able to achieve a comparable level of performance, even before fees, than a large fund as the latter can rely on a broad set of skills in its sponsor‘s workforce, including various finance specialists. Small funds are also less likely to develop governance structures and processes that are consistent with the fund‘s size and mission. They may be more exposed to conflicts of interest and be at the mercy of consultants and external advisors who may lead them to make risky investments that they may not fully understand.

The use of 'Master Trusts‘, as is the case in Australia, the United Kingdom, and other Anglo-Saxon countries, may be one way around the governance challenges facing smaller pension funds. Under such arrangements, the fund is directly under the control of a specialist institution, such as an insurance company or benefit consulting firm. But such solutions come with their own challenges (notably how to control conflicts of interest). An equivalent option being considered in DB arrangements is "fiduciary management" of the pension fund, whereby a commercial provider takes care of not just the operational

[60] Clapman et al. (2007)

but also some key decisions of the fund, such as strategic asset allocation and external manager selection and monitoring. It is unclear whether commercial providers can manage the conflicts of interest inherent to such activities. One option to better align the incentives of the fiduciary manager would be for the pension fund to take an equity stake in the manager, as was recently done by a medium-sized pension fund in the Netherlands. However, such stakes need to be sufficiently large in order to have an impact on the manager‘s incentives. Small funds, given their size and diversifications goals, may gain little by investing in their fiduciary managers.

Other solutions that have been quite effective in some countries involve multi-employer arrangements, such as the industry-wide pension funds that exist in countries like Australia, Denmark and the Netherlands. Such pension funds were originally established via collective bargaining arrangements at the industry level, but in the case of Australia are now also open to companies and workers outside their industry.

3.4 Major problems and challenges in pension fund governance

One of the key governance issues facing pension funds at the current moment is the need for the governing body to fully understand its role in the pension process. The governing body needs to have the necessary skills to guide the pension fund so that it achieves the mission and objectives set for it.

The current world economic climate is challenging every organization in the financial services – even those organisations with very highly qualified, experienced and adequately remunerated executives. This poses a very significant problem for pension funds, particularly those established by employers.

Conflicts of interest

Best practice is for the governing body of pension funds to have representatives of both the employer and the scheme participants. The dilemma arises in terms of having representatives on the governing body with the appropriate experience to help the fund address the issues that need to be addressed in these turbulent economic times. In the current climate, there is perhaps a need for professional governing board members to represent scheme participants, and even sponsoring employers, so as to facilitate better decision making processes. As previously indicated there are often concerns about the ability of governing board members to fully understand the advice being provided to them from various service providers or to challenge that advice.

Pension fund governing board members and senior executives of the fund need to clearly understand the purpose of their pension fund and be dedicated in seeing that purpose put into reality. This means identifying and communicating a clear mission statement and objectives.

Another issue is the context in which pension funds operate. The governing body and its service providers have to clearly understand the possible conflict of interest that can arise when balancing the competing interests of those with a stake in the pension fund. This is particularly the case in DB schemes or DC schemes where there is a guarantee. They need to exhibit a clear awareness of the balancing act that pension funds with a guarantee typically present to them, which can be a difficult task. The reality is that the financial interests of various stakeholder groups in these types of pension funds do not always present a win-win situation. So instead of providing oversight to the pension organization, governing bodies can become involved in working out the respective financial interests of retirees, active workers, future workers, and sometimes even those of corporate bond holders, shareholders, or current and future taxpayers. There is a need to develop good organization values and high levels of trust in pension funds.

There is also the related question of trying to understand laws and regulations associated with these issues.

Credibility and Public Opinion

Public opinion surveys in many countries show there is a significantly reduced level of credibility of pension funds. A 2009 survey for the UK Department of Work and Pensions found that attitudes to financial companies, banks and building societies as potential pension providers have become much more negative. The proportion of respondents who believed that banks and building societies will act with competence has declined by eight percentage points and with care by 18%age points since 2006. This survey predates the financial bailouts of banks in the UK and therefore current attitudes are likely to be even more severe.[61]

Similarly, in Ukraine the USAID Capital Markets Project carried out a public opinion survey that showed only 5% of respondents had any trust in the non-state pension system.[62]

Strategic Planning and Organisational Design

There is a need to develop formal strategic planning processes. This will result in clearer management focus on such issues as resource planning, organization design and compensation. Increasingly pension funds are going to have to take the same approach as large businesses in the way they operate and deliver services to their stakeholders.

The pension fund oversight function needs to become a focus of the governing board. We have already raised the issue that the selection process for governing board members is deficient in many ways. There is a need for self-evaluation of the governing board's effectiveness. If there is weak oversight of the pension fund's day-to-day operations there are likely to be difficulties in sorting out the competing financial interests of differing stakeholder groups. They can also lead to organization dysfunction. Specific examples which need to be examined include a lack of delegation clarity between board and management responsibilities. Where tasks are delegated the accountability and delegated responsibilities for all elements of running the scheme need to be identified, documented and understood by those involved. Once a decision has been taken to delegate tasks the governing body should not micro-manage those with delegated authority. However, this does not mean that the governing body abrogates responsibility.

Resources for Control and Evaluation

Sufficient time and resources should be identified and made available for maintaining the ongoing governance of the pension fund. Service providers must support the governing body and the scheme sponsor to understand their responsibility for providing accurate information, on a timely basis, to scheme advisers and service providers.

The governing body should establish procedures and controls to ensure the effectiveness and performance of the services offered by scheme advisers and service providers. They need to establish adequate internal controls which mitigate significant operational, financial, regulatory and compliance risks.

Those running schemes should be open and honest with their regulators. They should regard the regulator as a resource to be used if needed rather than an opponent who needs to be overcome. Advice from the regulator should be addressed source in a timely and effective manner.

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[61] Clery, E et al (2010)

[62] USAID (2010)

Sufficient time and resources need to be made available to monitor and review the pension fund's operation and to ensure that it continues to meet good practice. The governing body needs to have procedures and controls in place to ensure the effectiveness and performance of the services offered by scheme advisers and service providers. The governing body should meet regularly with the service providers to both hear reports from them on the fund's operation and to ask their own questions about current and future developments.

For their part the service providers need to maintain adequate internal controls, which mitigate significant operational, financial, regulatory and compliance risk. They need to take appropriate steps to pursue and resolve all late and inaccurate payments of contributions.

The governing body also needs to ensure the competence of the scheme administrator. Membership records for all scheme participants – those who are current contributors, those who are current pensioners and those who have left the fund but still have an entitlement need to be both complete and accurate. These records need to be subject to regular data evaluation.

All scheme transactions must be processed promptly and accurately. Administration systems must be appropriate to the fund's size and complexity. So much today depends upon IT systems. These must be delivered under all circumstances and have suitable back-up and disaster recovery options.

The governing body needs to monitor the ongoing suitability of any default investment strategy, particularly in the case of DC schemes. The performance of each investment option, including any default investment option needs to be regularly assessed against the governing body's declared investment objectives.

Communication with members is a key activity. All members of the schemes – employees, pensioners and those with a future entitlement need to be regularly informed on the status of the fund, its achievements and the challenges that it is or will face in the future. Communication needs to be accurate, clear, understandable and engaging. It must address the needs of members from when they make a decision to joining the fund through to the time they receive their last payment from the fund.

In DC schemes that offer the participant a choice about where his or her contributions are to be invested, the participant needs to be regularly informed of the importance of reviewing the suitability of their investment choices. Again in DC schemes there needs to be clear communication with members on the options that are available to them at retirement. The fund needs to provide services to those about to retire that supports them in choosing the option that is most appropriate to their circumstances. This will particularly be the case in pension funds sponsored by financial services organisations, which also provide annuities. There needs to be independent and authoritative advice, particularly if the member can benefit considerably by opting for a benefit provided by a rival organisation.

3.5 Similarities and differences in governance of commercial organisations and pension funds

The structure of the governing body is determined by the legal form of the pension fund. There are two types of autonomous pension funds. There is an institutional type where the fund is an independent entity with legal personality and capacity and hence it has its own internal governing board. Examples of pension funds of the institutional type include pension foundations and associations as they exist in countries such as Denmark, Finland, Hungary, Italy, Japan, Norway, Poland, the Netherlands, and Switzerland, as well as corporations such as the, Pensionskassen in Austria and Germany. In most of these countries pension funds have a single governing board, whose members are typically chosen by sponsoring employers and employees (or their representatives). In some countries, like Germany and the Netherlands, there is a dual-board structure. In Germany, there is a supervisory board which is responsible for selecting and monitoring the management board, which in turn is responsible for all strategic decisions.

By contrast a pension fund of the contractual type consists of a segregated pool of assets without legal personality and capacity that is governed by a separate entity, typically a financial institution such as a bank, insurance company or a pension fund management company. The governing body of a fund set up in the contractual form is usually the board of directors of the management entity, though in some countries (e.g. Spain) some key responsibilities are shared with a separate oversight committee (comisión de control). Other examples of pension funds set up in the contractual form include those in the Czech Republic, Mexico, Portugal, Slovakia, Turkey, and the open funds in Italy and Poland.

The trust, which is the legal form used by pension funds in countries with an Anglo-Saxon legal tradition, does not fit comfortably into either category. It has characteristics of both the institutional and the contractual type. Under the trust form it is the trustees who legally own (have the legal title to) the pension fund assets. Trustees must administer the trust assets in the sole interest of the plan participants, who are the beneficiaries from the investment of those assets according to the trust deed. While this feature of trusts is similar to that of foundations, the trustees are not legally part of the trust. Indeed, a trustee may be of the corporate type (as in sometimes the case in Australia and Ireland) which makes the pension fund resemble a contractual arrangement.

The United States has an additional feature as the governing body may be the plan sponsor, the trustee, or/and some third party. ERISA requires single company pension plans to have one or more named fiduciaries that have authority to control and manage the pension plan, including its investments. The sponsoring employer and the trustee are always named fiduciaries but it is possible for the trustee to be devoid of any major fiduciary responsibility (directed trustee), following instead another named fiduciary (e.g. a plan committee). In addition, asset managers, financial advisors and other persons and entities that exercise some discretion over the fund‘s assets are considered functional fiduciaries, all of whom have some legal responsibility for the pension fund.

From a theoretical point of view there should be no differences in the overall approach to corporate governance between any type of pension fund, whether it be DB or DC or whether it be an employer sponsored fund, a multi-employer fund or a fund run by a commercial organization.

The main principles in the mission statement of any pension fund would be basically the same:

1. To provide the best possible retirement benefits

2. To provide high level customer focused services

3. To preserve and protect fund assets for the exclusive benefit of participants.

As a principle, the OECD guidelines should be adopted and implemented by all pension funds regardless of who the sponsor of the fund is. Several main challenges relating to pension fund governance remain, primarily in trust-based and contract-based pension systems. First, trustees and fiduciaries generally lack suitable knowledge, experience or training, which additionally hinders them from being able to understand and challenge advice they receive from outside experts. Second, conflicts of interest still remain, both within boards and in relation to independent, commercial trustees. Finally, the problem of how to ensure that suitable governance mechanisms are in place for contract-based DC schemes has also yet to be solved.

3.6 Dealing with conflicts of interest within pension funds and with external parties

It is imperative that the pension fund has in place a specific policy to handle situations that could be interpreted as leading to a potential conflict of interest. This policy should be made aware to all service providers.

One of the key issues in pension fund governance is the question of trusteeship and therefore management of the fund. This can be an issue in open pension funds where, usually, all decisions relating to the fund – primarily the investment strategy, the organisations which will provide services to the fund and how much they will be paid for these services, are taken without participation of those who are participating in the fund. In the majority of cases, the trustee of open funds will decide to appoint organisations which either they wholly own are or affiliated with as a service provider. And in many cases there is no independent assessment of the cost charged for these services.

In the circumstances where pension funds are established by commercial organisations it is desirable to establish an independent supervisory board or oversight committee whose main functions are the selection and oversight of the body in charge of strategic decisions. The supervisory board may have other responsibilities, and may, for example, appoint the auditor or actuary of the pension fund and control potential conflicts of interest.

In all types of pension funds, possible conflicts of interest may arise in the case of the investment of assets. Whilst generally the governing body will allow the asset management company to freely choose for example what shares of companies to buy and sell within the overall limits established for the fund, there may be instances whereby the governing body may attempt to influence such decisions e.g. in the case of takeover bids where the pension fund could be used to buy or sell assets of a company that may be of interest to the fund sponsor.

Another possible conflict of interest may arise in respect of the service providers. Particularly in DC schemes, but to a large degree in all schemes the cost of providing the day-to-day administration services can become an issue. For instance, some pension funds are self-administered i.e. the sponsoring employer either meets the cost of administering the fund or actually provides the staff and infrastructure necessary to administer the scheme. Increasingly employers are looking to reduce costs by outsourcing the administration. In such a circumstance the cost of administration would become a direct charge against the individual scheme member's account balance and therefore ultimately reduce their retirement benefit whilst at the same time reducing the employer's expenditure.

In some countries legislation is in place to minimise some potential conflict of interests. Particularly in commercial pension funds, there is a tendency to have all services provided by one organization. Best practice would see a split in the roles of asset manager and custodian.

Legislation in many countries prohibits the custodian from being owned by a party related to the asset management company (usually in this type of pension fund the sponsoring organisation). An independent custodian may not be required, but it would be good practice to separate the asset management and custodial functions.

The independence of the auditor from the pension entity, the governing body, and the plan sponsor is important to ensure the impartiality of the audit. Normally, the auditor should be appointed by the governing body of the pension entity and in a manner consistent with fiduciary duties. In some countries, legislation prescribes that the auditor of the pension fund cannot be the auditor of the plan sponsor. Again where this is not prescribed it would be good practice for the governing body to appoint an independent auditor.

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4. KEY FINDINGS AND IMPLICATIONS FOR THE RUSSIAN FEDERATION

4.1 Introduction

This section of the report gives an overview of the Russian pension system and addresses the challenges in pension policy in the Russian federation today. The analysis is carried out from the perspective of system design and operation, on the basis of indicators such as benefit adequacy, investment performance, and operational efficiency and is framed against the background of the OECD's recommendations for private pension regulation and supervision.

The Russian Federation has historically had a retirement scheme for workers in the form of a state pension which until 2002 was a DB scheme and financed on a pay-as-you-go basis. At this time, the state pension system was a mixture of a traditional old age retirement scheme together with what in OECD countries would be regarded as occupational pension schemes, paying special benefits to certain categories of employees, most notably to those who worked under hazardous conditions and those who were accorded special pension privileges, such as civil servants, scientific workers and members of the Duma. Retirement benefits were relatively generous and pensions were (and still are) paid from the age of 55 for women and 60 for men.

In 1992, a decree was issued permitting the creation of private non-state pension funds (NPFs) that could be used for accumulating money on a voluntary basis to obtain additional pensions in the future, independently of and supplementary to the state pension. The basic principles were that contributions could only be made on a voluntary basis and by citizens and/or by enterprises for the benefit of their employees.

For quite some time private pensions were provided on an unregulated basis. This changed with the establishment of the Inspectorate of Non-State Pension Funds under the then Ministry of Labour and Social Protection. It was not, however, until 1998 that the Duma passed the first law on non-state pension provision. This gave a legal basis to the private pension funds that were in existence or which would be established in the future.

The pension legislation in the Russian Federation had to be drafted in accordance with the country's legislative base. Consequently, the funds are established as not-for-profit organisations and can be compared with the trust funds or foundations that operate in many OECD countries. The concept of trust law used in many countries was not able to become the basis of Russian private pension fund provision.

Traditionally, major organisations, often in the mining, energy and utilities sectors, were those which established a private pension scheme using NPFs. Today, there is a greater use of NPF's by other industries and within the public pension system since the pension reform in 2002. The growing role of the NPF's emphasises the need for appropriate regulation and supervision, as does the growing number of actors involved in the Russian pension system.

4.2 The current design of the reformed pension system in the Russian Federation

In 2002, as has been the case in many countries around the world, the Government of the Russian Federation reformed its compulsory, state pension system. The state pension system, known as the Labour Pension, contained three components: a basic pension, an insurance benefit based on a notional defined contribution (NDC) account and a funded, defined contribution scheme.

The basic pension and the notional defined contribution scheme

The basic pension was incorporated into the insurance part of the labour pension as of January, 1 2010. It is a flat rate pension provided to all those with minimum 5 years of contributory service before reaching the retirement age which is 60 for men and 55 for women. Since most of those currently retiring worked in Soviet times, almost all current retirees receive this pension. The basic pension is uniform but higher benefits are granted to individuals in different categories, for example those over the age of 79, the disabled with reduced working capacity, caregivers and those who live or have worked in the Tundra. The basic monthly flat-rate benefit for a pensioner with no dependents was RUB 2 963 (USD 96)[63] and RUB 5 926 (USD 196) with three or more dependents in 2012. Comparatively, the basic monthly flat-rate amount for a pensioner age 80 or older is RUB 5 926 (USD 192) with no dependents and RUB 8 889 (USD 228) with three or more dependents.

The basic pension is indexed annually to average wages, but limited to the annual growth of the Pension Fund of the Russian Federation’s (PFR) income, expressed per pensioner. Special provisions apply if inflation exceeds 6%. Other ad hoc increases have also been granted by the Duma.

Currently, the main qualifying condition for the basic component of the pension is the individual’s age. However, from 2015 onwards, the basic defined benefit component of the Labour Pension will depend on the contributory period and will increase by 6% for each year beyond 25 contributory years for women, and 30 contributory years for men.

The basic pension provides a flat benefit which is financed by the portion of the uniform social tax that is paid by employers to the federal budget and then transferred to the budget of the Pension Fund of the Russian Federation (PFR). Since 2010 it has been financed through insurance contributions for the mandatory pension insurance. The contribution rate channelled to the basic pension has declined from 14% in 2005 to 6%in 2009 for those born in 1967 or later. This contribution is since then consolidated with that of the notional defined contribution schemes in the insurance component of the labour pension (please also refer to table 3 below).

The second part of the pension is an insurance or earnings-related plan designed as a notional defined contribution (NDC) scheme. In 2013, the contribution rate to this part of the pension system is 22% of wages for those born before 1967 and 16% of wages for those born after 1967 up to a ceiling of RUB 568 000 (USD 18 773) annually. For those with an annual income above this ceiling an additional 10% of salary is payable in contributions. The interest rate attributed to these contributions is the growth in the rate of contribution revenue per pensioner as a measure of the increase in the average wage (please refer to table 3).

At retirement, at age 60 for men and 55 for women, the amount standing to the individual’s account is annuitised using a factor based on life expectancy. The design of the system is similar to those in Poland and Sweden, which also have a combination of notional defined contribution schemes and funded plans. However, not all of the principles of notional accounts have been implemented in the Russian NDC system. Unlike these countries, the annuitisation of entitlements is not as strongly linked to current life expectancy predictions. The same annuity factor is used for both men and women. When the reform first started the annuity factor was 144. It was set to increase by six months annually until it reached 16 years until reaching 228 months (19 years) which it did in 2013. This increase in the annuity factor is to a large extent compensating for the underestimation of earlier life expectancy projections.

[63] The currency exchange rate used in this document is the national currency units per US-Dollar (monthly average) extracted from the OECD Main Economic Indicators (MEI) database.

The mandatory funded defined contribution scheme

The third part of the Labour Pension includes the mandatory funded DC scheme, the introduction of which took on two phases. The first was short-lived and applied for two years only whereby men born between 1953 and 1966 and women born between 1957 and 1966 participated in the funded component of the pension system. In 2004, this was rescinded so that only those born on or after 1 January 1967 participated in the funded system. Initially all funded contributions were invested in the PFR.

From January 1, 2004 an insured individual was entitled to forego receiving the funded part of his/her retirement pension from the PFR and transfer pension assets to a private pension fund, the NPFs. Workers can choose the following once a year: (1) to have their contributions invested and administered in one of the privately run funds (2) to keep their funds in the PFR and managed by Vnesheconombank (VEB) which is appointed as the state asset management company, or (3) to keep their funds in the PFR and managed by a private asset manager.

Typically, individuals do not have a choice as to how the portfolio is allocated between different asset classes. Most providers offer a "one-size-fits-all" portfolio, although there is a growing trend towards offering investment choice. Most countries adopting mandatory funded pensions initially started with single portfolios, but many – such as Australia, Chile, Hungary, Mexico, Poland and the Slovak Republic – have now moved to offer a choice of portfolios with each provider. These portfolios are designed to offer different degrees of risk and potential investment returns.

Participants in the Russian mandatory funded scheme can choose their pension administrator and asset manager once a year. The idea is to stimulate individuals to take an active interest in the accumulation of their future pensions while limiting the degree of costly switching between providers that as has been the case in many of the funded pension systems in Latin America. However, private pension companies are not allowed to compete actively for a share of the market with each other or with the government agencies through for example advertisements.

Currently, 6 % of an individual's wages goes to the funded component although in 2012 the Duma passed legislation to reduce the funded component for some participants to 2%, envisaged to come into effect from January 2015. This reversal is treated further in section 4.5.

Voluntary retirement savings

Voluntary funded pensions covered about 6.8 million individuals as of December, 31 2012 and are fundamentally run by the NPFs. Few insurance companies provide pension products. NPF's pay out pension benefits to 1.1 million individuals under voluntary saving contracts. About 90% of the voluntary pension savings are in employer-sponsored schemes.

As of September 30, 2013, there were 137 NPFs operating in the country, of which 107 also operated in the compulsory system. The NPFs held assets valued at BRUB 1427 (BUSD 45) on December 31, 2012 of which BRUB 758 (BUSD 24) were in the voluntary pension system and BRUB 669 (BUSD 21) were in the mandatory system.[64]

Contributions may be paid by either employees or their employers and most of the schemes in the Russian Federation are run on a DC basis. The corporate sponsored voluntary schemes in OECD countries have typically been DB schemes but there is a marked shift towards DC schemes. Some voluntary plans in the Russian Federation offer minimum return or benefit guarantees. These guarantees are then usually

[64] Source: The Federal Commission on Securities Market , Russian Federation

contracted out to an external asset manager. The protection against asset managers that enter into bankruptcy and cannot fulfil investment return guarantees has been weak as is the public perception of NPFs according to anecdotal evidence.

In 2010, Russia also introduced a system of co-financing or matching additional contributions from the state to the mandatory funded pension system. The program is financed by investment income from the National Welfare Fund which is a sovereign wealth fund established in 2001 with oil proceeds. As of the beginning of 2013 over 10 million requests to participate had been received, of which approximately 2.5 million had been granted at the end of 2012.[65] The state subsidy can therefore be an important tool to promote higher retirement savings and therefore improve future adequacy of retirement income given that the scheme is carried out for a long enough period of time. Such a scheme is similar to that introduced in countries such as Australia, Germany and New Zealand, although in Germany and New Zealand the state subsidy is greater as a percentage of income for lower income workers. Such designs strengthen the incentive on these workers to participate in the scheme.

The co-financing scheme in the Russian Federation is open to individuals who are eligible for the mandatory pension but the first payment has to be made to the scheme by October 1, 2013. State co-funding is allocated for 10 years maximum, which is also the period for which the contributions are bound in the system. Individuals choose the level of extra contributions and the Government co-finances the additional pension savings in the range from RUB 2000 to 12000. An individual has the right to set and change contributions, as well as cease or resume paying then at any time.

In this sense the savings period for this type of DC scheme is quite short as the best way to reduce uncertainty in funded DC plans and to improve the chances of achieving an adequate retirement income is to contribute large enough amounts and for long periods. Longer contribution periods allow for higher retirement income for a given level of contributions. The length of the contribution period determines for how long amounts contributed accumulate and benefit from compounding of interest. Hence, the longer the contribution period the longer accumulated assets earn returns and the less money people need to put aside regularly to build assets to finance retirement.

4.3 Addressing the need to improve adequacy of pension benefits

The cut-off cohort to be enrolled into the mixed financing system (currently 1967) has changed twice since the initial reforms. The basic pension has also been changed on a discretionary basis over the last ten years, leading to wide swings in the ratio of pensions to wages. Instability in pension levels can make it difficult to plan for retirement and create mistrust in the political ability to maintain adequate pension levels over time.

Some of these changes, such as recent increases in the basic pension, have been necessary to address a growing problem of old-age poverty.[66] The old-age poverty rate is defined as the percentage of individuals aged 65 and over with incomes of less than half the national household median income The OECD uses a different poverty line than the official Russian statistics. To allow for different income levels prevailing in different countries, the OECD poverty line is set at half the national median household income, with the latter adjusted to reflect differences in household sizes. Considering this relative poverty line in international comparison, in 2008 poverty amongst those aged 65 and over in the Russian Federation was twice as high as the OECD average.[67]

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[65] Ministry of Finance of the Russian Federation

[66] Yermo (2012)

[67] OECD (2008)

In 2009 and 2010, the Russian Federation introduced increases to the benefit payments from the social pension. The average social pension payment increased to a level just above the social minimum. Average pension payments at the beginning of 2008 were worth just over 20% of average earnings, but by the beginning of 2010, the average pension had almost doubled to just below 40% of average earnings. During the crisis, despite a sharp reduction in GDP, real incomes increased 1.8%. Real wages fell in 2009 by 3.5%, but the expansion in pensions and social assistance benefits contributed to the increase in incomes, and the vast expansion of social protection benefits continued in 2010. Pensions increased in real terms by 18.1% in 2008, 10.7% in 2009, and 34.8% in 2010. As a result of the expansion of social protection benefits, the share of the these benefits in total incomes of the population increased from 11.6% in 2007 to 18.1% in 2011, the highest rate over the last 20 years however real income growth was 1.1%, the lowest rate in many years.[68]

The ratio of current average pension payments to average wage has also increased in the past years. In 2008, this ratio was 21% and increased to 38% in 2010. This is a continuing trend. According to PFR data, as of January 1, 2013, 33.5 million pensioners receive the average retirement pension of RUB 9 414 (USD 303) per month[69] and amounts to double the amount of the subsistence level in the Russian Federation which is RUB 6 131 (USD 197) for the same year. According to preliminary data, this is around 35 % of the average nominal monthly accrued wage for 2012.[70]

Table 1. Ratio of Average pension payments on 1 January 2008 and 1 January 2010 as related to the minimum subsistence levels and average wages[1]

	Ratio of average pension payment to:			
	Minimum subsistence level		**Average wage**	
	2008	**2010**	**2008**	**2010**
Total Pensions	115	174	21	38
Labour pensions	117	179	22	39
Social pensions	85	104	16	22

1. The minimum subsistence level for pensioners was RUB 3 191 per month at 1 January 2008 and RUB 4 091 at the end of December 2009; on the same dates the average wages were RUB 17 290 and RUB 18 938, respectively.

Source: Data provided by the Ministry of Health and Social Development of the Russian Federation.

Furthermore, in the Russian Federation, qualifying for, and receipt of, an old-age pension does not always entail that people have withdrawn from the labour force. More than one-third of the 33 million old-age pensioners in receipt of the old-age labour pension are in employment, and this proportion is higher for those who started to draw a pension in the past five years. Employment rates among pensioners are highest for those covered by special early retirement provisions for long service and specific occupations and geographical regions.[71] Therefore those that have just reached pensionable age are often relatively well off, and poverty among "new" or young pensioners is lower than for older retirees (Please also see Appendix 1).

[68] Source: Federal State Statistics Service, Russian Federation

[69] Source: Pension Fund of the Russian Federation

[70] Source: Federal State Statistics Service, Russian Federation

[71] Source: Sinjavskaya, 2004

Table 2. Number of pensioners registered in the system of the Pension Fund of the Russian Federation and number of working pensioners in the Russian Federation, in thousands

	1970	1980	1990	1995	2000	2005*	2007	2008	2009	2010*	2011
Number of pensioners registered in the PFR	22 513	27 417	32 848	37 083	38 411	38 313	38 467	38 598	39 090	39 706	40 162
The number of working pensioners	-	-	6 801	8 426	6 102	8 592	10 198	10 970	11 708	12 380	13 030

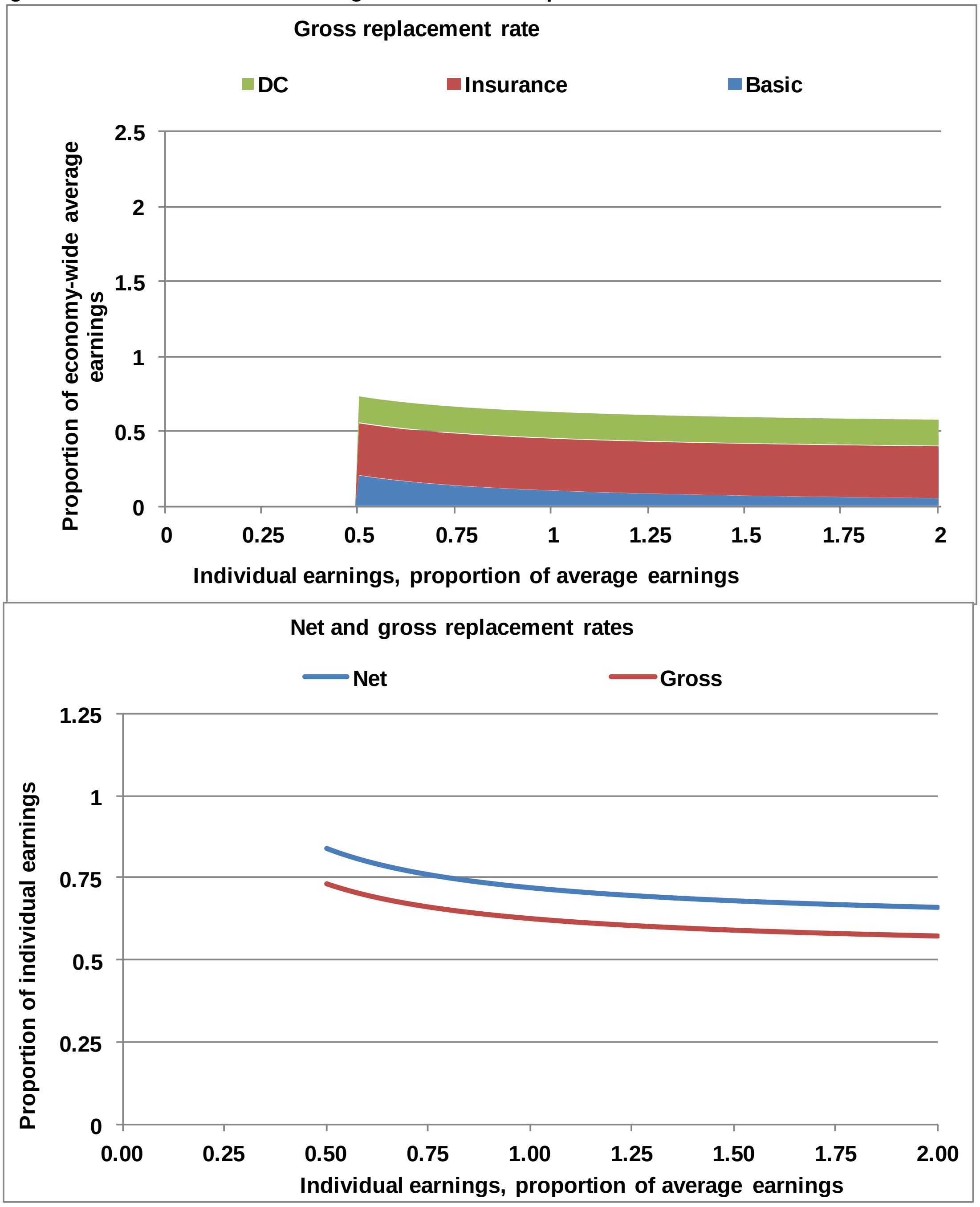
Source: Federal State Statistics Service

The OECD provides a framework for cross-country comparisons of pension systems and future pension entitlements by standardising long-term economic and financial assumptions (price inflation, wage growth, investment returns, etc.). The exercise focuses on differences in the parameters and rules of pension systems rather than on the variance in national economic trajectories. It gives a picture of the pensions that future retirees can expect to receive under legislated rules as compared with the tables above which show the situation of those that are currently retired.

For new employees with full careers and retiring at the normal retirement age, the future structure of pension benefits in the Russian Federation is modelled in figure 11. The figure compares the replacement rate for workers with different earnings and breaks it down by the three main components of the mandatory system (basic, the NDC earnings-related component, and the mandatory funded DC component). The replacement rate is defined as the ratio of an individual's average pension in a given time period and the average income in a given time period.

Under legislated rules for the accrual of pensions entitlements in 2008 in the Russian Federation, a man assumed to have average earnings (RUB 207 500 (USD 8 300) working from age 20 to the normal pensionable age of 60 would receive a gross replacement rate (pension relative to individual earnings) of about 58%. The lower right hand chart shows future replacement rates in net terms (after taxes), comparing it to that before taxes (gross). For a worker on average earnings, the total net replacement rate from the mandatory system would be close to 70% which is above the OECD average. These figures also show the importance of the DC scheme given the assumed annual rate of return of 3.5% net of administrative charges and the other assumptions are realised.

Figure 11. Pension benefit modelling: Gross and net replacement rates for the Russian Federation

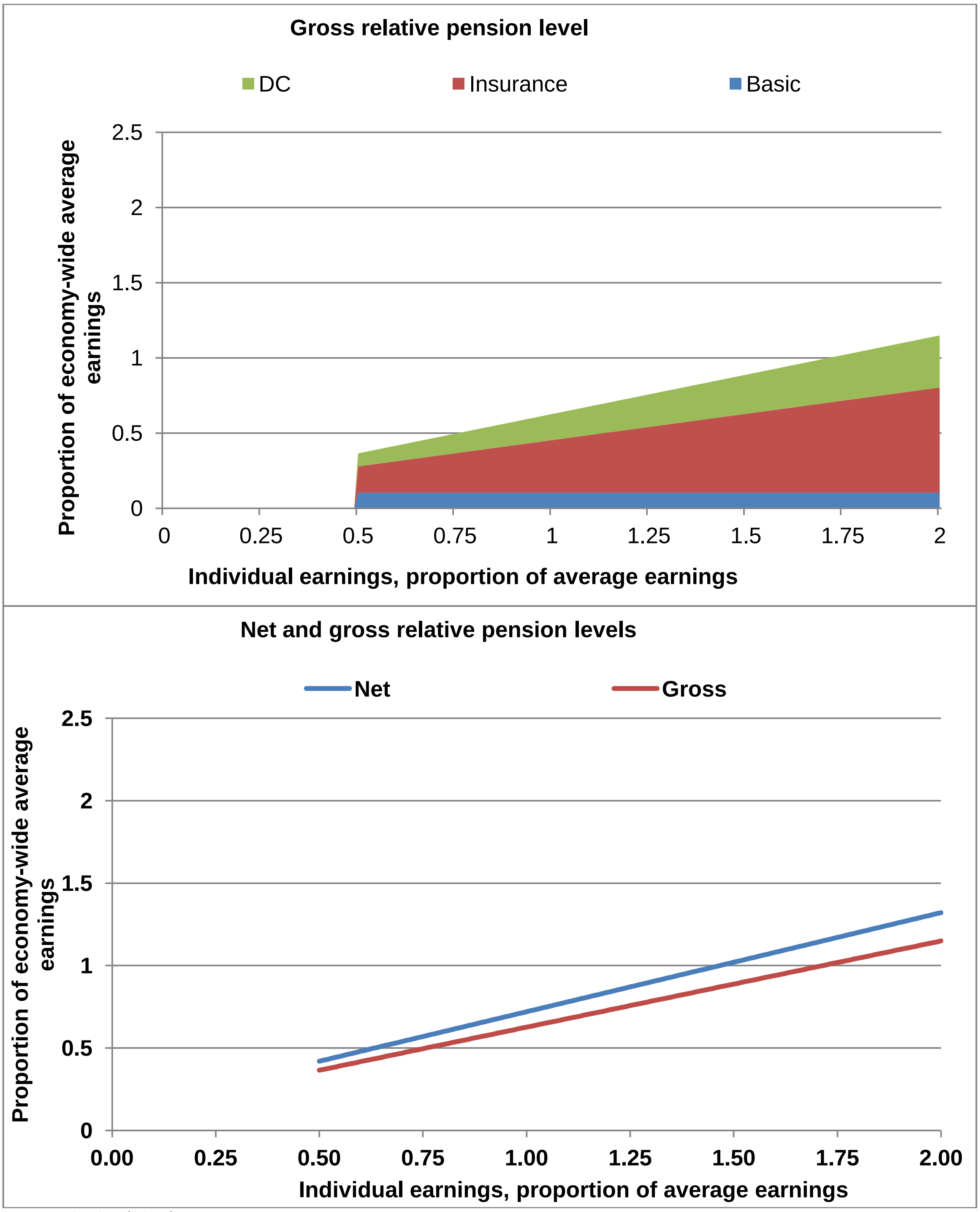


Source: OECD (2011)

Most pension systems which provide a flat rate benefit or provide some kind of protection for those with the lowest incomes in retirement will tend to be redistributive in nature. This entails that low income earners usually have the highest replacement rates and PAYG systems often play a larger role in their retirement income. This less favourable situation for high wage earners is common in most OECD countries and the same patterns can be observed in the modelling results of the Russian Federation above. The results reflect the progressive nature of the formula of pension benefits. For high income earners a more direct link between contributions and benefits is a key element to receiving higher replacement rates and the role of private and funded pension saving is more pertinent in their retirement income.

It is, however, important to note that although replacement rates fall in line with increasing incomes, high income earners in the Russian Federation can still expect to receive higher retirement incomes in absolute terms, as seen in the modelling results for the pension level below.

Figure 12. Pension benefit modelling: Gross and net pension level for the Russian Federation



Source: OECD (2011)

4.4 Addressing the need to improve financial sustainability

Financing the deficit of the PAYG system

The Russian pension system is currently a mixed system. The contribution rate is nominally set on the basis of the system being a DB PAYG scheme. Theoretically, the contribution rate is set so that the revenue collected equals the sum paid by the fund to benefit recipients. In reality, the pension system has been in a constant state of flux since the first reforms of the late 1990s. The system's parameters have changed substantially over the course of the last decade. For instance the mandatory contribution rate was 20% before 2011, was raised to 26% that year, and was reduced to 22% in 2012. A further contribution of 2.9% of wages is paid to the social security fund where the annual compensation is more than the maximum the employer must pay an additional 10% insurance contribution into the PFR as of 2012. Additionally, 6 percentage points of the contributions have been diverted to the mandatory funded component for individuals born after 1967.

The mandatory contribution rate, at 22% and is paid by employers up to an annual income of RUB 586 000 (USD 18 773). Above this ceiling additional 10% contribution rate is applied since 2012, which increases employer costs for employees with higher salaries. These additional contributions do not lead to higher pension accruals for the employee but are added to a pool of funds collectively used to pay base state pensions and other benefits. This is relatively high by OECD standards, although some occupational groups benefit from much lower contribution rates. There are different contribution categories with pension fund contributions for these groups ranging from 18% down to 8%. These groups include those employed in agriculture, IT organisations, higher education, media organisations and those paying the simplified tax. Contribution rates for the past few years are shown in table 3 below.

Table 3. Mandatory contribution rates to the pension system of the Russian Federation

For individuals born before 1966 or earlier

Year	Salary range in RUB	Basic part	Insurance part	Funded part	Total contribution rate	Maximum possible contribution
2009	from 0 up to 280,000	6.0%	14.0%	0.0%	20.0%	92,800
	from 280,001 up to 600,000	6.0%	5.5%	0.0%	11.5%	
2010	from 0 up to 415,000	Basic part merged into insurance	20.0%	0.0%	20.0%	83,000
2011	from 0 up to 463,000	Basic part merged into insurance	26.0%	0.0%	26.0%	107,900
2012	from 0 up to 512,000	Basic part merged into insurance	22.0% and10% of a salary over 512,000	0.0%	22.0%	112,6400 and10% of a salary over 512,000
2013	from 0 up to 568,000	Basic part merged into insurance	22.0% and10% of a salary over 568,000	0.0%	22.0%	124,960 and10% of a salary over 568,000

For individuals born 1967 or later

Year	Salary range in roubles	Basic pension	PAYG scheme	Funded defined contribution scheme	Total contribution rate	Maximum possible contribution
2009	from 0 up to 280,000	6.0%	8.0%	6.0%	20.0%	92,800
	from 280,001 up to 600,000	6.0%	3.1%	2.4%	11.5%	
2010	from 0 up to 415,000	Basic part merged into PAYG	14.0%	6.0%	20.0%	83,000
2011	from 0 up to 463,000	Basic part merged into PAYG	20.0%	6.0%	26.0%	107,900
2012	from 0 up to 512,000	Basic part merged into PAYG	16.0% and10% of a salary over 512,000	6.0%	22.0%	112,640 and10% of a salary over 512,000
2013	from 0 up to 568,000	Basic part merged into PAYG	16.0% and10% of a salary over 568,000	6.0%	22.0%	124,960 and10% of a salary over 568,000

Note: The threshold amount is subject to annual indexation in line with growth of average earnings.

Source – PFR and information provided by the Russian authorities

Kudrin and Gurvich (2012) argue that such high contribution rates may be discouraging to the labour supply and damaging the competitiveness of the Russian economy. Furthermore, despite the relatively high contribution rate, the pension system has increasingly been receiving subsidies from the general budget to cover the growing deficit in the PAYG systems.

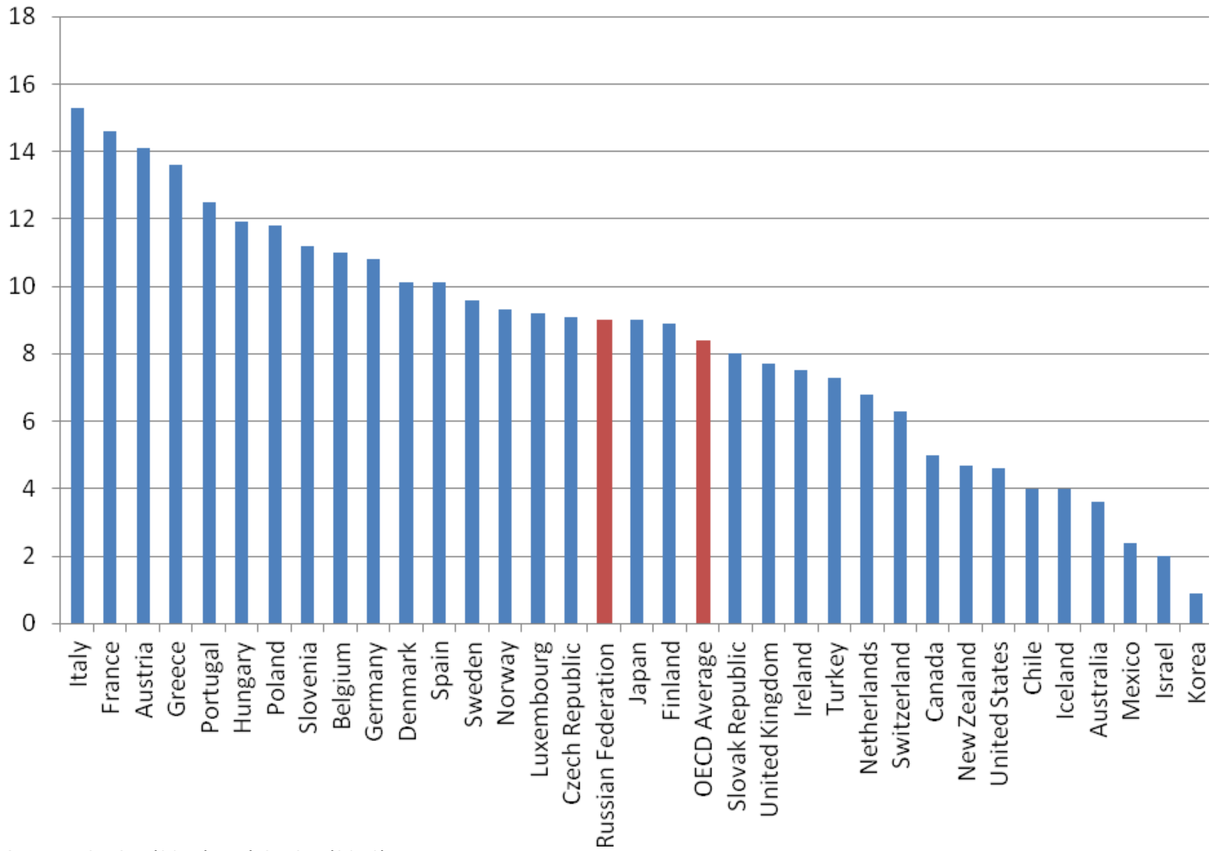
More than 10 million employers pay social contributions to the PFR for more than 72 million employees. There are nearly 40 million persons receiving pensions through the PFR today. More than 18 million Russians - veterans, the disabled and other categories of people also receive monthly payments and additional monthly financial support via the PFR. Over 68 million people have an individual account as part of their labour pensions.

The draft budget for the PFR in 2013 estimates expenditure amounting to RUB 6 088 (USD 201) billion and income of RUB 6 343 (USD 209) billion of which only RUB 2 960 (USD 95) billion comes from contributions. The total amount of contributions is, however, insufficient to balance the system financially and so the government has to make increasing transfers from general revenues to cover the deficit.[72]

[72] Source: PFR, http://www.pfrf.ru/index.php?chapter_id=100508&data_id=56914&do=view_single

The financing problem is worsening over the years. The share of general budget financing of pensions has increased from 24% of total pension expenditure in 2007 to 46% in 2011. The pension system is rapidly chipping away at the government's fiscal resources, which could have major implications for the country's ability to invest in other social services such as education, health and infrastructure. At 8.7% of GDP in 2011 (see figure 12), Russian public pension expenditure is already above the OECD average and has increased rapidly in recent years, from a level of 5.1% in 2007.

Figure 13. Public expenditure on pensions as a percentage of GDP, Russian Federation and OECD countries, 2011



Source: OECD (2011) and OECD (2012)

The informal economy and contribution collection

Russia has a significant shadow or informal economy whereby people work in organisations that are outside the formal taxation and social security net. In 2011, according to the Russian Federal State Statistics Service, the informal economy amounted to 16% of the country's gross domestic product. Data showed that some 13 million people, or 17-18% of the economically active population, are employed in the shadow economy. Even after allowing for the lower wages likely to be declared by those currently in the informal sector, it appears that possibly up to BRUB 350 (BUSD 11) in revenue was being foregone through social insurance evasion in the shadow economy.

It is widely acknowledged that employers under-report the earnings of their employees. Estimates of the extent of this practice are subject to a high degree of uncertainty, but this could be as high as 35-40% of aggregate earnings (or about 11-12% of GDP). This seriously compromises contribution revenues. To avoid overburdening employers, the PFR will hold joint inspections with other relevant public agencies (such as the tax authorities or the social-insurance fund). However, the PFR lacks instant access to the databases of these and other public authorities, and vice versa.[73] A significant increase in compliance with contribution rules is difficult to expect in the Russian Federation in the near future unless policy moves to address these access issues, but there is some indication that the number of participants in pension funds is increasing rapidly as the system matures.

The rate of return used to credit the NDC component of the Russian pension system is proportional to the increase in pension contributions collected by the PFR. Whilst this is a valid way of "crediting interest" it is impacted upon by the effectiveness of contribution collection. It is generally agreed that contribution collection has been ineffective and now the PFR has reportedly with some success increased the level of contribution collection. Return rates are still likely to be at or just above inflation giving a possible small positive rate of return.

Early retirement and special pension privileges

Another part of the explanation for the failure to reach a financial balance in the PAYG component of the pension system are the wide-spread early retirement schemes and the special, low contribution rates for certain occupations.

Special pension privileges and retirement at an early age are some of the features that threaten the financial sustainability of the pension system. These features have not been retained in most CIS countries' pension reforms. The system of pension privileges basically allowing for early retirement incorporates what in most OECD countries are provided through occupational pension schemes. There is generally little debate about the need to provide pensions for employees who work in difficult working conditions that lead to impaired lives or to those in employment categories which are in demand. Supplementary pension benefits act as part of the overall employment package in OECD countries and many post-Soviet countries. These are paid for by additional contributions over and above the compulsory contributions to the state pension system. In Bulgaria, for instance, privileged pensions are financed by employer contributions to a separate pension scheme only open to those with pension privileges. In Poland, privileged pensions were effectively revoked during the 1999 pension reform.

These types of pensions in most OECD countries are occupational pensions. Governments as employers have the right to provide supplementary pensions to attract and/or retain employees. In OECD countries, government occupational pension schemes are often unfunded DB schemes as is the case in Russia. There is a trend, however, to account these pension liabilities in the government accounts and some countries such as Australia and the Netherlands have moved to prefund these schemes.

The need to delay retirement

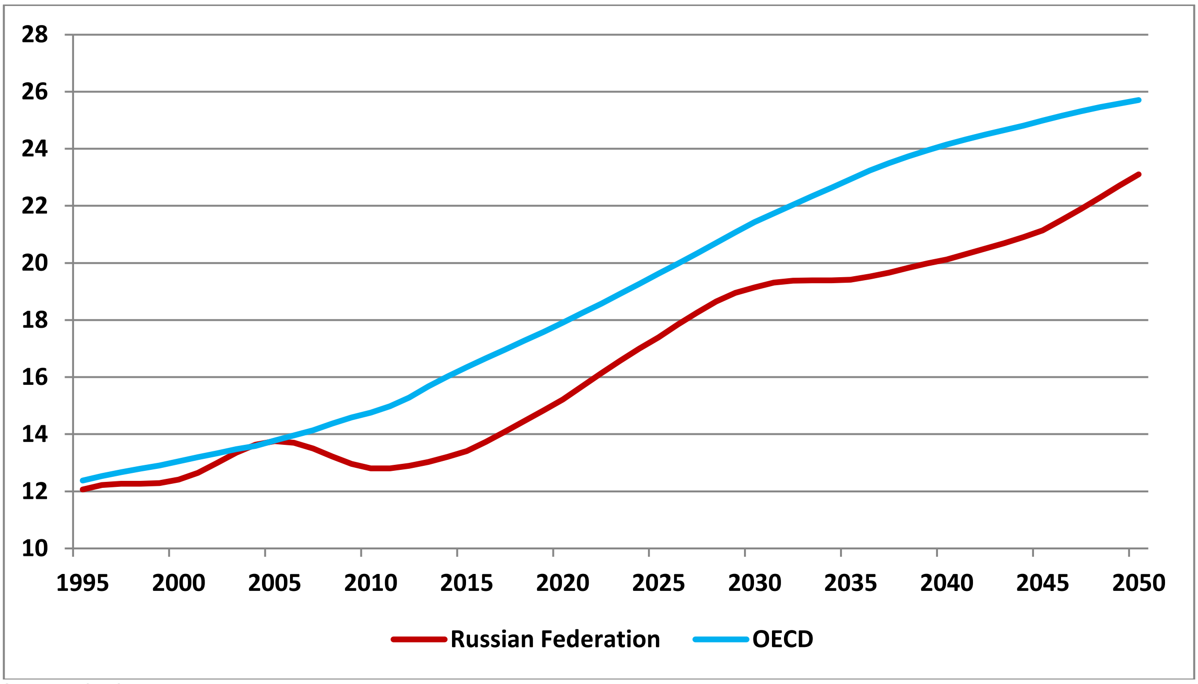
By OECD standards, the Russian Pension System is still one of the most generous in terms of when a pension can be received. Subject to a person having 5 years of contributory service a male can receive a labour pension from 60 and a female from age 55. Social pensions are paid from 65 for men and 60 for women. To date there has been no increase in the age at which a labour pension can be paid. An increase in the retirement age (or in the minimum contribution period required for a full pension) will be essential to ensure the long-term financial sustainability of the system.

The low age at which early retirement pensions can be retrieved adds to the problem. However, a reform of occupational pension arrangements requiring employers to meet the cost of early retirement schemes should positively affect retirement ages. Increasing the male and female retirement age would also reduce an employer's occupational pension cost since these early pensions would be paid at a later age.

[73] OECD(2011)

All the statistics point to the need to increase the effective retirement age. While currently, life expectancy at birth is low by OECD standards, the projected increases in longevity, combined with relatively low fertility rates, will lead to an aging of the Russian population in the coming decades. The old-age dependency ratio (the ratio of the population aged 65 and older to those aged 20 to 64) is projected to nearly double between 2010 and 2050 (see Figure 13).

Figure 14. Old-age dependency ratios in the Russian Federation and the OECD: historical and projected values, 1995-2050



Source: OECD

According to Eich F. et al (2012) very slow increases in the male and female retirement age to 65 by 2050 could see the percentage of GDP spent on pensions in 2050 drop from 16.3% if there was no reform to 9.8% under the scenario proposed by the authors.[74] The effects would be considerable even if an increase in the retirement age does not have a significant initial impact on the PFR budgetary situation. If standard pensionable ages could be increased to 62 years, the number of pensioners in 2025 would be around 30 million, rather than 36 million on current policies. This would also increase the number of workers contributing to the system. Both developments would improve the scheme's finances which, through the link between benefits and the growth in revenues per contributor, would also enhance the value of pensions.[75]

4.5 Assessment of the partial reversal for the Russian pension system

Typically, there are two main types of mandatory funded pension systems; those that are set up with new pension contributions (complementary) and those that are financed with contributions that have been diverted from the PAYG system (substitutive). Of the fourteen OECD countries with mandatory contributions to funded pension systems, only six are of the substitutive type. The mandatory funded

[74] Eich F. et al (2012)

[75] OECD (2011)

systems in these six countries are also all DC schemes. Russia's mandatory funded system is also of this type (substitutive, DC).

Such systems create long-term fiscal gains in terms of lower public pension expenditure at the expense of a short-term revenue shortfall in the PAYG system. This is because a part of the contributions used to finance social security pensions are transferred to the funded pension system. Typically, the fiscal benefits from such reforms are not immediate as the reforms typically pertain to new contributions and the benefits earned through past accruals in government financed PAYG systems still need to be honoured.

One concern for policy makers with such reforms pertains to participation in the DC system. In most countries, a choice to participate in the DC scheme was given to individuals. In many cases, certain incentives were also given for participation. The magnitude of contributions transferred into individual accounts was often larger than what had been budgeted, requiring the resources to pay for current benefits from the pay-as-you-go systems to be found elsewhere. OECD calculations suggest transfers worth between 1.1% and 2.3% of GDP in six countries, with a significantly lower figure for Romania. This "transition cost" of money diverted from the public purse into individual accounts in selected OECD and non-OECD countries is shown at the right-hand side of table 4.

Table 4. Transition costs and pension fund assets, 2010

As a % of GDP

	Accumulated assets in private pension funds	Transition cost (contribution revenues diverted to individual accounts)
Estonia	7,4	1,1
Hungary	14,6	1,2
Poland	15,8	1,7
Slovak Republic	7,4	1,2
Bulgaria	5,7	..
Latvia	..	2,3
Lithuania	..	1,1
Romania	0,9	0,4
Czech Republic	6,3	
Slovenia	2,5	

Note: There is no transition cost for the Czech Republic or Slovenia because they have not introduced individual accounts.

Source: Statistical annex, Table A18 and OECD (2011) "Pension Markets in Focus", Issue No. 8, July, OECD, Paris; Égert, B. (2012), "The Impact of Changes in Second Pension Pillars on Public Finances in Central and Eastern Europe", OECD Economics Department Working Papers, No. 942, OECD Publishing, Paris, Table 1.

A major risk to such reforms is the under-financing of the PAYG systems, which may lead governments to unwind the DC schemes if this subjects Government budgets to major fiscal pressures. In some cases, these reversals are meant to be temporary. In Estonia, for example, contributions to private plans were suspended in 2010, reduced to 2% in 2011 and returned to 4% in 2012. Similarly, Lithuania cut the contribution rate from 5.5% to 2% in 2010 before returning it to 5.5% in 2011. In both cases, the contributions that were channelled to defined-contribution plans were diverted to the public pension scheme. In Poland, the reversal was partial: the contributions going into individual accounts were cut from 7.3% to 2.3% from 2011 and are to be increased to 3.5% from 2017. Latvia's policy was a mix of these approaches. The 8% contribution to private plans was reduced to 2% in 2010, but increased to 4% in 2011 and is 6% from 2012 onwards. This is a partial reversal of the original plans, which would have seen a 10% contribution rate from 2010. Romania postponed the intended increase in contributions for 2010, but in 2011, the phased increases (eventually to 5%) were resumed, albeit at a rate below the original plan.

In Hungary, the reversal of the systemic reform is complete and permanent so all contributions were reverted to the public scheme from 2011, although a temporary suspension had already been implemented in November 2010. The change is also, in effect, retrospective. The assets in private pensions were appropriated by the government and all invested contributions were diverted to the PAYG system. Individuals' investment losses or gains were crystallised and the funded system when the funded system was shut down. In other cases of temporary or partial reversal, balances in existing accounts were left intact. This is, therefore, by far the most dramatic change in retirement-income policy among these countries. Argentina is the only other country to nationalise private-pension assets in this way.[76]

New legislation is currently being discussed in the Russian Federation that can significantly change the Russian pension system. Under the possible legislation the contribution rate for those persons who have their contributions invested in the PFR will be reduced to 2% from their current 6%. The difference (4%) will be paid into their NDC account instead.

Individuals who by 1 January 2015 have either chosen a private asset manager or a NPF or who are currently in such an arrangement and do not change to the state pension fund or the state asset manager will be allowed to retain their 6% contribution with a private asset manager or fund. The option is therefore to continue to have either a 6% accumulation invested privately or have a 2% component invested with the VEB with the 4% difference being added to the existing 16% contribution rate paid to PAYG NDC scheme. The proposal provides what appears to be a once-only choice open for current participants in the scheme up to January1, 2015.

An important issue to consider is if a similar choice is extended to new entrants. If no choice is suggested 20% of their contributions are automatically allocated to the NDC component and 2% will be paid to the mandatory funded scheme and invested on their behalf by VEB. Alternatively this could be offered as a default option unless they choose to shift the asset management of their contributions to a private asset manager or to have their contributions paid to a NPF.

Another issue to consider is whether the shift of funds pertains to those that have already been accumulated and invested or only to new contributions paid into the system as of the reform. Shifting already accumulated funds either to the NDC system from the VEB or from the VEB to a NPF or private asset manager and vice versa means that investments would need to be liquidated prematurely, and the performance accumulated since 2002 would be crystallised.

Impact of the reversal on the government budget

The proposal from the government to reduce the cash flow going to the funded DC system also reduces the amount of budget subsidy needed to meet the difference between contributions collected and benefits paid out in the NDC PAYG system. The 4% paid to the NDC system would be an alternate source of finance to meet this expenditure gap.

1 January 2013, the VEB managed 78% of accrued pension assets from the funded part of the labour pension.[77] This entails that a significant amount of the contributions that would otherwise be directed to VEB will be retained within the PFR and the Government budget. The government can increase the cash resources it has available to reduce the PFR deficit even if only to a limited degree. For the industry there

[76] OECD (2011)

[77] Ministry of Economic Development of the Russian Federation

will continue to be the opportunity to grow funds in the capital markets, even if to a lesser extent than previously. The government estimates that the new pension bill will cut the annual deficit of the PFR by 30-35%. However, this measure will have only a temporary effect and does little to resolve the long term problem of funding the pension system deficit as the number of pensioners begin to exceed the labour force.[78]

The PFR reports as of 2013 56.5 million people accumulate pension savings from the mandatory funded scheme in the VEB, 549 thousand people save in the private asset management companies and 20 million people in NPFs.[79]

In 2012, PFR regional bodies received nearly 8.8 million applications for the transfer of pension savings from one organization to another which is almost double the amount of applications received in 2010. Of the applications where a positive decision was taken, 4.8 million people transferred their pension savings from the PFR to an NPF. In comparison a little over 150 thousand people returned from the NPF to the PFR, and almost 16 thousand people changed management companies. 1 million 341 thousand people have moved from one NPF to another. [80] Given a final opportunity to transfer to a NPF there is a strong possibility this trend will continue to increase more rapidly.

The behaviour of individuals up until 2015 may reduce the funds that can be diverted to the NDC system. This creates some uncertainty with regards to the budgetary impact of the reform. The behaviour of individuals will also be subject to the financial incentives that the government may provide to swing public choice.

The long term implications of a shift of contributions to finance the PFR deficit also need to be considered. OECD simulations suggest that the Hungarian pension reversal reduced the central government deficit and debt only temporarily, mainly because of Hungary's costly defined-benefit PAYG pension scheme.[81] In the Polish reform as part of the recent weakening of the funded DC pension pillar, the Polish government also discussed the possibility of introducing a tax break on savings going to the voluntary fully-funded pensions. Despite this type of reform, replacement rates may become unsustainably low from a social and political point of view, which in turn would increase spending to top up pension benefits below minimum pensions. If the extra costs of tax breaks and the additional costs of social pensions are accounted for, the pension system's deficit becomes higher around 2050 after the reform, even though permanent gains in debt reduction remain due to the transfer of upfront savings.[82]

As a shift of contributions from the funded DC scheme to the NDC scheme can be perceived as a hidden increase in taxation, there could also be additional incentive for the informal economy to continue avoiding paying taxes. In this case revenues collected by the government might appear to be lower than if the current system were maintained.

Furthermore, less funding of retirement savings will lower the availability of long-term capital for investments on the domestic market. This in turn can affect the pace of economic development in the Russian Federation, which can have fiscal spill over effects.

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[78] Égert (2012)

[79] Source: The Pension Fund of the Russian Federation, http://www.pfrf.ru/index.php?chapter_id=100508&data_id=59813&do=view_single

[80] Source: ibid

[81] OECD (2012)

[82] Égert (2012)

Impact on the asset accumulation and membership projections for the VEB

One issue to be considered is what happens to the existing assets invested in the VEB and to the 2% of contributions that will be accumulated there in the future. A long-term accumulation at the rate of 2% will achieve very little in terms of retirement benefits. These benefits will be further reduced by charges and based on past investment returns likely to be further eroded away in terms of real wage growth. Changing the investment guidelines for the VEB fund can facilitate it to recover past losses.

Another key factor affecting the amount of assets in the VEB is how many people who currently have their accumulation with VEB will decide to transfer to a NPF by 2015. This is naturally unknown but there is a possibility that an increasing number will opt to make an active choice to do so when given this final opportunity. What is known is that from 2015 the number of individuals that have chosen to have their accumulations managed by the VEB will increase if new entrants to the pension system will not be able to have their contributions paid to a NPF. Based on the estimates of the growth in working age population in Russia, it is possible that the numbers of new pensioners in coming years will exceed the number of new entrants to the workforce thereby reducing the annual increase in asset value in the future.

The wage profile of the individuals that have chosen to have their accumulations managed by the VEB also affects asset accumulation. Those remaining in the default fund tend to have lower incomes. It is therefore possible to assume that the wage level of those with accounts with VEB would be lower than those who choose a NPF. Furthermore the asset accrual is also affected by the fact that lower contributions will be paid into the VEB.

Impact on the asset accumulation and membership projections of NPFs

It is expected that already invested capital will be allowed to remain in the funded scheme, unlike in Hungary or Argentina where there was a complete nationalisation of the funded capital. In this sense, the reform will be more gradual. Accumulated funds are not abruptly drawn from pension funds and gives the industry time to adjust to the new levels of contributions that will be paid into the system rather than what may have been previously expected. The delay of the introduction of the implementation of the reversal reform until January 1, 2015 also gives the industry time to prepare its case to both retain existing contributors and attract new contributors.

As established in the previous section, there is a possibility that more participants in the mandatory funded scheme will take the opportunity to move their assets to private providers during 2013 when this possibility has been opened to them. In 2004, when participants were first given a choice to invest contributions in the VEB or the private sector it is reported that only 4% chose the private sector. In 2011, the PFR reported that there was a 25% increase in the number of people who moved from VEB to the private sector. Over the last 10 years, many of the fears that participants have had regarding their accumulation being privately invested have dissipated. This experience can be positively used by the private sector over the next 12 months to attract participants to invest privately.

It can also be assumed that older participants in the funded DC scheme who are closer to retirement will most likely choose to have their contributions paid to the VEB. In this sense, the members in privately managed provision would tend to be younger. Participants who choose private pension arrangements for the mandatory accumulation also tend to be those with higher and more regular incomes. This has an impact on the asset accumulation of the NPFs.

This also involves that the members of the NPFs and private asset managers are more likely to be better informed about the choice they are making. For the industry to fully reap the advantages of this client base, providing them with complete information regarding their investments can be an important marketing tool. It can also be worth investing in information and marketing tools directed towards participants that would typically retain their accumulations with the VEB. At the same time, greater emphasis is put on the need for proper financial education and proper communication by the industry and the need for vigilance in that plans should not be sold inappropriately to contributors.

One aim of the shift to a funded pension system was to support the growth of Russia's securities markets and boost the functioning of pension funds so that they can engage in long-term financing activities. In the view of capital market proponents, the shift of contributions to the NDC system implies weaker and slower development of the financial sector in Russia. This decision will only gradually increase this percentage it will not necessarily see it reduced given that already accumulated funds are retained in the system.

Impact of the reversal for current and future pensioners

The legislation passed in December 2012 should have no effect on existing pensioners. In theory, it may in fact actually benefit them since the reform it is designed to reduce the cash flow going to external investment and increases current the funds within the PFR and the State Budget. This allows for the possibility to give increments to current pensioners. It however, pertinent to note that increases in benefits in the near future will most likely be difficult to finance given the current deficit in the PFR budget.

For future retirees the reform has a more significant impact. How much money a person has to retire on will be influenced by the choices an individual makes in the accumulation phase. More specifically the issue at hand is what differences will there be at retirement between a 20% accumulation in the PAYG scheme plus 2% from VEB compared to 16% from the PAYG component and 6% from a NPF. The differences will amount to the factors that come into play in an accumulation. These are the rate of contribution, the amount deducted for administration, the amount deducted for asset management charges, the interest rate earned on the net contributions the indexation of benefits. The main element affecting a person's pension during the payout phase is the factor that will be used to convert the accumulation to an annuity. The extent of the impact is also affected by the person's income level and how close they are to retirement.

There are different investment restrictions applying to the VEB portfolio when compared to a NPF (please see section 4.7). The investment portfolio will have a significant element invested in domestic equities, international equities or a combination of both before we consider other investment alternatives such as property, commodities or even precious metals. Given the lack of opportunity to invest in these types of assets, subject to market performance, it can be expected that over the life time of a person participating in the pension system the VEB return will underperform compared with the returns achieved by an asset manager with greater investment opportunities. However, the higher investment returns in NFPs can quickly be eroded through product charges that are above international standards. (Please also refer to section 4.6).

At the same time by investing in an NPF the individual takes on a bigger investment risk for a greater part of their total pension contributions. Additionally, the costs and fees for a riskier investment will typically also tend to be higher and the returns on contributions will be lower unless greater investment profits can be made.

Participation in a private pension arrangement should be better value for a significant number of participants in the funded DC plan, especially for those with higher incomes who can more easily bear investment risks. Real rates of interest in private pension funds should be higher than those in the notional defined contribution fund where the interest rate is based on the level of contributions collected by the

PFR. Generally speaking, high income earners are also more likely to make added gains from a funded scheme with a more direct link between contributions and benefits than in a redistributive scheme.

At the other end of the spectrum there are those for whom it may be more advantageous to have their accumulations in the NDC scheme even if moving from a private arrangement to the NDC scheme would entail freezing any investment losses that they have incurred since becoming a participant in a private arrangement. For low income workers the charges of private funds will more easily erode the benefits of private asset management. An important impact to consider is the difference in the expected returns in the NDC system as compared with those in the funded DC system. Lower returns in the NDC system will lead to lower replacement rates and benefits. This can also result in a greater dependency on the social pension, especially for low income workers, which can erode the strengthened link between contributions and benefits that individuals benefitted from in the 2002 reform. The incentives to work and contribute to the pension system may also therefore be further weakened.

The private funds should address their efforts of conversion to those who are currently in the default fund but would be advantaged by the better performance of the NFPs even if it entails crystallising past investment losses in the VEB.

Individuals who will be participating in the system for a longer period of time before retirement will be able to overcome the investment losses of the past years more easily. For those who were born close to the cut-off date of 1 January 1967, regaining the investment losses can prove to be more difficult and they may struggle to build up an adequate replacement rate from the funded scheme. In this sense choosing the option where a larger accumulation is made to the NDC system may secure a better pension for older cohorts.

The question facing these cohorts is if they should take the risk that a NPF or private asset manager will enable them to get slightly better investment returns than opting for the VEB fund whose more conservative investment will reduce the risk of making further losses in the future but will do little to make up for the losses of the last 10 years. Those in older cohorts choosing to make the switch from the VEB to a NPF or vice versa need to consider whether or not to realise the losses that have occurred over the past 10 years and to take a risk that investments during the accumulation years up to retirement can provide a higher retirement income. Introducing life-cycle funding where less exposure to financial risks is offered to those closest to retirement could also be an option.

A worrying aspect of the choice facing participants is their ability to make an informed choice based on unbiased information and being able to acquire the necessary knowledge in a short period of time. In this sense, allowing individuals to choose between having their contributions invested in the NDC or funded DC schemes even beyond 2014 would be to take the members interests into consideration. While this may add to the uncertainties pertaining to the finances of the schemes, it allows individuals to diversify their retirement savings in a way that better suits their circumstances. It can, however, be important to limit the frequency of switching between schemes even from the individuals' point of view in order to allow for stability in the accrual and investment regimes and limit costs.

The government typically has a vested interest in consolidating contributions to the NDC scheme whereas private asset managers and pension funds have an equally vested interest in getting as many people as possible to choose to participate in a NPF. The NAPF can play an important role in insuring the unbiased information and advice is provided to participants. Individualised information will also play a bigger role for members. Furthermore, the NAPF and supervisory authorities have an important role in informing the public on parameters that typically should affect their choice, not in the least with regards to investments and costs. Furthermore, the regulator can have an important role to play in exercising its powers to ensure that applications to participate in the VEB or NPF are treated uniformly and justly.

4.6 Assessing the design of the pay-out phase in the mandatory funded DC Scheme

The design of the mandatory funded DC pension scheme needs to be coherent internally and with other parts of the pension system. The design needs to be fully considered including how pension payments will be calculated and provided to those who are in the funded component of the mandatory accumulation scheme. In 2011, the Russian Federation formally adopted legislation with regards to the design of the payment of benefits from the mandatory funded DC scheme. The first payments in accordance with the new legislation were made in 2012. The legislation covers benefit design and indexation but also guaranteeing payment obligations.

Assessing the design and indexation of the benefit payments

Designing payments

The new legislation allows for three basic types of payments to be made by the PFR and NFPs: (1) One-off payments, (2) fixed term payments and (3) monthly payments from the mandatory funded DC pension.

The one-off payments can be paid to those individuals who may not have the right to receive an old-age labour pension due to a lack of fulfilling the minimum accrual period or if their accruals from the funded DC pension are small. Typically, lump-sum distributions should be limited to a small part of the accumulated balance at retirement (e.g. at most 20%), except perhaps for very small accounts.[83] This solution allows individuals to be reimbursed a minimum of the contributions they have paid into the system without engaging in drawn-out and costly administration of small amounts.

A fixed term payment with a minimum payout period of ten years can also be made after the right to the labour pension has been established, typically at the age of 55 for women and 60 for men. Fixed term payments can be made for accruals accumulated through supplementary contributions made to the mandatory funded DC scheme by an individual, for voluntary pension contributions made by an individual’s employer or through the joint financing scheme. The total fixed-term payment is typically calculated as a sum of the accumulated funds of the individual divided by the number of months for which the payment is being made. This type of so-called phased or programmed withdrawals provide more flexibility and liquidity for individuals and with the ten year minimum also provide some protection from longevity risks. The new legislation in the Russian federation also allows for payments to be directed to survivors in the case of the death of the beneficiary.

Payments for the mandatory funded DC scheme are made to insured individuals after the establishment of their accrual of the right to be allocated the old-age labour pension. The accumulated capital from contributions and investment returns is converted into a stream of monthly payments using the same life-expectancy factor as the notional accounts scheme and is set at 228 months (19 years) for 2013. Draft law indicates an increase of one year per year for the conversion factor for 2014 and 14 and 2015. Thereafter, the conversion factor is to be determined annually on the basis of official statistics for life expectancy for recipients of this part of the labour pension. In general, unisex longevity tables are used by pension funds. Given current pensionable ages for men and women, the first old-age pension benefits based on a full record of contributions will be made in 2022. Remaining accumulations after the death of a beneficiary are redirected to the PFR.

The details of the latter should advantageously be based on frequently updated longevity tables. This should help better address longevity risk which is the risk that future outcomes in mortality and life

[83] OECD (2012)

expectancy will turn out higher than expected and accounted for. Longevity risk affects individuals, pension funds, annuity providers and governments. As a result of the uncertainty about future mortality and life expectancy outcomes, individuals risk outliving their resources (assets accumulated to finance retirement) and being forced to reduce their standard of living in old age. Pension funds, governments and annuity providers risk having to pay benefits for a longer period than reckoned in their actuarial assumptions, which they may not be able to afford. Furthermore, if the monthly payments from the mandatory funded scheme are designed as a fixed-term payment and pay-out products for those that may expect to live longer than the determined pay-out period should be considered.

Indexation of payments

The fixed-term payment and the monthly payments for the funded DC schemes in the Russian federation are to be adjusted annually in accordance with legislation. The same principle for the adjustment is applied to both types of payments. Once the disbursement of these types of payments from the funded system has commenced, the remainder of accumulated contributions are invested in a separate fund and are subject to the investment regulations placed upon these funds. The fixed term payment and the pension benefit from the mandatory funded DC scheme are adjusted based on the remaining value of accumulated funds and the investment performance of the fund. If investment losses incur benefit payments will not be adjusted upwards until the losses have been recovered, thus leaving a part of the investment risk upon individuals even during retirement.

In this sense, programmed withdrawals and the type of variable annuity offered give access to returns from capital market investments that traditional annuities fail to provide. However, under programmed withdrawals there again the investment risk remains as does the risk that the capital will be completely exhausted while the retiree is still alive.

The structure of the payout phase may need to include protection against inflation, although this requires the issuance of long term inflation-indexed bonds by the government in sufficiently high quantities. In some countries retirement income from DC pension plans may not always be indexed to inflation. The lack of inflation indexation could reduce the purchasing power of retirement income by as much as one third over a 20- year period. To avoid such important losses in purchasing power at old ages, retirement incomes from DC plans need to be indexed to inflation at a minimum. Unfortunately, indexing retirement income to inflation requires a bigger saving effort. For example, contribution rates need to increase a little over 1 percentage point over a 40-year contribution period to have benefits indexed to inflation given a 20 year life expectancy at age 65, according to OECD calculations.[84] Country practices on programmed withdrawals vary from simply imposing a minimum payment requirement to setting both minimum and maximum limits, through to highly prescriptive formulas that leave no discretion to the individual.[85]

Draft legislation in the Russian Federation is suggesting the need to provide some protection of the accrued rights of insured individuals during the payout phase. The legislation intends to provide protection for individuals for the nominal amount of paid contributions in the case of weakened finances of a pension fund. This guarantee covers individuals participating in the mandatory funded DC scheme regardless if they are participating through a NPF or the PFR. In this case it is important to consider the costs of the guarantee and the need to set up proper supervision determining the protection to individuals in any case of wrong doing on the part of the pension funds or asset management companies.

[84] OECD (2012)

[85] Antolin et al (2008)

Administering the pay-out phase

Lump sums and programmed withdrawals (or gradual drawdowns) are generally provided by pension funds in most countries. However, with regard to annuities, providers vary from insurance companies, pension funds, financial intermediaries to centralised annuity funds. While pension funds remain the main providers of the life annuity in Brazil and several CEE countries, this practice is relatively rare. The use of a state or other centralised annuity provider is even less common, although it has been discussed in Bolivia, Poland and Ireland. There is, in practice, a state annuity provider in Sweden, where the actual accumulated contributions in the mandatory DC part of the pension system are combined with the more dominant notional DC account to determine the individual's overall retirement pension income payable from a single source.[86]

New legislation in the Russian Federation requires that the accumulated value of contributions under disbursement as a fixed term payment or the monthly payments of the mandatory funded part of the labour pension are invested separately and the obligations of the fund to the beneficiary are accounted for separately. NPFs shall transfer the remaining accumulated funds to a management company for trust management, with the purpose of receiving returns on investments that provide the possibility to meet relevant payments. Similarly, the PFR shall transfer funds into a state-owned management company under similar premises.

The investment regulations are quite restrictive and are set out in legislation. Investment costs are to be covered out of the accumulated funds but may not exceed 1.1% of the average value of net assets in the trust management. A state-owned management company can receive remuneration, although not exceeding 10% of the amount gained from the investment, as specified by a government decree. Private management companies will receive their remuneration from the funds from contributory accruals of the insured in accordance to the trust agreement. In case of investment losses the remuneration will be nullified.

Promoting a cost efficient annuity market in the long term

Typically speaking, allowing for an open annuity market allows for a wider range of benefit options for individuals. It also allows for better possibilities to provide individuals with products protecting them against risks for outliving their resources, inflation and interest rates. This type of product could be promoted as a default option for at least the mandatory funded scheme, but the annuity market would need to be well-regulated to provide efficient and beneficial products. As the market develops, so will the possibilities for annuity providers to hedge their liability risks. It is, however, important to avoid over regulating the payout phase as it could deter cost-efficient competition in the annuity market. In particular, pension funds could continue to provide annuities alongside insurers, as long as they are adequately regulated, helping to foster competition.

In practical terms, life insurance companies are normally better prepared than other types of intermediaries to offer life annuities, as they have the technical capabilities, the expertise and, in theory, may be naturally hedged as they may operate in both sides of the market (life expectancy and mortality). In Russia, however, there is a need to modernise the life-insurance industry, with regards to using up to date instruments, especially for longevity measurements, and increasing the level of competence, information and consumer protection.

When pension funds pay benefits in the form of annuities, appropriate prudential funding regulations need to be in place to protect retirement income. These rules need to take into account the risks that pension funds are exposed to as well as the nature of benefit promises and other sources of financing and

[86] Antolin et al (2008)

protection. In particular, pension plan sponsors – and in some cases members – may be ultimately responsible for any pension shortfall, and there may also be collective guarantee arrangements in place in case of sponsor insolvency.

A single entity or state annuity fund could also provide annuities. This alternative is attracting interest among policy makers, though the issue of how to combine a state annuity fund and life insurance companies competing in the same market may need to be assessed further. In this sense, a state annuity fund should not crowd out private financial institutions and it should avoid reducing incentives to develop private markets.

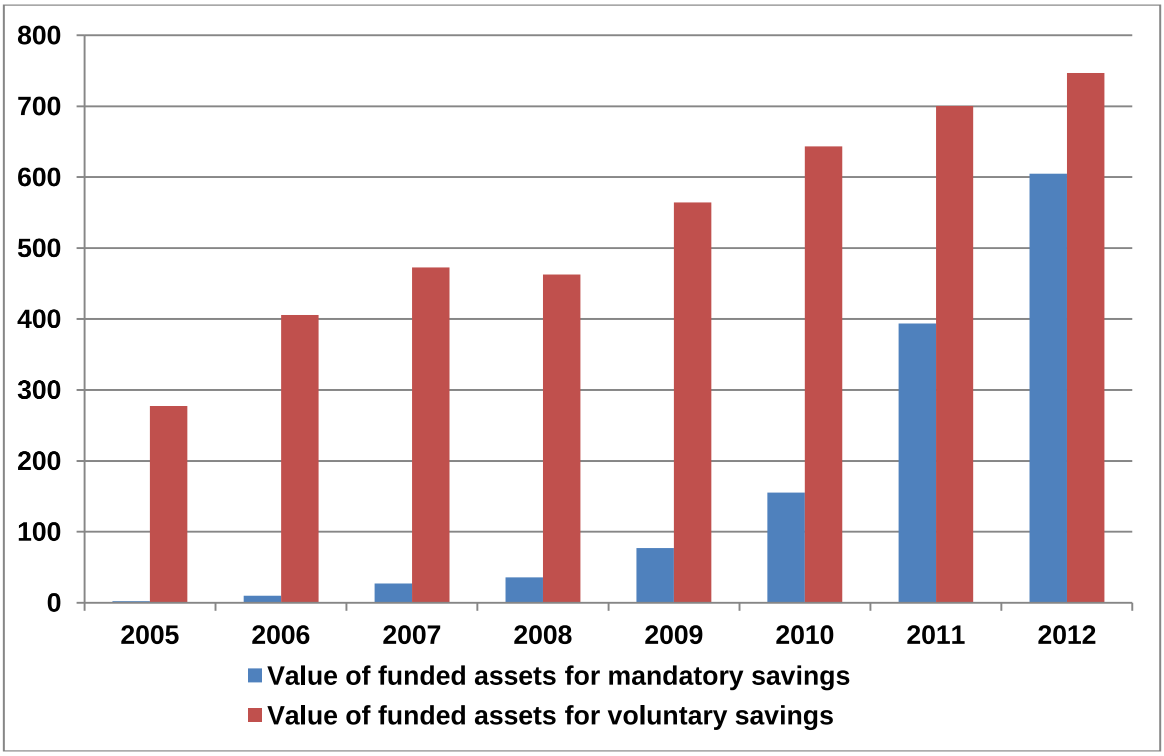
As the annuities market develops in Russia, it will be essential to develop a transparent, central quotation system or other form of information provision to allow individuals to shop for the most suitable deals. Some countries such as Chile have introduced very effective quotation systems that have allowed a major reduction in intermediary fees and facilitated choice by members.

4.7 Addressing challenges in the investment strategies of Russian pension system

Optimising and diversifying investment strategies

Total pension fund assets under private management represent only 3% of gross domestic product, far smaller than the 15% share in Poland.[87] The majority of NPF assets are from voluntary pensions. The assets from voluntary pensions have grown as have those from the mandatory funded pensions. Assets for voluntary pensions decreased somewhat in 2008 primarily due to poor investment performance but increased again in the following years.

Figure 15. The annual development of the NPF assets as of 30 September 2005-2012, BRUB



[87] Source: OECD. For more detailed tables please see Appendix 2.

Source: Ministry of Finance

According to the current restrictions on the investment of the mandatory funded DC scheme contributions directed to NPF's and private asset management companies, a maximum of 65% can be invested in equities, 40% in regional government bonds, municipal bonds or mortgage bonds, 20% in bonds of international financial organizations and 80% in bonds of Russian issuers. There is no limit on investments in Russian government bonds. A maximum of 80% can also be invested in deposits and balances in accounts with lending institutions. No investments are allowed in retail investment trusts, private investment funds or loans of any type (se table 5 below).

This structure is slightly different to those for voluntary pension contributions where no investments in foreign assets are allowed. Russian insurance companies only compete with NPFs for voluntary contributions. They do, however, have fewer restrictions on their investment regimes than NPFs which can give them a competitive advantage. The most pertinent of these differences is that the rules for insurance companies are more flexible in terms of foreign investments and currencies.[88]

In comparison, the investment regulations are particularly restrictive for the assets managed by the VEB. Until late 2009, the default investment option under VEB was restricted to government securities. This was recently expanded to allow investment in a wider range of domestic securities (including corporate bonds, mortgage bonds and Russian Bank deposits) and bonds of global banks listed in Russia. In 2009 a more conservative investment option was introduced in 2009 with assets invested in state securities only.

From an economic perspective, the distinction between the PAYG and the funded component in Russia is somewhat illusory because a large proportion of total assets in the mandatory funded system (about 80%) are invested in Russian sovereign bonds.[89] While funding still provides the benefit of asset ownership that is absent in a PAYG system, the current asset allocation implies that there is a limited benefit in terms of promoting productive private sector investment or achieving diversification gains from different asset classes and foreign investment.

[88] Source: Russia Consulting

[89] PAYG financing is also a form of implicit sovereign debt.

Table 5. Portfolio limits on pension fund investment in selected asset categories in the Russian Federation for the mandatory funded pension scheme, 2010

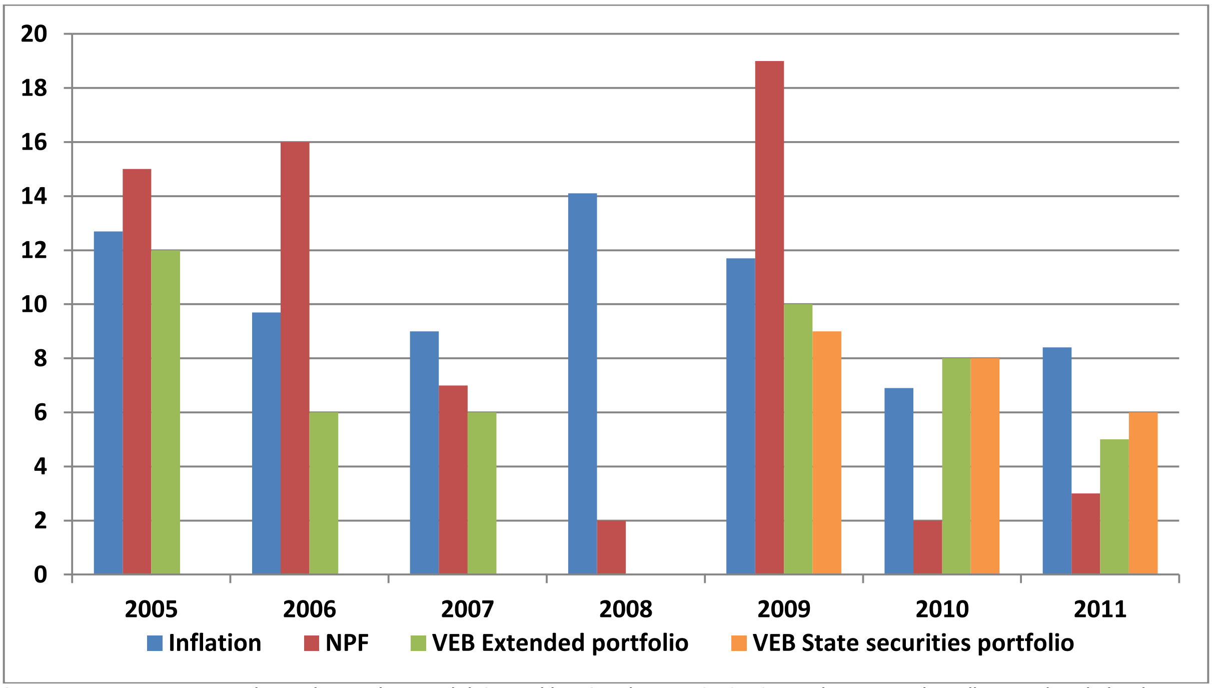
NPFs	VEB Conservative securities portfolio (since October 2009)	VEB Advanced securities portfolio (since October 2009)
- Equity: 65% - Real Estate: not allowed - Retail Investment Funds: not allowed - Private Investment funds: not allowed - Loans: not allowed - Bank deposits: 80% (balances in accounts with lending institutions) - Russia government bonds denominated in roubles: No limit - Russia government bonds: No limit - Regional government bonds: 40% - Municipal bonds: 40% - Mortgage bonds: 40% - Bonds of Russian issuers: 80% - Bonds of international financial organisations:20%	- Equity: not allowed - Real Estate: not allowed - Retail Investment Funds: not allowed - Private Investment funds: not allowed - Loans: not allowed - Bank deposits: 80% (balances in accounts with lending institutions) - Russia government bonds denominated in roubles: No limit - Bonds of Russian issuers guaranteed by Russia government: No limit - Russia government bonds denominated in foreign currency: 80%	- Equity: not allowed - Real Estate: not allowed - Retail Investment Funds: not allowed - Private Investment funds: not allowed - Loans: not allowed - Bank deposits: 80% (balances in accounts with lending institutions) - Russia government bonds denominated in roubles: No limit - Russia government bonds denominated in foreign currency: 80% - Regional government bonds: 10% - Mortgage bonds: 20% - Bonds of Russian issuers not guaranteed by Russia government: 40% - Bonds of international financial organisations:20% - Russia government bonds denominated in roubles and bonds of Russian issuers not guaranteed by Russia government: not less than 50% in sum

Source: OECD, 2010 Survey of Investment Regulations of Pension Funds

Despite the new, less conservative default portfolio that was established in 2010 for the assets managed by the PFR, government bonds (both traded securities and special issues for institutional investors) still account for nearly 70% of total assets of that portfolio. Neither the conservative nor the default portfolios have any equity investment. The only foreign investment is a 1.1% allocation to bonds issued by international organizations in the default portfolio.

The conservative investment policy imposed on VEB is one reason for the poorer returns on these accounts. As of 2011, the yields from investing the default fund assets under the extended portfolio were 5.47% and under the government bonds' portfolio 5.90%. However, with the annual inflation rate for the year at 8.4%, the VEB's real rate of return was still negative. The nominal return on the funded part of the labour pension that was managed by the PFR and invested in the default state management company the VEB, the alternate management companies and the NPFs is shown in figure 16 below.

Figure 16. The nominal return on the funded part of the labour pension, percent, 2005-2011



Source: Ernst & Young and Pension and Actuarial Consulting Services LLC, OECD Main Economic Indicators (MEI) database

Interestingly, the returns on the perceivably secure NPFs were significantly higher than the average return in 2011 but were significantly below the average in a 2010.[90] This perhaps indicates that those funds which are less secure are taking greater risks with clients' money given the current volatility of financial markets.

A conservative asset allocation focused mainly on domestic government bonds is particularly risky in the context of relatively high inflation experienced by the country. The Russian investment regime contrasts with that in most OECD countries, where equities and foreign investment play a major role in risk diversification.

Given the prevalence of DC private pension saving in the Russian Federation, both mandatory and voluntary, it would be pertinent to consider the regulatory framework in light of the goal of such a scheme.

[90] Source: National Ratings Agency

In a DC scheme, the investment strategy needs to allow for returns on contributions to be maximised subject to appropriate risk level. This is in contrast to insurance companies and pension schemes offering DB products where the investment strategy is much more focused on securing funding for the liabilities in the scheme (Please also refer to section 2.4).

Outlook for pension benefits

An important objective for introducing the mandatory funded defined contribution scheme was that the investment of the mandatory accumulation of contributions would bring significant positive returns and boost retirement income. But as was seen previously in the analysis, with a very significant proportion of the population with their accumulation being invested by VEB, the real rates of return on the contributions to date are actually negative.

Given a 5% contribution rate, and assuming a 40-year accumulation, a 20-year pay-out period and 3.5% annual real wage growth, a nominal return that is barely in line with inflation (that is, a zero real return) will only be able to provide a replacement rate for individuals of approximately 6 to 7%. Funded schemes should be able to offer much higher returns. A long-term average real return of 4% will need to reach a 13 to 14% replacement rate from the second pillar, while a 6% real average performance will be needed to reach a 20% replacement rate.[91]

Steps to minimise the risk profile of investments of insured individuals should be undertaken with the possibility of some limited individual choice or through a significant and regular review of the default investment option under each NPF. The possibility of introducing some degree of life-styling in investment strategies should also be considered, as further discussed below.

Improvements in the investment regulation of pension funds

The Russian Government has recently stated that it wants pension funds to invest in infrastructure bonds. This is a viable alternative for pension funds. Investments in a country's national retirement savings plan need the type of long-run, stable and strong returns which infrastructure assets usually provide. Yet to date, finding the structure to reconcile this match has eluded policymakers in most countries.

The lack of objective, high-quality data on infrastructure investments and returns makes it difficult to assess the risks of these investments and to understand correlations with the investment returns of other assets. Without such information, pension funds are reluctant to make such allocations.[92] It is, however, important that pension fund boards are allowed to steer the investment in infrastructure and are not driven by government pressures or regulation in this regard, so as to be able to keep the best interests of their members in mind. This requires that NPFs and asset managers have the capacity and training to manage these types of investments and that the instruments for these types of investments are properly structured.

Another area of possible investment by private pension funds is in new firms and private equity. Here too there is a lack of reliable data in Russia, which makes it difficult to follow the development of the private equity market. Private equity can be divided into two main classes – venture capital and non-venture capital. There are three ways in which pension funds might typically invest in private equity – through a limited partnership, through a fund-of-funds or through an investment trust.[93] The use of

[91] Source: World Bank

[92] Source: Della Croce, R. (2012),

[93] Please also refer to section 2 on the investment management of pension plans.

alternative investment products can boost returns and there is a need to look at further diversification of the assets that the contributions to the mandatory accumulation scheme could be invested in.

Barriers to pension funds investing their assets overseas should also be relaxed over time. One of the key principles of investing pension fund assets is to ensure that there is a diversity of the portfolio. Allowing for investments in foreign markets allows for the possibility to further diversify portfolios and thus mitigate risks. Foreign investment also allows for the possibility of yielding added gains from investments in the economies growing faster than the domestic one. On the other hand, investments in foreign markets also often come with higher costs and added currency risk (please also refer to section 2.5).

When looking at possible areas of additional investment it would be prudent to consider a decrease in the current asset restrictions. Scheme participants are paying a relatively high amount for the investment of their contributions in fees but to a large extent the asset managers are constrained in their attempts to achieve value for money for participants. Many pension systems around the world have removed caps on a particular asset class or provide caps only on very specific investment, usually self-investment or investment in related parties. Rather than having a cap on investments the obligation countries set upon the fund is to invest "prudently". Previous investments were based on the "prudent person rule" but increasingly today the use of the term "prudent investor" is being used. For example under the Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORP Directive), EU member states must invest according to the "prudent investor rule". This could be considered in the Russian Federation as the market develops. The "prudent investor" reflects a modern portfolio theory and total return approach to the exercise of fiduciary investment discretion. It allows fiduciaries to utilize modern portfolio theory to guide investment decisions and requires risk versus return analysis. The "prudent Investor" rule differs from the "prudent person" rule in four major ways:

1. The fund's entire investment portfolio is considered when determining the prudence of an individual investment. A fiduciary would not be held liable for individual investment losses, so long as the investment, at the time of acquisition, was consistent with the overall portfolio objectives of the account.

2. Diversification is explicitly required as a duty for prudent fiduciary investing.

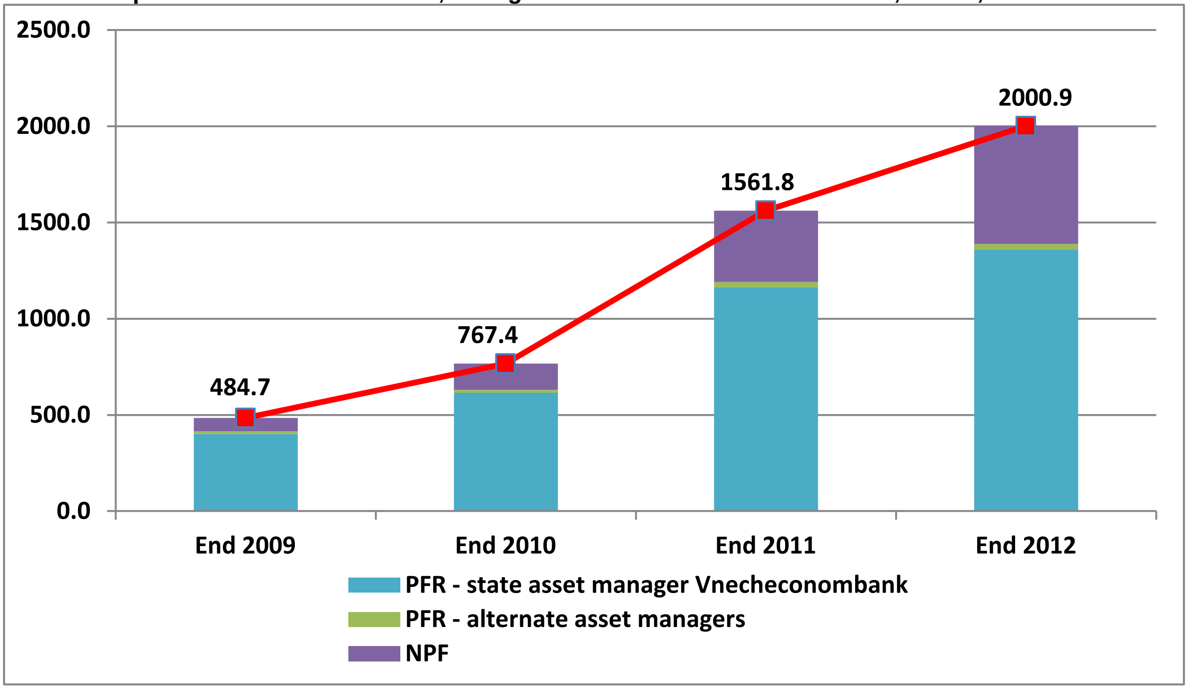
3. No category or type of investment is deemed inherently imprudent. Instead, suitability to the fund's purposes and beneficiaries' needs is considered the determinant. As a result, investments in limited partnerships, derivatives, futures, and similar investment vehicles, are not per se considered imprudent. However, while the fiduciary is now permitted, even encouraged, to develop greater flexibility in overall portfolio management, speculation and outright risk taking is not sanctioned by the rule. The fiduciary remains subject to criticism and possible liability.

4. A fiduciary is permitted to delegate investment management and other functions to third parties.

Creating a competitive and transparent pension industry

The vast part of the assets held in the mandatory funded pension system is administered by the PFR and invested by the VEB. Few participants have chosen to opt out from state management. However, over the last six years, the proportion choosing a private asset manager instead of VEB has been growing (see figure 16). Similarly, the share of assets in NPFs has grown from 3% of the total in 2006 to almost 30% of total assets in the mandatory funded scheme by end of 2012.

Figure 17. Pension savings funds passed by the PFR to non-state pension funds and asset management companies on an accrual basis, taking investment returns into account, BRUB, 2009-2012



Note: VEB is the state-owned bank and asset manager, MC stands for (private) asset management company, NPF stands for Non-state pension fund.

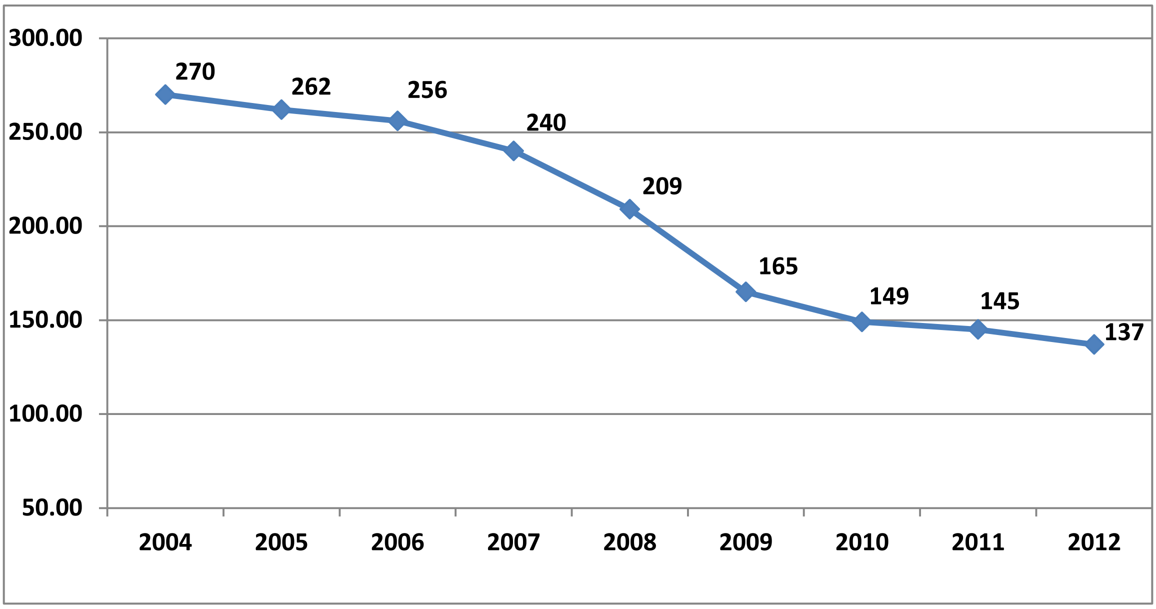
Source: Ministry of Finance of the Russian Federation

The Russian non-state pension fund sector is highly concentrated. Whilst the number of operating NPFs is large, there is only limited competition between funds. In 2012, the Federal Financial Markets Service (FFMS) reported the results of 137 licensed NPFs. In total their assets were nearly BRUB 1 400 (BUSD 44) in the third quarter of 2012. Out of these the ten largest funds had 75% of the assets of all funds. The total number of scheme participants was nearly 16 million and five schemes had over one million participants. However 36 funds reported that they had no participants and a further 14 funds had less than 1000 participants.[94] The 10 largest NPFs operating in the mandatory funded scheme have 68% of all scheme participants.[95]

[94] Federal Financial Markets Service (2012)

[95] Rudolph and Holtzer (2010)

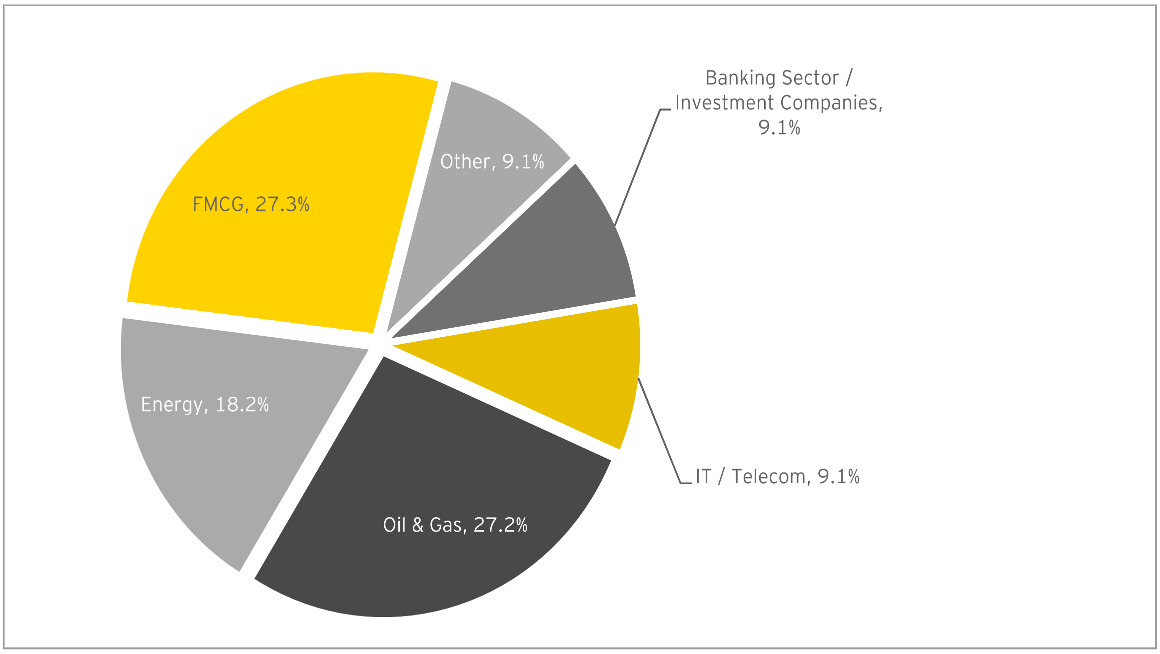
Figure 18. The number of NPFs active in the Russian Federation, 2004-2012



Source: Federal Financial Markets Service

Historically the NPFs have been established by major corporations often in the mining and natural monopoly sectors. Today, NPFs are also being established within other industries. In 2011, Ernst and Young together with Pension and Actuarial Consulting Services surveyed a number of leading non-state pension funds. Those who responded to the survey showed increased diversity in the sectors that they represented.

Figure 19. Sectoral breakdown of NPFs responding to the Ernst & Young and Pension and Actuarial Consulting Services LLC survey, 2011



Source: Ernst & Young and Pension and Actuarial Consulting Services LLC

According to theory, market forces will prevail in terms of providing services to pension fund clients. At the same time, the authorities should consider whether there may be a need for further consolidation in the industry to exploit scale economies, improve efficiency and reduce fees. A small number of very efficient and effective funds which are soundly based are better than a large number of ineffective funds that risk causing problems for those that are well run.

In other countries with mandatory funded systems, such as Poland, there has been a reduction in terms of the number of providers. Initially there were 21 providers in the mandatory funded scheme (OFE's). Today there are only 14. The non-state pension funds should be able to achieve economies of scale in their costs and pass those savings onto participants.

The main goal of having different competing providers in the mandatory funded system is to allow the forces of competition to lead to lower costs and better and more individualised services for the participants. However, over the last few years there have been some cases of irregularities in the Russian Federation where, for example, members were switched from the state default fund to a private provider without their knowledge. Pension fund management costs are also relatively high. These challenges need to be addressed through appropriate regulation, effective communication and financial education policies if net returns are to be optimised from this system.

Dealing with costs and charges

Legislation allows NPFs to charge fees that are up to 15% of investment income, plus surrender charges and a management fee if there is an employer plan sponsor. The NPFs can also charge up to 3% on voluntary contributions received, plus surrender charges and a management fee if there is an employer plan sponsor. NPF's must legally contract out most of the asset management to professional asset managers. These asset managers may charge separate fees and the typical level is about 2.0% to 2.5% of assets under management. Although the maximum fees are rarely, if ever, charged, the cost of the administration is high by international standards.

The NPF's need to be vigilant and transparent with regards to their administration costs. NPF's may argue that enhanced investment returns justify their fees and costs but those who do not support the use of NPF's can argue against these high costs quoting research on the impact of charges on net returns. The extra investment returns needed to recover administration charges is very high and involves riskier investments. This may bring better returns but can equally run the risk of lower returns. NPF's need to work out if their goal is to retain their existing participant base, add to their existing participant base or making bigger profits from higher charges which in turn may lead to a diminishing client base.

Currently, those who may want to make voluntary contributions in an NPF do so but through a different open scheme. This involves another set of deductions for administration and asset management fees. Combining voluntary contributions to the mandatory DC scheme may allow people to build up their retirement account more efficiently. This could cost the NPF's some lost income by having only one as opposed to two NPF pension accounts, but is also likely to be more cost effective for NPF's to administer one account than for a person to have two separate accounts.

One problem in all pension systems, not just in the Russian Federation, is the inaction of participants. A very small number of participants actually "vote with their feet" by transferring their accumulation from one fund to another despite a combination of high charges and/or poor investment returns. Inertia is a contributory factor here but often the problem is the lack of understanding of the implications of a decision to change or remain in a fund or asset management company.

Greater efforts also need to be made to enhance the transparency of the operating costs of the NPFs and of the fees that the charge to plan members. A benchmarking exercise could be developed to assess the extent to which different NPFs meet basic standards of operating efficiency. The data could also be used by the NPFs to decide on possible consolidation plans and other strategies to enhance their efficiency.

Offering guarantees and life-styled investment strategies

Existing and potential participants in NPF's may like to see their accumulated savings guaranteed. There are a variety of possible guarantees but they come with a price attached that can be paid for by the participant either through a deduction from his or her account to meet the cost of the guarantee or by the government. Guarantees should also only be offered at retirement, as short-term performance guarantees are very costly and lead to highly conservative asset allocations, which are often not in the interest of plan members. In the Russian mandatory funded pension scheme there is a guarantee promising the nominal value of contributions at retirement of upon leaving an insurer.

There are arguments for and against guarantees. The purpose of DC return guarantees is to provide a floor or minimum income at retirement to prevent people from having inadequate pensions. However, in many OECD countries public pensions' automatic stabilisers and old-age safety nets already provide such a floor. The more generous such protection is the smaller will be the share of retirement income affected by market risk. Therefore, some people may argue that there may not be a need for minimum return guarantees in DC pension plans. Yet, public guarantees generally do not alleviate the impact of market risk for medium to high income individuals, or they do so only partially. In this sense, the decision over whether or not to introduce return guarantees in DC pension plans needs to be considered in the context of the pension system as a whole, the replacement rates provided by the entire system and the amount of exposure to financial risks that individuals face.

Minimum return guarantees, and in particular the capital guarantee, may help overcome popular fears over saving for retirement in DC pension plans. Surveys highlight that people's negative feelings about saving in DC pension plans often stem from the fear of losing even part of the nominal value of their contributions. It can, therefore, be beneficial to mitigate the investment risk by offering return guarantees that apply to the accumulated savings at retirement in order to cater to the long-term nature of the retirement savings. It may also be beneficial to introduce capital guarantees where the nominal value of contributions is legislated, as in the Russian Federation. This can increase the attractiveness of saving for retirement in DC accounts and promote coverage in these plans.

Investment strategies should also be better adapted to the needs and risk appetite of different cohorts. Younger workers should be able to take greater investment risk, while for older workers there should be greater focus on capital preservation and protection of savings from major market shocks. A life-cycle glide path could therefore be designed for default investment strategies, whereby equity risk is higher at younger ages and declines as the person approaches retirement. NPF's can introduce life-style funds on their own accord. Another option would be that participants would automatically be allocated to the life-style fund that corresponds to their age unless they opt out for a different asset allocation. Life-styling strategies can be organised around a single fund in which the allocation to risky assets falls with age (as in US target date funds) or as a group of balanced funds of different risk levels across which the member is shifted.

Life-styling investment strategies can help minimise sharp drops in retirement income that are a result of extreme negative investment outcomes. Moreover, they are easier to explain to the public in general. One of the most challenging aspects of life-cycle strategies is setting an adequate investment glide path, including a percentage allocation for equity investments at the beginning and at the end of the accumulation period. The choice of glide path will be affected by many factors, including the role of the DC plan in the overall retirement income system. However, it essential to stress that life-cycle investment strategies are not a panacea. First, when using the stochastic model without focusing on extreme negative outcomes or looking at historical data, it is unclear whether a fixed-portfolio or relatively straightforward life-cycle strategies perform better in terms of the probability distribution of replacement rates. Moreover, life-cycle strategies do not fully address the problem of volatility of retirement income resulting from market fluctuations or the problem of inadequate or low pensions.[96]

4.8 Assessing improvements needed in governance

As governments around the world find it harder and harder to meet their citizen's retirement needs greater emphasis is being placed upon the need for individuals to make their own pension contributions through private pension systems. Increasingly, governments are also using private pensions as part of their retirement income strategy.

As a result, the private pensions industry is under greater pressure to adopt the highest standards of pension fund governance. The low returns on investments during the financial crisis have also ignited a backlash against private pensions in some countries.

It is essential that private pension funds in Russia adopt the highest levels of integrity, responsibility and professionalism in the way that they manage the assets under their control. The governing body of the fund needs to have both the necessary expertise to take decisions and to ask the right questions of those who provide advice and/or services. There is a need for on-going training and professional development of those who are charged with the responsibility of managing pension funds. If the necessary expertise is not

[96] OECD (2012)

available in the governing body, members of that body should not hesitate in bringing in outside assistance to help in the decision making process.

At the same time, credibility is key in scheme participants maintaining their faith in the pension system. Whilst sponsors or governing bodies of pension funds may see some short-term gain in appointing associates or related companies as providers of services to their pension fund, they will actually be better served in the long run by having independent organisations provide some of the services, particularly audit and/or custody.

The pension fund's decision making process should involve representatives of those on whose behalf contributions are being made. There should be a system of participant representation on the pension fund board. The legal structure of pension funds also needs to be reviewed, as currently often the beneficiaries are also the named trustees of the fund. The legal beneficiaries of the pension fund should be the members, while the board members or trustees should have a fiduciary duty to meet the best interest of the participants.

A written investment policy should also be developed and reviewed at least annually. The fund should report to members on the actual performance compared with this investment policy. The supervisory authority should review the investment declarations made by pension fund boards to ensure that they actually give instructions to asset managers on the asset allocation of the fund's assets rather than restating the limits in the law and providing complete discretion to the asset manager. Pension funds over a minimum asset size should be required to engage an independent investment advisor to participate in the review of the investment declaration. Funds should be required to publish the recommendations from the investment advisor and their response to these recommendations within a prescribed period. Consideration should be given to introducing the prudent investor philosophy into the provisions relating to the investment of NPF assets and requiring the boards of NPF's to adhere to this investment principle when investing participant's contributions.

Pension funds should also be required to justify the charges they impose on fund members by showing how they are adding value compared to other types of investments. The supervisory authority should develop a risk management template that funds should assess their performance against at least annually. The board's statement regarding a fund's risk status should be reported to the supervisor as part of the reporting process.

Regulations should establish procedures to ensure that adequate internal controls are in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic organisational and administrative procedures. Depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, risk management procedures and compliance.

The NPF's governing body should develop a code of conduct and a conflicts of interest policy for them and the staff of the pension entity as well as for any party with operational responsibilities. There should also be appropriate controls to promote the independence and impartiality of the decisions taken by the governing body, to ensure the confidentiality of sensitive information pertaining to the fund and to prevent the improper use of privileged or confidential information.

Procedures for participating in and moving from private pension funds need to be simple and non-discriminatory. It should be considered whether the legal status of private pension funds as non-profit organizations is having an impact on the pension fund providers' services work in the financial services market. Any contributions deducted from an employee's wage for remittance to a NPF should be held on trust and should be remitted by a prescribed day in the month after that which they relate to. Any contributions deducted from employees' wages should be specifically excluded from any claims against the employer in the event of bankruptcy.

Vested benefits of individuals who have severed employment with an employer should be protected and not be subject to forfeiture, except in clearly defined cases. Vested benefits should be protected from the creditors of the plan sponsor and plan service providers (including any financial institutions or other entities managing the pension plan or plan assets or acting as a custodian of pension fund assets associated with the plan). Vested benefits should be protected when the plan sponsor or a plan service provider changes ownership due to merger, acquisition, sale, or other corporate transaction, or files for bankruptcy. The extent to which vested benefits are protected from the creditors of individual plan members and beneficiaries should be addressed. Individuals who are changing jobs should be able, upon request, to move the value of their vested account balance in a defined contribution plan from their former employer's pension plan either to the plan of their current employer (where permitted) or to a similar, tax-protected environment provided by an alternative financial instrument or institution. Where feasible, a similar portability right also should be available to individuals in defined benefit plans.

A procedure should be established to handle complaints about fund membership. The procedure should be expeditious and transparent, be easily understood and have only reasonable or no cost to the individual claimant. Referring a dispute to the courts, as is current practice, should only occur after all steps in the dispute resolution process have been exhausted. Referral directly to the courts may be perceived as riskier for the individual. Additionally, the supervisory body may have a deeper expertise on the issues involved in the dispute and be able to pass judgment based on both a legislative and regulatory basis. The regulator's powers in the case of a potential bankruptcy of professional participants of the securities market should be reviewed to provide maximum participant protection. Whether there should be legal recourse to the plan sponsor in case of bankruptcy of the pension fund needs to be considered.

The NAPF should work towards developing standards that comply with OECD principles for pension fund governance. Adherence to these standards could made on a voluntary basis or could be a prerequisite for NAPF membership with all funds as part of their publicity material being required to indicate whether or not they are NAPF members. Given that there will be competition to attract/retain mandatory accumulation contribution participants to the NPFs, it will be in a fund's best interest to do so. If an inadequate number of funds voluntarily adhere to such principles then consideration should be given to greater enforcement of the principles. One option would be to require NPFs to adopt OECD principles for pension fund governance as a condition of continuing to hold their licence.

4.9 Addressing the need to strengthen supervision

Meeting the goals of pension supervision

The goals of pension supervision are essentially twofold. First, the supervisor needs to protect the pension system by ensuring the financial and operational stability, security and good governance of the schemes or pensions funds and establishing efficiency and public confidence in the system. Second, their role is to protect the rights of the members and to ensure consumer protection regulations are adequate and employed by pension funds and associated intermediaries.

The development of funded, private pension funds is an integral part of providing those working in the Russian Federation with an adequate retirement benefit. It is essential that those who participate in the funded pension system have utmost faith in the system and its integrity. Pension supervision involves the oversight of pension institutions and the enforcement and promotion of adherence to and compliance with regulation relating to the structure and operation of pension funds and plans. The goal is to promote a well-functioning pension sector. In addition, achieving stability within the pension sector is an important part of securing the stability of the financial system as whole as investments made by pension funds have a major impact on the real economy in many countries.

The system of supervision over private pension funds needs to provide for common principles for the regulation and supervision of private pension fund operations under both the mandatory scheme and voluntary systems. They also need to ensure a smooth transition towards ensuring the prudential behaviour of NPFs especially if investment regulations are to be loosened. The supervisory authority could examine the possibility of introducing a form of risk-based supervision over private pension funds so that an assessment of the financial sustainability of private pension funds under different financial market and general economic scenarios can be gauged. This form of supervision has been implemented in many OECD countries and EU member states (please also refer to section 1.8).

The objectives of private pension supervision that focus on protecting the interests of pension fund members and beneficiaries do so by promoting the stability, security and good governance of pension funds. The regulator needs to be the institution that the population can turn to in any case of injustice or wrongdoing. Within this scope, it is important to consider consumer protection with regards to the decision members face regarding how they choose to invest their contributions. The freedom of choice needs to be supervised. It is important to ensure that pension funds, brokers and intermediaries are regulated and do not misuse members' lack of knowledge. The supervisory authority should also be able to intervene if members are wrongly lured or coerced to make choices they do not fully understand by financial or any other means.

Consolidating supervision

In order to ensure the integrity of the funded private pension system it is vital to review if the current regulation and supervision in the area of mandatory pension insurance are ensuring the sustainable development of funded private pensions. Transparency, integrity, independence and cost-efficiency are key in achieving this goal. The independence of the regulator in carrying out its regulatory duties need to be further established. In formal terms the independence of the FFMS may seem limited today. Its chairman and deputies are appointed by the government, without any clear legislative procedure for appointment. There is no formal board and thus the official process for taking and recording corporate decision is indistinct. The FFMS supervises the NPFs. It reports directly to the Prime Minister. Even if the authority is supervised by the Ministry of Finance, the Ministry cannot issue direction to them. Furthermore, the FFMS forms part of the Government budget and cuts can further exacerbate the issue of qualified and committed staff.

Generally speaking, supervision of financial institutions has been more segmented according to sectors or products in OECD countries. The onset of the financial crisis, the changing nature of financial markets with greater volatility and convergence between savings instruments has led to the scrutiny of supervisors and regulators in a number of OECD countries. One issue being discussed is the possibility of having a more unified supervision to better deal with the convergence of financial sectors and instruments and in order to improve efficiencies in the supervisory process.

In the current regulatory system in the Russian Federation there are a large number of regulatory and supervisory agencies that are not necessarily well coordinated, which undermines public control and oversight over the funded private pensions. Efforts to coordinate supervision in Russia, under the jurisdiction of the Central Bank of Russia, should increase the independence and effectiveness of supervision of pension funds. A unified supervision allows for an overall risk assessment of a financial institution in relation to the rest of the financial and economic backdrop.

As the Central bank of Russia prepares to take on the role of supervisor, it will be important to ensure that conflicts of interest between the supervisory role and that of determining the monetary policy in the country do not arise. Similarly, it is important to establish clear rules for supervising the pension funds especially in cases of insolvency and volatility. Furthermore, as pension funds make up a small part of the market sufficient resources need to be allocated to the supervision of these and to the development of the regulatory framework. If the work is to be delegated to other actors, such as regulatory bodies, it is important to establish a clear and transparent chain of responsibility, preferably that is answerable to the Duma.

4.10 Strengthening and completing the regulatory framework

Rule of law

"Rule of Law" refers to a principle of governance under which all persons, institutions and entities, public and private, including the state itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated. Measures to ensure adherence to the principles of supremacy of law, equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decision-making, legal certainty, avoidance of arbitrariness and procedural and legal transparency are needed. When applied to pensions "Rule of Law" is the extent to which formal legal systems are consistent and reliable. Approaches for ensuring the application of the rule of law can be either a light touch approach or a heavy handed approach.

Hinz and Mataoanu (2005) quote research which indicates that the rule of law in respect to pensions to a large extent correlates to the legal system under which the pension system is established. In systems that are based on civil law in countries such as in Russia, Chile, Mexico, Central and Eastern Europe the approach is typically more intensive, more directive and more punitive rather than a compensatory approach to corrective actions and sanctions.

Another correlation appears to exist between the rule of law approach and a country's economic development. Analyses indicate a strong relationship between a country's overall level of economic development and its approach to private pension supervision. Countries with the highest income levels are associated with supervisory approaches that impose fewer entry barriers and qualifications for pension funds and are less intensive or intervention oriented. Those with a lower GDP per capita are associated with more pro-active methods and less likely to rely on market discipline to control the pension systems.[97]

In Russia's case, the legal system for pensions is based on civil law and gross national income per capita per year is less than USD 11,905. Therefore, according to Hinz and Mataoanu we would expect Russia's pension supervision model to be more intensive and intervention oriented than in countries such as the US or Australia. There appear, however, to be weaknesses in the Russian pension system in the area of regulation that need to be overcome to further protect participants (Please also refer to section 1.7 and 1.8).

Prudential regulation and consumer protection

The capacity to regulate the activities of employers in respect of voluntary pensions (NPFs) is currently extremely limited in Russia. The process is open to interpretation and there can be many different practices, none of which would be regarded as breaches of the principles. The defining document in respect of NPF's is the pension contract between the employer and employees. This is part of the labour contract, regulation of which would be done under the labour code. It is not subject to any part of the pension

[97] Hinz and Mataoanu (2005)

regulation process as the pension legislation does not cover the pension contract. Whilst the law on mandatory accumulation schemes overcomes some of the difficulties with respect to voluntary pension provision, particularly employer obligations and participant rights, there is still a need to strengthen the corporate governance of private pension funds to enhance participant rights.

The legislation regulating the activities of NPFs was passed in 1998 following significant debate that in some instances saw the interests of service providers pitted against those with the interests of participants. Consequently, the law only sets out the basic requirements on minimum funding levels to be provided for DB schemes. The pension rules of the funds may envisage the right, in the event of a worsened financial situation, to demand that the contributor pay additional amounts, or to decrease the amount of the pension to be paid to a participant under the initial agreement. However, there is no legal obligation for a plan sponsor to follow through on pension promises or to make additional contributions in the event of a bankrupt or financially weak NPF.

NPFs are required to hold a pension reserve equal to at least 5% of total pension obligations for both DB and DC schemes in addition to the existing pension fund assets. An actuarial valuation is required every year but the assumptions used are at the discretion of the NPF and are not determined by regulation or the supervisory body. There are no regulatory requirements for funding a deficit or ensuring that the plan sponsor delivers on pension promises. The supervisor (FFMS) can, however, send an injunction if funding levels are low.

There are no specific direct limits on contribution rates to voluntary pension plans but the employer's contribution level is regulated through tax rates. There are no lower or upper limits on the salary on which contributions to voluntary pension plans may be paid. Plan sponsors decide on what proportion of the employer contribution is returned to a contributor who does not reach retirement age. The rules about transferring accrued benefits are also determined by the plan sponsor. There is no legal guidance on this. From a regulatory and supervisory perspective, there is no formal distinction between contributions made by employers or employees for vesting accrued contributions or other purposes. There is no regulation or formal monitoring of late payments.

Disclosure requirements are minimal. There are no requirements to disclose information on accounting procedures. Members receive an annual statement stating their account balances in the funded part of the labour pension, but no information is provided as to the choices they face in the mandatory system. Not much information is provided on the fees and returns of the different providers in the mandatory system (the state asset manager, the alternate asset managers or the NPF's).

As the NPF law was introduced in 1998, at a time when the vast majority of existing schemes were offering to provide promised benefits to participants there was little attention paid to defined contribution schemes. The legislation is void in the area for voluntary defined contribution schemes although a majority of occupational pension schemes today and the mandatory funded scheme follow this design.

As stated under the section on the "Rule of Law", Russian NPFs operate under a system of civil law and in an emerging economy. Under this scenario, the regulatory approach is typically of a more intensive and directive character. A punitive rather than a compensatory approach to corrective actions and sanctions is taken. The regulatory approach tends to focus on rectifying mistakes rather than trying to prevent them occurring in the first place. Similarly, the supervision of pension funds in Russia is based on compliance control with little attention given to financial soundness of funds and maximisation of pension benefits.

Countries operating their pension systems under common law (or trust based schemes) have tended to move away from rule based supervision and moved to risk based supervision (RBS). Under this scenario the regulator tries to identify risks within a scheme early and minimise the likelihood of problems arising.

Whilst RBS may not necessarily work in Russia's civil code based system, it is possible that an early warning system can be integrated into the legislation for the oversight of pension funds. The Government of the Russian Federation has commissioned a study on the introduction of prudential supervision. The report will pay special attention to investigating the capacity of the supervisor to gather adequate and relevant information, timely process it and avert risky situations.

4.11 Assessing the role of the private sector in shaping a sustainable pension model

Public perception of the pension system

The success of any pension system around the world is in assuring participants that when they need their pension it will be adequate enough for them to live a lifestyle similar to that which they had prior to retirement. The key to this is the public's faith in the system. However, many countries are experiencing a crisis of public confidence in retirement systems. Some of this is brought on by continual pension reform, some of it is brought on by service providers not providing value for money to participants and some of it is beyond the control of pension funds themselves and has been brought on by the global financial crisis.

One of the major issues affecting public confidence in pension systems was the generosity of pension provision provided to those born in the early part of the twentieth century. This was especially the case in OECD countries. Participants in employer sponsored pension schemes were guaranteed benefits that then generously kept pace with inflation once a person retired. Participants paid little attention to their pension arrangements since they bore no risk. All the risk was with employers and the main dispute between employers and representatives of pension scheme participants was how to distribute any surplus. Today, most pension schemes are shifting from defined benefit to defined contribution plans where all the risk is borne by the participant. Participants have to contend with lower than expected investment returns and longer life expectancies may lead to lower than expected retirement benefits.

Previously in OECD countries, a significant part of the population was not participating in any employer sponsored pension arrangements but they were provided with relatively generous public pensions, were able to retire relatively young, received generous supplementary measures from the state and paid a relatively small amount in contributions. For example, since its inception, the employee contribution to the UK state pension system has increased from 6.5% to 12%. Today, contribution rates are higher and more years of contributions are needed to get an equivalent benefit to before. Although this is coupled with longer and healthier lives, it is difficult to gain political understanding for the need to work longer as the population lives longer. Many of today's younger generation perceive it as unlikely that the state will provide for them adequately when they retire.

Stability in pension system design is critical for gaining public confidence. Some OECD countries have very complex pension systems. One reason is that the norm is that a benefit should be paid out under the rules that it has been accrued. Therefore, there are often a myriad of pension rules and regulations within a pension system some of which may apply only to certain cohorts. Introducing reforms and then reversing accrual rules, as in the Russian pension system, increases the instability and complexity in the system. This affects the public perception of the system negatively.

Public confidence in private pension schemes has also been shaken, often due to situations where there has been a lack of accountability towards participants of the scheme regarding the securing the promise that they may perceive has been promised to them. In the 1990's there was a public scandal in the UK where pension products that were unsuitable were sold to the public solely on the basis of the salesman receiving a commission for every person who bought that type of pension product. Prior to the Russian financial crisis of 1998, regulation on financially weak NPFs provided insufficient protection for members.

Russian regulators decided to increase the capital requirements of NPFs which also helped bring security to the industry by bringing about forced mergers of funds.

The move to mandatory privatised funded pensions has been perceived as an advantage to the financial services industry in some countries, especially with regards to the charges and fees collected by service providers. High asset management charges are a significant part of the reason for poor investment management returns. The industry plays an important role in increasing competition and pressing down charges and increasing net returns. In Poland and Hungary, the Governments passed legislation to force suppliers to reduce the fees or charges they were deducting from individuals' accounts.

The public's general perception of the state and the financial sector are a key variable. There are those who argue that the fact that so few of the population initially chose a private provider in Russia's mandatory funded scheme was an indication that the public didn't trust the State but trusted the private sector even less.[98]

To overcome the lack of public confidence in the pension system requires a multi-pronged approach. Firstly, the Government needs to be consistent in its approach to pensions. Pensions are a long-term undertaking and promise. Results from a pension reform with transitional rules cannot usually be seen in a short time frame. Secondly, the industry needs to provide value for money to participants in the system. Charges for administering and investing individual pension assets need to be both fair to the service provider and to the individual fund participant. Thirdly, coherence in the overall structure and objectives of the pension system is required. The industry and government need to work consistently together. System design also needs to be internally coherent, that is the accumulation and payout phases of DC pension plans need to be consistent, which requires that the investment strategies used to build up assets are properly aligned with the form that the payout phase takes.

The transfer of risk to individuals along with the increasing volatility in retirement income actually entails that policy makers and pension providers need to monitor all risks and should work together to promote financial literacy amongst the population so that it better understands the issues facing them as they get older and so that people have the skills, knowledge and tools to make decisions on how best to plan for retirement.[99]

Communication and financial education

In private pensions and especially defined contribution schemes individuals face a myriad of complex choices and risks that will determine the adequacy of their retirement income, from how much to save and through which vehicles to what kind of benefit payout option to choose.

Communication and financial literacy are inextricably interwoven. If there are inadequate communication materials even the most financial literate person will be able to absorb the complexities of the pension system. On the other hand, if people are financially illiterate the best produced communication materials will prove to be inadequate.

The communication materials for NPFs rated by National Ratings Agency varied enormously in their quality and ease of reading. Some funds were extremely good in presenting their information and provided information that was easily accessible whilst in others the information was very basic and could not be

[98] USAID (2010)

[99] OECD (2012)

found. The competition that is open to funds for attracting contributions should encourage providing information as a means to attract new clients.

NPFs generally provide information on investment returns, but to lesser extent on historical returns over longer periods. This should be a major component of any decision on which fund to participate in. The vast majority provided information on the percentage of the fund that was invested in particular asset classes but few provided a statement of their investment objectives, how they were performing against these objectives or information to participants on what future trends they saw occurring. No fund publicly made a statement about the charges that are deducted from an individual's account. Whilst this may be able to be ascertained from personal account information it would have been normal to expect that funds would use this as a marketing tool, unless of course their charges are very high.

The regulator or supervisor needs to develop standard public information documents that funds should provide to both participants and other interested parties. Apart from ready access to the plan's documents and other relevant contractual material, individuals should be provided with a regular individualised benefit statement, which apart from a record of contributions and the account balances should also provide clear benefit projections under prudent and standardised assumptions. Such projections should ideally include information on how much higher benefits could be if additional contributions were to be made or if the age of retirement was to be delayed. Collective information from the different parts of the pension system would also help to create an understanding of the entirety of a person's retirement income and facilitate the individual retirement decision making process. A member reporting standard for all funds to use could be developed as in many countries around the world.

NPF's need to address the issue of why a participant will be better off in the long run being a participant in a NPF than being a participant in VEB, some of which have been discussed above. One way to market this is to provide individualised examples of a person's pension by providing pension projections based on simulated returns and actual costs of administration.

The ability to exercise rational choice between NPFs and the PFR will become increasingly pertinent if the proposal to shift contributions from the mandatory funded scheme to the NDC scheme for individuals investing their contributions to the funded component in the PFR is realised (please see section 4.5). The right for individuals to choose how much of their contributions they should invest in funded requires a certain level of understanding of the pension system and financial literacy. In this sense such a reform would need to be accompanied by extensive public information campaigns. This is also important to promote an active choice by participants, many of who do not exercise this right today and land up in the default choice.

There are many examples of countries where individuals receive regular information on their account via a pension statement, one of the best known ones being Sweden's orange envelope. Web-based tools can also be made available to members. In Sweden, a web-based tool provides projections to individuals showing their expected total retirement income based on accumulations from different pension schemes, and depending on different behavioural and economic assumptions. In Australia, the government provides the population with a pension calculator on a website which participants can use to compare the projected benefits of one superannuation fund against another (superannuation in the Australian term for pension).[100] The calculator allows individuals to compare their returns from two different funds depending on how much they have already have accrued, their salary, their contribution and what the administration, investment management and investment returns may be. In Australia, the capacity to convert the accumulation into an annuity is also built onto the program. This allows the participant to get an estimate

[100] Please refer to https://www.moneysmart.gov.au/tools-and-resources/calculators-and-tools/superannuation-calculator for more information.

of their retirement benefit under each model. Such a model would allow the NPFs to show the difference between accruals in a NPF compared to VEB. The participant could also compare two different NPFs.

NPFs could do much to improve their communication to participants. The annual report could become a benchmark for information to be used to attract/retain new participants in NPFs. Illustrations of the impact of the new arrangements on people with different income levels could be interesting information to be included.

Typically, an individual can affect the accumulation phase of their pensions. Since the rate of return in an NPF is the same for all contributions there should be an incentive to create awareness that the amount contributed to the fund affects the pensions. The government and the supervisory authority should be actively involved in promoting financial literacy. The NAPF directly or in association with a national university also has a key role in this regard and could for instance help develop a course of training for the staff of NPFs with the goal of attaining certain educational levels, and them being a pre-requisite for appointment to more responsible positions within the industry.

Disclosure materials need to be written in a manner to be readily understood by the members and beneficiaries to whom they are directed. This may be a particularly challenging task for members with very low levels of financial literacy, some of whom may not even understand basic concepts such as compound interest or the difference between a stock and a bond. Hence, communication policies need to be complemented with financial education programmes both at schools and amongst the adult population.

In early 2012 the OECD produced a report on the results of the results of the OECD / International Network on Financial Education (INFE) pilot study. In every country there is significant room for improvement in terms of financial knowledge. Understanding of some everyday financial concepts such as compound interest and diversification is lacking amongst sizeable proportions of the population in every country. In most of the countries surveyed women are less knowledgeable than their male counterparts. The findings also highlight a large proportion of individuals who could benefit from initiatives designed to change their behaviour. The analysis also showed how knowledge and behaviour are associated in every country, that is to say the more knowledgeable individuals are more likely they are to exhibit positive financial behaviour and vice versa.[101]

The OECD and INFE had been working on high-level principles on national strategies for financial education. The previously mentioned report was used in the finalization of these principles and their adoption in August 2012. At the request of the APEC Russian Presidency, these Principles were also transmitted to APEC Ministers of Finance who welcomed their endorsement by APEC leaders at their meeting on 30 August 2012. The guidelines encourage individual countries to develop a National Strategy for Financial Education.

The Ministry of Finance of the Russian Federation is the implementing agency for Russia's national strategy. In 2012, the Ministry presented its strategy for the implementing these principles and for developing the National Financial Literacy Strategy in conjunction with the World Bank. This is a 5 year project scheduled to end in June 2016 having the objective of improving the financial literacy, efficient and responsible financial behaviour of Russians and improving financial consumer protection. This is a major initiative which will require private pension fund suppliers to work with and for the attainment of these objectives.

The OECD Recommendations on Good Practices for Financial Education Relating to Private Pensions provide further detail on such programmes, which should include public awareness and

[101] Atkinson, A. and F. Messy (2012)

communication efforts as well as more traditional educational programmes aimed more directly at raising financial literacy levels.[102]

Respective roles of the state and private institutions in providing adequate pensions

The role of a government in providing for its citizens' retirement needs is changing. While the state has traditionally provided a safety net and a later an income related pension, recent reforms in PAYG schemes have seen the need for additional forms of saving to provide adequately in old age as benefits are being reduced at a given retirement age, especially for an emerging middle class.[103] Governments tend to impose reductions in state pension benefits on the population very early into a mandate period. One of the reasons for this is that pensions are sensitive and long term commitments that are politically very difficult to change, be it a systemic change to a system, a change to the retirement age or to benefits. These changes do, however, have a significant affect not only on beneficiaries but also often on service providers.

At the same time, the number of employers who are making voluntary pension provision for their employees is falling. In the UK there were reportedly 8.3 million active members of occupational pension schemes, the lowest level since the 1950s.[104] We have also seen employers change the nature of employer sponsored occupational schemes. Most schemes that were previously defined benefit schemes are now defined contribution schemes. The pattern of negotiations in converting defined benefit, employer sponsored schemes has often resulted in only prospective changes to the scheme. In many instances existing participants are also given a choice to move from one scheme to another, often with an inducement to move since the more who move to the new scheme the greater the savings in the employer's long-term cost.

Those with higher incomes may be more prone to realise that the state will only provide a small proportion of their income needs in retirement. They act to provide for themselves, if they have the capacity and the financial literacy to do so. At the other end of the spectrum those with lower incomes usually receive a higher replacement income from state provided pension provision but a lower pension. The big challenge is the emerging middle class who have increasing expectations for their retirement income to be adequate but tend not to participate in voluntary retirement saving.

Government and industry in Russia need to develop strategies to encourage savings in private pension provision by as many persons as possible to encourage an even distribution of income in retirement. The industry needs to provide efficient services whiles the government may need to incentivise the population to make sure that people contribute enough and for long enough periods of time. There are different types of incentives that can be used, be they through mandating contributions to private and funded schemes, through taxes or through other types of financial incentives like matching contributions.[105] While mandating contributions is an effective way of increasing savings, pension providers also need to show that they can add value to the process through appropriate investment policies and administration costs that meet the needs of both buyers and sellers of pension schemes in order to uphold public confidence in the system as discussed in the previous section.

The amount of retirement income that private and funded pension plans should aim to deliver depends on the overall structure of the pension system. Retirement income and associated replacement rates in private and funded pension plans should be higher in countries where they are the main source of funds to

[102] http://www.oecd.org/insurance/privatepensions/40537843.pdf

[103] OECD (2011)

[104] The UK Office of National Statistics (2010)

[105] Please also refer to section 1.10.

finance retirement. In countries where PAYG-financed public pensions already provide high benefits, private pension plans will only need to target a low replacement rate to achieve overall retirement income adequacy. The first step in the design of funded pension plans and associated regulations should therefore be for regulators and policymakers to consider a target retirement income. In order to identify such a target, regulators and policy makers need to consider both choice and risk variables, including the amount of contributions, retirement ages, contribution periods, labour market conditions, returns on investment and life expectancy.

The mandatory PAYG pension system in Russia is expected to provide a replacement rate of around 40% of wages (please refer to figure 5).The co-financing scheme introduced for additional savings to the mandatory funded pension provision can strengthen retirement income adequacy. However, it will be important to assess the reach of these subsidies and whether they could be better designed to attract more low income workers.

The taxation status of private pension funds should also be reviewed to see firstly if there are any negative elements currently impacting upon funds and secondly whether there is a possibility to further incentivize the population's participation in the private pension system.

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5. CONCLUDING REMARKS

The systemic change from a DB system to a NDC and funded DC scheme in the Russian Federation has shifted risks from the pension plan to the individual. Individuals now bear investment and longevity risks that are not comprehended by many. This puts an added pressure on governing bodies, supervisors and administrators to assume high levels of integrity, professionalism, and responsibility, keeping the scheme participants' best interests in mind.

In this environment, certain recommendations can be suggested based on the OECD guidelines and principles in the area of private pensions and on examples of good practices in other countries. The recommendations can be summarised to cover structural reforms, investment management and asset allocation, governance, supervision, and fostering public confidence and the way forward in promoting private pension savings.

The pension system has been in a constant state of flux since the first reforms of the late 1990s and the system's parameters have changed substantially over the course of the last decade. Pension systems also need degree of some stability and gradual change to allow the population to adjust their behaviour to the incentives given to them in the reform. It is also important that people are given the right information and education in order to make informed choices.

Introducing private pensions and having a diversified retirement savings portfolio is advocated. To fully reap the gains of funded pensions, however, a diversified risk portfolio and cost efficient management needs to be adopted.

There needs to be a more systemic approach to reviewing and governing the mandatory pension system in order to allow individuals to believe that their savings will not be used for purposes other than increasing their own retirement savings. This type of public confidence is vital for the political and commercial survival of the mandatory funded DC scheme.

APPENDIX 1

Number of Pensioners and Average Accrued Pensions by Types of Pension provisions and Retirement Categories (for 2007, 2008, 2010 as of end of year and for 2011 as of 01.01.2012) Updated - 13.06.2012

	1970	1980	1990	1995	2000	2005*	2007	2008	2009	2010*	2011
Number of pensioners registered in the system of Pension Fund of the Russian Federation ** (in thousands)	22,513	27,417	32,848	37,083	38,411	38,313	38,467	38,598	39,090	39,706	40,162
including receiving pensions:											
Old age labour pension	14,155	19,540	25,659	29,011	28,813	29,192	29,788	30,153	30,828	32,462	32,981
Disability labour pension	3,865	3,469	3,514	4,270	4,822	4,323	4,062	3,925	3,816	2,703	2,588
Survivor's labour pension (for each disabled family mamber)	4,033	3,864	2,792	2,482	2,116	2,737	2,172	1,716	1,523	1,456	1,401
Victims by the radiation and man-made disasters and their families	-	-	-	-	-	215	249	272	275	273	284
Federal state civil employees	-	-	-	-	-	27	35	40	43	49	56
For long service***	124	95	82	197	674	-	-	-	-	0	0
Test-pilots	-	-	-	-	-	-	-	-	-	1	1
Average state pension security (social pension)	-	-	470	1,123	1,986	1,819	2,161	2,492	2,605	2,762	2,851
Share of women aged under 55 in the total number of old age labour pension**, %**	...	4.60	4.40	5.10	4.60	6.10	6.40	5.90	5.70	5.40	...
Share of men aged under 60 in the total number of old age labour pension**, %**	...	3.60	4.20	6.30	3.40	5.00	5.40	5.10	5.00	4.80	...
The number of working pensioners (in thousands)	-	-	6,801	8,426	6,102	8,592	10,198	10,970	11,708	12,380	13,030
including receiving pensions:											
Old age labour pension	-	-	6,026	7,646	4,631	7,503	9,096	9,866	10,589	11,345	11,995
Disability labour pension	-	-	747	681	783	935	936	923	926	831	818
Survivor's labour pension (for each disabled family mamber)	-	-	...	13	43	23	12	10	10	10	10
Victims by the radiation and man-made disasters and their families	-	-	-	-	-	71	86	95	98	101	105
Federal state civil employees **For long service*****	-	-	-	-	-	4	6	10	10	13	15
Test-pilots	-	-	-	-	-	-	-	-	-	1	1
Average state	-	-	...	17	115	56	62	66	75	79	86

pension security (social pension)											
Average size of accrued pensions***, RUB (untill 1998 - thou. RUR)**											
All pensioners	0	0	0	243	823	2,538	3,682	4,546	6,177	7,594	8,273
including receiving pensions:											
Old age labour pension	0	0	0	259	894	2,764	3,973	4,910	6,630	8,166	8,876
Disability labour pension	0	0	0	218	699	1,982	2,875	3,492	4,785	5,137	5,539
Survivor's labour pension (for each disabled family mamber)	0	0	0	133	502	1,494	2,119	2,762	3,740	4,819	5,333
Victims by the radiation and man-made disasters and their families	-	-	-	-	-	2,439	3,720	4,339	6,031	6,856	7,514
Federal state civil employees	-	-	-	-	-	4,389	6,048	7,843	9,565	10,969	11,495
For long service* **	0	0	0	277	674	-	-	-	-	56,574	56,630
Test-pilots	-	-	-	-	-	-	-	-	-	51,018	56,311
Average state pension security (social pension)	-	-	0	160	497	1,798	2,724	3,007	4,245	4,731	5,206

* Due to changes in pension legislation at 2002 and 2010 the number of pensioners has been redistributed by types of pension provision and categories of pensioners. Since 2005 data have been recalculated to compare with the methodology of 2010.

** For 1970-2000 - data is given on pensioners registered in the social security agencies

*** Since 2010 - for long service for pensioners-cosmonauts

**** Receiving a pension in accordance with the Federal Law of 17.12.2001 No 173-FZ "On labour pensions in the Russian Federation"

Source: Federal State Statistics Service

APPENDIX 2

Autonomous pension funds' assets as a percent of GDP in OECD countries

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Australia	75.3	70.4	68.9	71.6	80.4	90.4	110.4	93.0	82.6	89.0	92.8
Austria	2.9	3.8	4.1	4.4	4.8	4.9	4.8	4.4	5.1	5.4	4.9
Belgium	5.5	4.9	3.9	4.0	4.4	4.2	4.5	3.3	4.1	3.8	4.2
Canada	52.5	48.3	51.6	53.9	58.2	63.4	62.3	51.4	62.9	64.7	63.7
Chile	..	55.1	58.2	59.1	59.4	61.0	64.4	52.8	65.1	67.0	58.5
Czech Republic	2.3	2.7	3.1	3.5	4.1	4.5	4.7	5.2	6.0	6.3	6.5
Denmark	27.2	26.0	28.5	30.8	33.7	32.4	32.4	47.5	43.3	49.7	49.7
Estonia	0.0	0.2	0.9	1.9	2.8	3.7	4.6	4.6	6.9	7.4	5.3
Finland	49.5	49.2	53.9	61.8	68.6	71.3	71.0	60.6	77.8	82.1	75.0
France	..	..	..	..	0.0	0.0	0.1	0.1	0.2	0.2	0.2
Germany	3.4	3.5	3.6	3.8	4.0	4.2	4.7	4.7	5.2	5.4	5.5
Greece	..	..	..	..	..	..	0.0	0.0	0.0	0.0	0.0
Hungary	3.9	4.5	5.2	6.8	8.5	9.7	10.9	9.6	13.1	14.6	3.8
Iceland	84.0	83.9	98.3	106.6	119.6	129.7	134.0	114.1	118.3	123.9	128.7
Ireland	43.7	34.4	39.8	42.0	48.3	50.2	46.6	34.1	44.1	49.0	46.2
Israel	25.1	27.2	27.7	28.3	34.0	32.2	33.2	42.8	46.4	48.9	49.4
Italy	2.2	2.3	2.4	2.6	2.8	3.0	3.3	3.4	4.1	4.6	4.9
Japan	18.5	25.5	28.6	25.8	27.7	26.3	25.7	22.9	26.5	25.2	25.1
Korea	..	1.5	1.6	1.7	1.9	3.0	3.1	3.0	3.5	4.0	4.5
Luxembourg	..	..	..	0.3	1.1	1.0	1.0	1.1	2.2	1.9	1.9
Mexico	4.3	5.2	5.8	6.3	10.0	11.5	11.5	10.2	11.9	12.7	12.9
Netherlands	102.6	85.5	101.2	108.1	121.7	125.7	138.1	112.7	119.2	128.5	138.2
New Zealand	15.3	13.3	11.6	11.6	11.5	12.5	11.5	10.5	12.0	14.4	15.8
Norway	5.5	5.5	6.5	6.5	6.7	6.8	7.0	6.0	7.3	7.8	7.4
Poland	2.4	3.8	5.3	6.8	8.7	11.1	12.2	11.0	13.5	15.8	15.0
Portugal	11.5	11.5	11.8	10.5	12.7	13.6	13.7	12.2	13.4	11.4	7.7
Slovak Republic	0.0	0.0	0.0	..	0.5	2.4	3.7	4.7	6.3	7.4	8.4
Slovenia	..	..	0.5	0.9	1.3	1.6	1.8	1.9	2.6	2.5	2.9
Spain	5.8	5.7	6.2	6.6	7.2	7.5	8.2	7.1	8.1	7.9	7.8
Sweden	8.1	7.4	7.5	7.4	9.1	9.3	8.7	7.4	8.4	9.6	..
Switzerland	102.5	95.9	102.9	107.2	117.0	120.0	119.2	101.2	111.9	113.7	110.8
Turkey	..	..	..	0.4	0.7	0.7	1.2	1.5	2.3	2.3	2.2
United Kingdom	72.0	58.8	64.4	67.6	78.6	83.4	78.9	64.3	80.5	88.7	88.2
United States	71.5	63.2	72.6	74.0	74.8	79.3	79.4	57.9	67.6	72.6	70.5

Source: OECD

Pension funds' assets as a percent of GDP in selected Non-OECD countries

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Albania	..	..	..	..	..	..	0.0	0.0	0.0	0.0	0.0
Argentina	..	12.4	12.5	12.1	12.8	13.7	11.6	..	..	..	..
Bolivia	..	15.1	18.9	19.8	21.5	20.0	21.5	22.6	26.7	..	..
Brazil	..	..	..	..	..	17.9	16.4	13.7	15.5	14.7	13.8
Bulgaria	0.6	1.0	1.4	2.0	2.5	2.9	3.9	3.3	4.6	5.7	6.1
China	..	..	..	0.3	0.4	0.4	0.6	..	0.7	0.7	..
Colombia	5.0	6.4	7.5	8.6	11.4	11.3	15.0	14.4	13.3	16.1	17.0
Costa Rica	3.0	4.8	6.2	4.7	5.8	6.7	6.2	7.2	8.0	7.7	8.7
Croatia	..	1.1	2.3	3.6	4.4	..	..	..	..	..	..
Dominican Republic	..	..	0.2	0.7	1.3	1.8	2.4	3.0	4.0	4.7	..
Egypt	..	..	..	..	..	..	..	2.4	..	..	..
El Salvador	..	7.4	10.5	13.6	16.8	17.9	19.4	20.2	23.8	..	..
Hong Kong (China)	14.6	16.8	18.3	23.0	24.8	27.8	31.1	27.9	32.0	34.7	32.5
India	..	..	..	..	..	..	..	..	..	0.2	0.2
Indonesia	..	2.2	2.4	2.4	2.2	2.2	2.2	..	..	1.6	1.8
Jamaica	..	..	..	15.9	..	16.8	19.6	19.5	20.5	22.0	..
Kenya	8.1	9.4	10.7	11.0	11.8	13.6	..	13.0	12.9	16.9	..
Latvia	0.2	0.5	0.7	1.0	1.3	1.6	..	..	0.7	0.9	0.8
Former Yug. Rep. of Macedonia	..	..	..	..	..	..	0.9	1.2	2.1	2.9	3.6
Mauritius	42.8	42.5	44.0	50.3	53.9	..	..	..	..	..	..
Nigeria	..	..	..	..	..	..	4.2	4.6	5.5	6.9	..
Pakistan	..	..	..	..	..	..	0.0	0.0	0.0	0.0	0.0
Peru	6.6	8.0	10.4	10.9	12.5	15.3	18.3	13.6	18.4	20.2	16.9
Romania	..	..	..	..	..	..	0.0	0.2	0.5	0.9	1.2
Russian Federation	..	..	..	..	..	0.9	1.0	0.7	1.4	1.9	3.2
Serbia	..	..	..	..	..	0.0	0.1	..	0.3	0.3	..
South Africa	81.9	74.1	71.4	77.1	81.7	91.7	96.2	86.7	78.2	82.5	..
Suriname	..	19.2	13.9	19.5	..	..	..	..	..	..	..
Thailand	4.3	4.5	4.8	4.7	4.9	5.0	5.2	5.1	5.7	5.7	5.9
Trinidad and Tobago	..	..	..	..	..	17.3	17.0	..	..	..	..
Ukraine	..	..	..	..	..	..	..	0.1	..	0.1	0.1
Uruguay	..	9.3	11.4	11.7	12.2	13.2	13.0	10.7	14.1	17.0	..
Zambia	4.1	4.0	5.7	4.1	3.8	..	..	..	..	..	..

Source: OECD and Ministry of Finance, Russian Federation. Data only refer to the mandatory part of the Russian system.