



ANNEX 89

Twinning Project AZ/13/ENP/SO/24

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

«Establishment of non-state pension institutions and development of legal framework»

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29th April, 2015

Main issues for establishing Private Pension funds in Azerbaijan

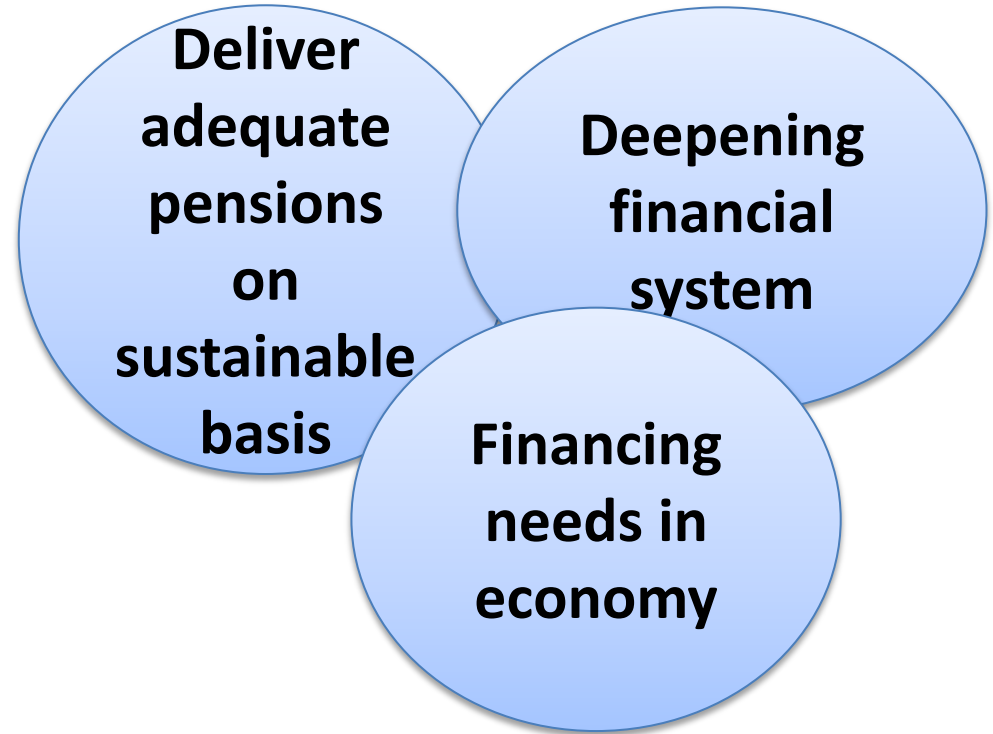
1. Goals and principles of non-state pension savings system
2. Recent developments of private pension systems across the Europe
3. Establishment of Private Pension Management Companies (Private Pension funds)
 - Types of companies, governance structure, types of products, licensing rules, shareholders capital needed,
4. Participation rules in Private Pension funds
 - Participants and contributions in Private Pension funds, Individual accounts of participants, Pay-out issues of pension benefits, Guaranties to participants
5. Occupational pension arrangements
6. Asset Management
7. Custodian and it's role in Private Pension funds activities
8. State supervision of Private Pension Funds activities
9. Tax incentives for savings in Private Pension funds
10. Main challenges for establishing Private Pension funds in Azerbaijan

1. Goals and principles of non-state pension savings system

Role of private pensions

Private pensions play an important and **growing role** in providing for old age.

As one of the **main types of institutional investors**, it also plays a significant role in fulfilling the diverse financing needs of various sectors of an economy and thus contributes to the economic development of a country as well as to the **deepening of its financial system** and promoting stability.



Primary objectives:

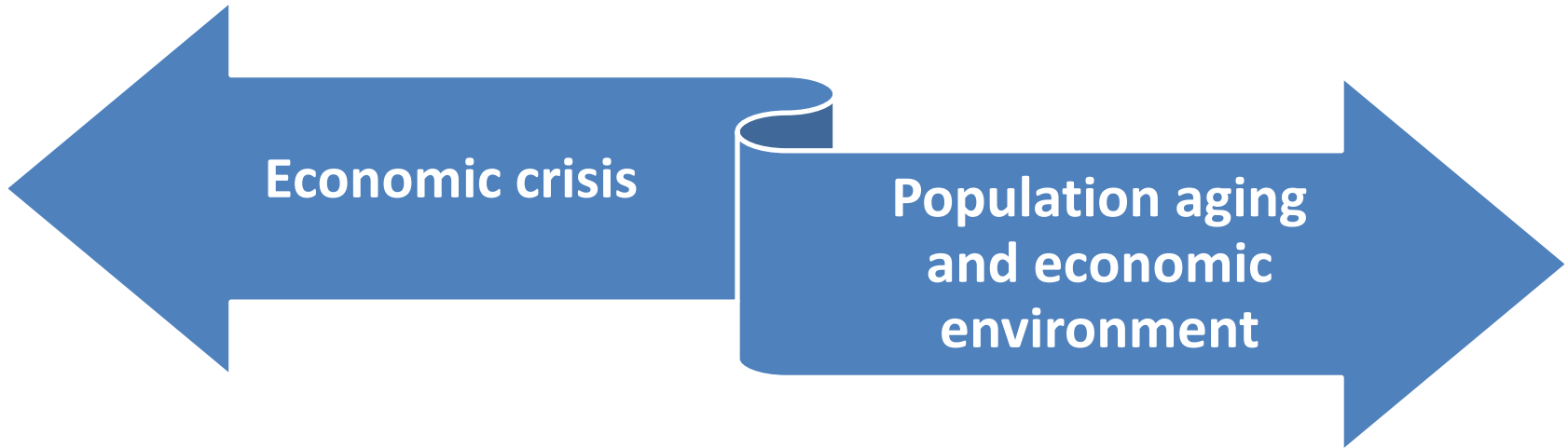
- poverty reduction among the aged
- lifetime consumption smoothing

Secondary objectives:

- increased national savings
- capital market growth
- labor market incentives

2. Recent developments of private pension systems across the Europe

Challenges for private pension systems



Reduction of government revenues to finance PAYG system
Space for a growing role of private pensions

Introducing challenges to the ability of private pensions to deliver **adequate retirement income**
DB schemes – solvency
DC schemes – adequacy of income

Future of complementary retirement savings

Improve cost-effectiveness, safety and equitable access to supplementary pension schemes

Addressing gender equality aspects will also be crucial in order to avoid widening the existing gender gaps

Tax & financial incentives
Role of collective bargaining

Women currently have fewer opportunities to build up supplementary retirement savings than men

Strong pressure on distrust in the financial sector



GER – public support for private pensions?

PL & HU – abolished or scaled down mandatory funded pension systems

Automatic enrolment

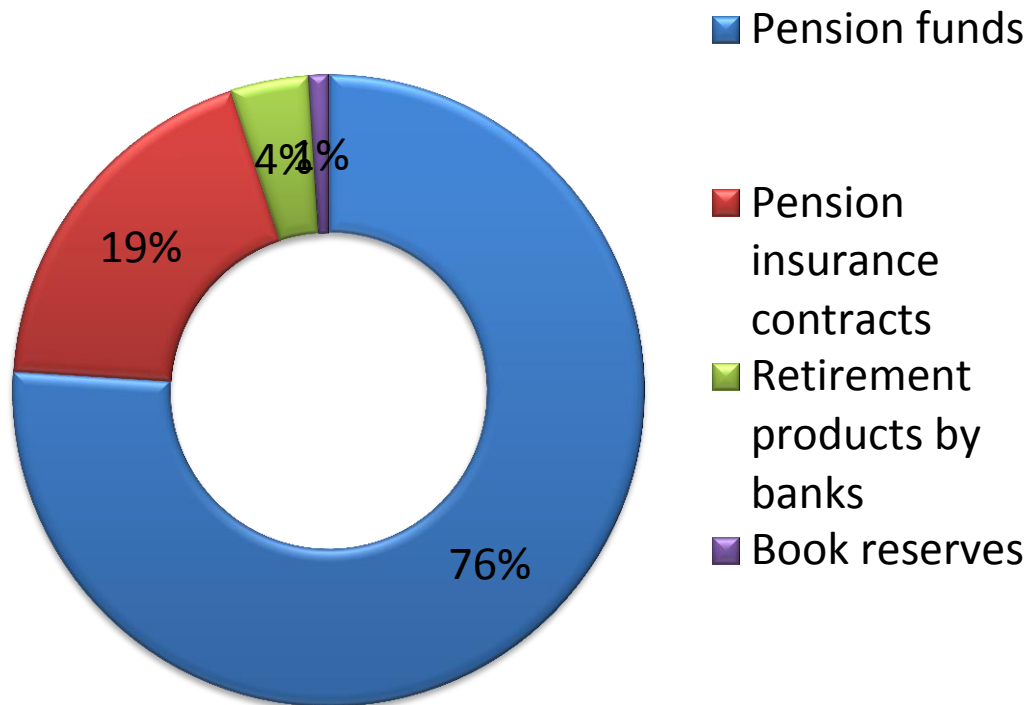


From voluntary to soft compulsion: auto-enrolment or even mandatory

DK & NL – Prudent and effective management with positive investment returns in real terms

Private pension arrangements

Pension arrangements in OECD countries

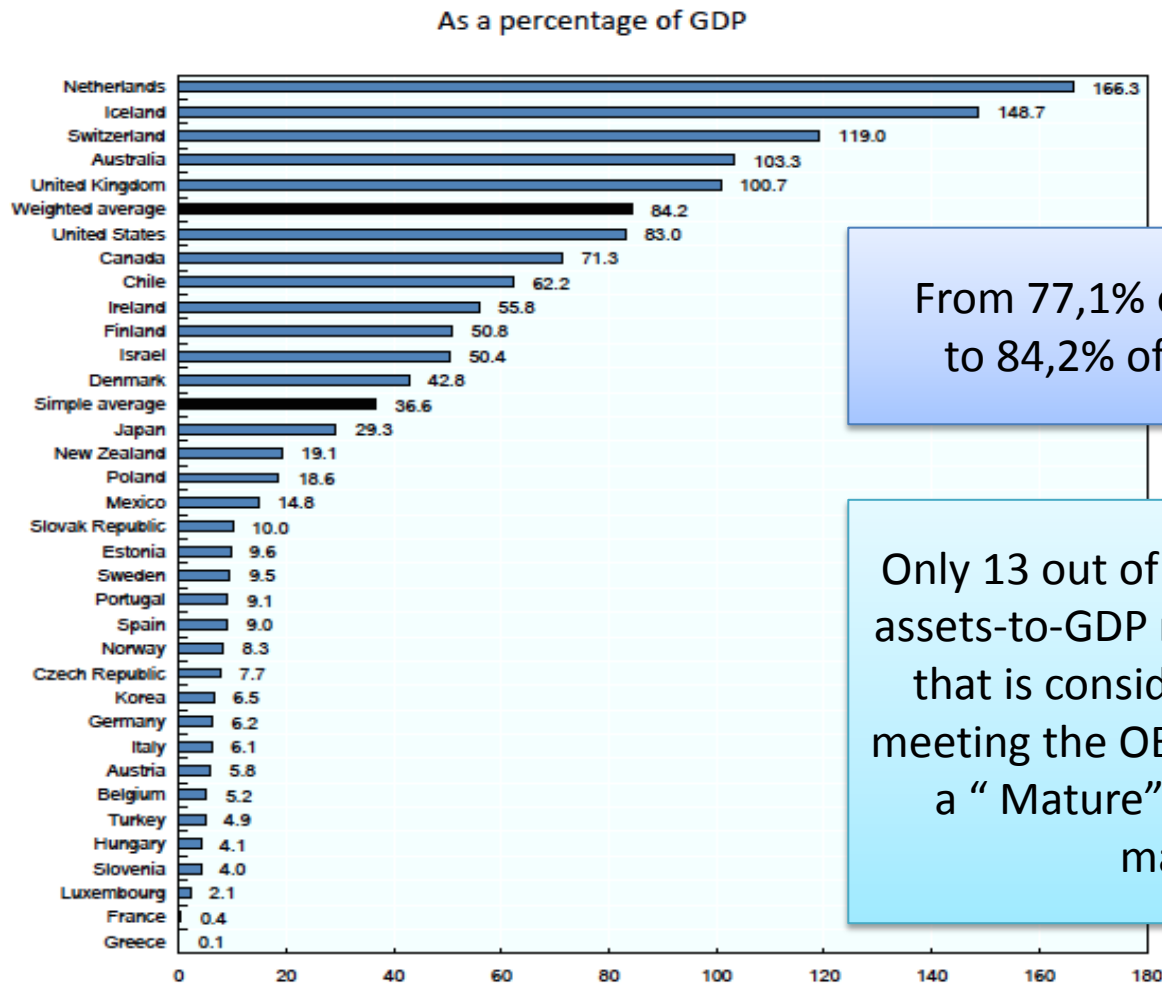


In 18 countries from 34, private pensions are mandatory or quasi-mandatory (near-universal coverage of employees through collective bargaining agreements)

In 8 OECD countries, voluntary private pensions (occupational and personal) cover more than 40% of the working age population

Scale of pension funds activity

Figure 3. Importance of pension funds relative to the size of the economy in the OECD, 2013



From 77,1% of GDP in 2012 to 84,2% of GDP in 2013

Only 13 out of 34 countries had assets-to-GDP ratios above 20%, that is considered as min for meeting the OECD's definition of a "Mature" pension fund market

Note: For methodological notes see page 32 onwards.

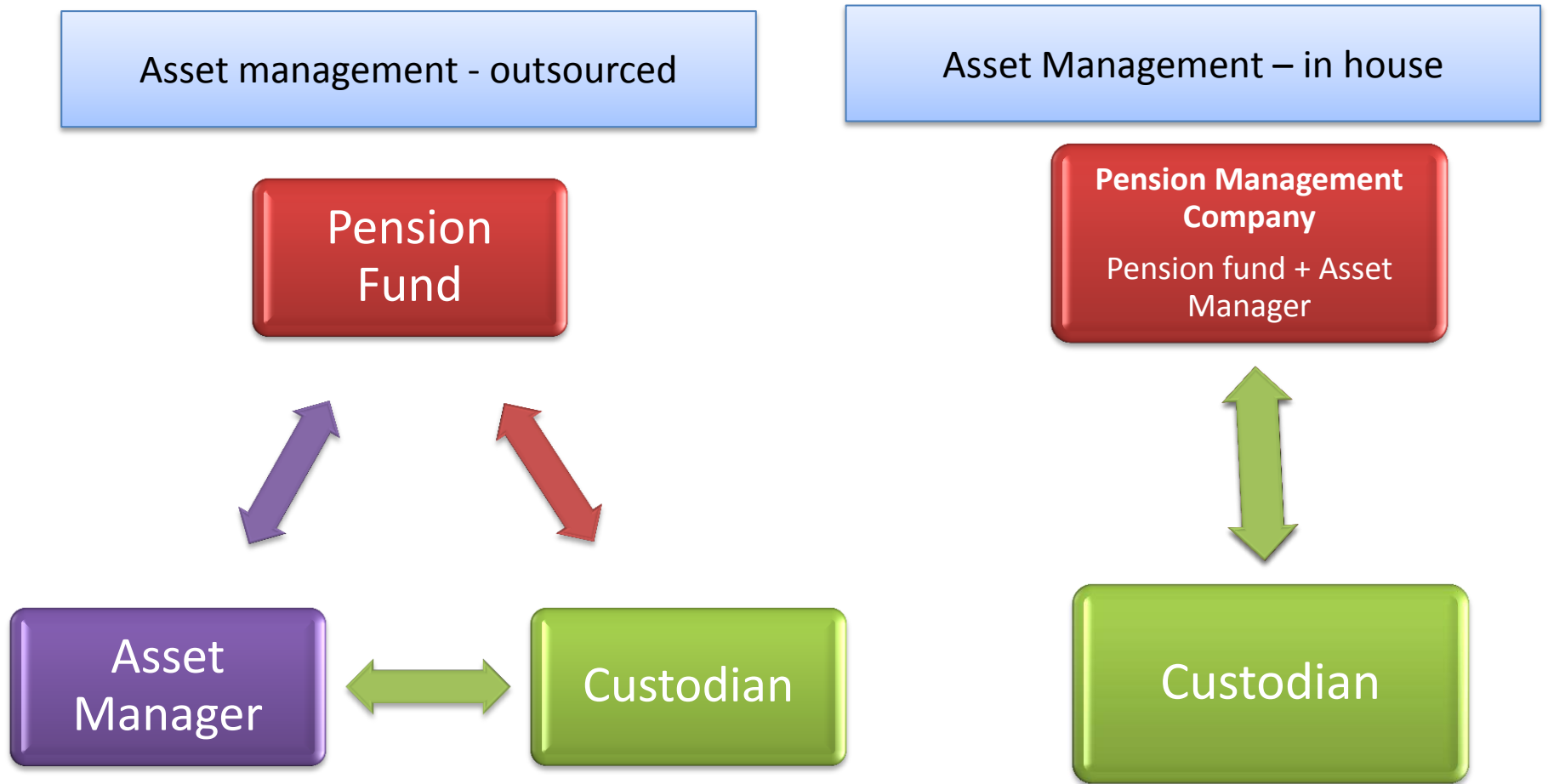
Source: OECD Global Pension Statistics.

3. Establishment of Private Pension Management Companies (Private Pension funds)

Concept of private pension funds

- **Accumulation** of pension plan participants contributions voluntary made by themselves or on behalf by employer or other individuals;
- **Investment** of pension plan assets regarding to investment strategy of each pension plan;
- **Organizing** of participants individual accounts and providing information to pension plan participants;
- **Marketing** of pension plans to potential participants – employers and private persons/individuals;
- **Providing of pension benefits** (pay-outs) from accrued pension capital to pension plans participants or their heirs in accordance of pension plan rules.

Private pension funds / Pension Management company



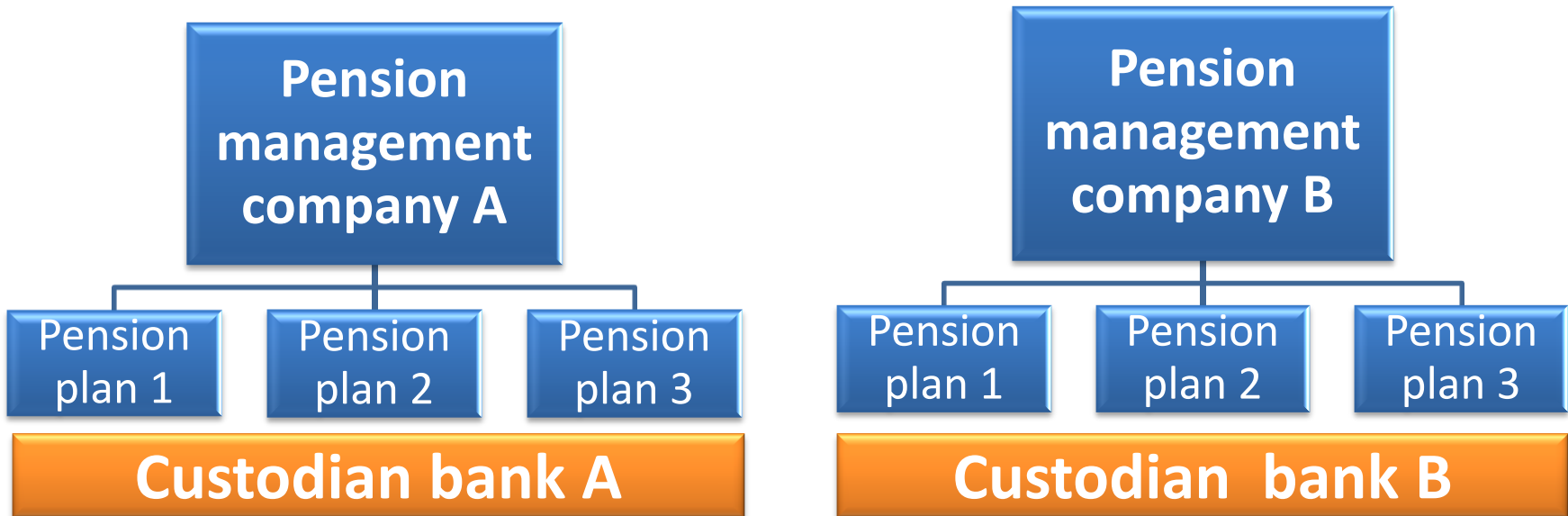
Main functions of Pension management company

- Attracts **new participants to pension plans** (individuals & corporates)
- **Accumulate all contributions** and provides investments to participants regarding to pension plans rules
- Provides administration **of Individual accounts of participants** & provides them with all information
- Provide pay-out of pension benefits
- **Asset management functions**
 - Takes tactical & strategic investment decisions and makes investment regarding to Investment policy
 - Gives investment orders to custodian
 - Calculates Investment return

Main functions of Custodian Bank

- Servicing Contributions in & benefits out of participants in pension plans
- Controls investment limits regarding to Investment policy
- Keeps all investment documents
- Performs all Investment orders

Pension Management company functional scheme



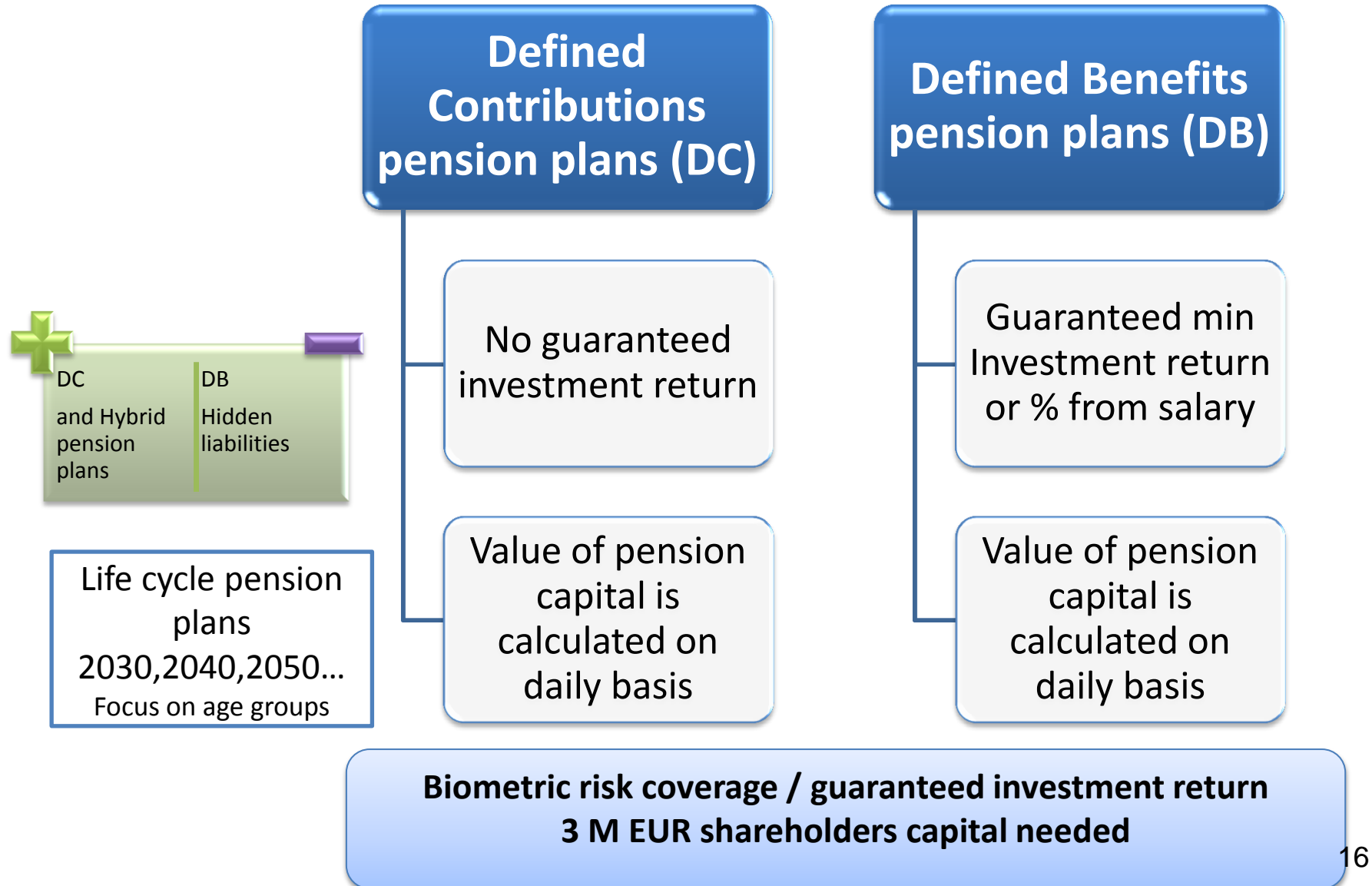
Competition should be based on:

products offered (pension plans), pricing of products and services, advice of customers and participants, management of individual accounts, information and self services provided to participants, investment performance)

Development of Pension plans:

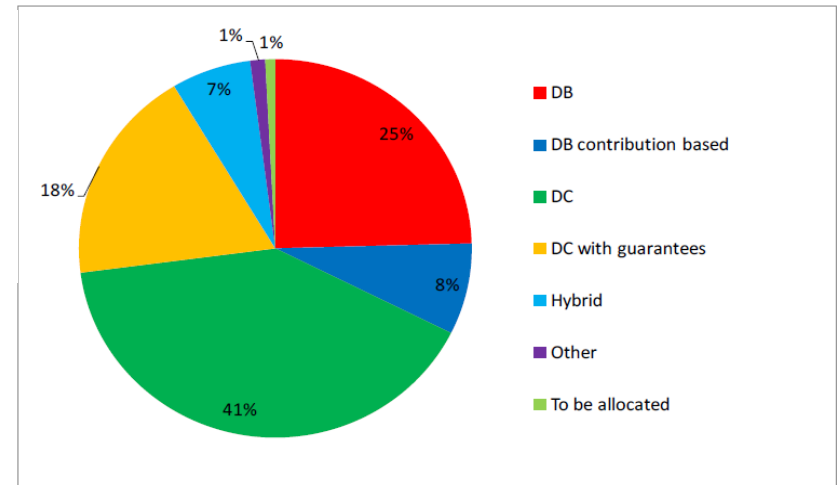
- Can be universal based on specific investment strategy and open for everybody
- Can be developed for specific company or professional association

Pension products or types of pension plans – savings instruments are not limited



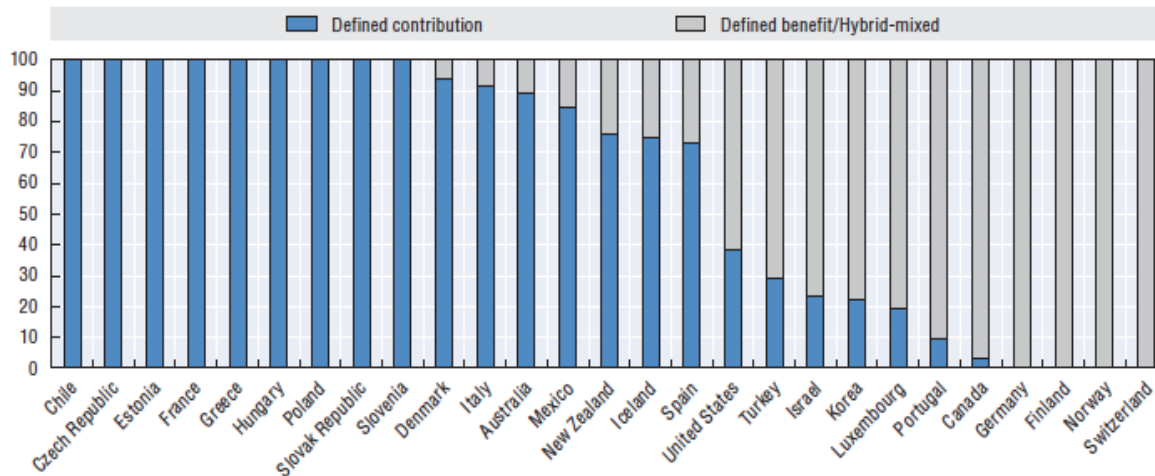
Occupational vs personal pension plans/products in EEA 2014

	Occupational	Personal	Occupational and Personal	To be allocated	Total
DB	55	4	1		60
DC	51	45	3		99
Other	49	25	9		83
To be allocated	1			1	2
Total	156	74	13	1	244



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

As a percentage of total assets



Source: OECD, Global Pension Statistics.

Types of Private Pension management companies and their shareholders

4 000
AZN min.
capital

OPEN

Joint stock company

- Commercial banks
- Life insurance companies
- Asset Management companies

Profit pension company with profit sharing regulation

CLOSED

Joint stock company

- One or several employers (corporates or professional associations)

Non-profit pension company

2 000
AZN min.
capital

Licensing rules for Private Pension Management Companies

Especially for the Azerbaijan licensing rules can also be seen as a mechanism to ensure public confidence in the private pension system, by applying transparent standards and establishing security to warrantee the integrity of pension funds.

Only licensed pension funds can execute private pension savings business.

Requirements for licensing:

- 1) Business plan
- 2) Pension plans
- 3) Investment policy of pension plans
- 4) Individual participation agreements and rules of registering
- 5) Agreement with Asset Manager (if outsourced) and Custodian
- 6) Methodology of capital pay-out
- 7) Organizational structure, description of management structure, description of accounting policy, IT system protection rules and other relevant documentation
- 8) Prove that management boards and supervisory board members have required professional qualification and experience
- 9) Outsourced functions and agreements
- 10) Description of principles of reinsurance policy (if insurance provided)

Governance of Private Pension funds regarding to OECD guidelines

GOVERNANCE STRUCTURE

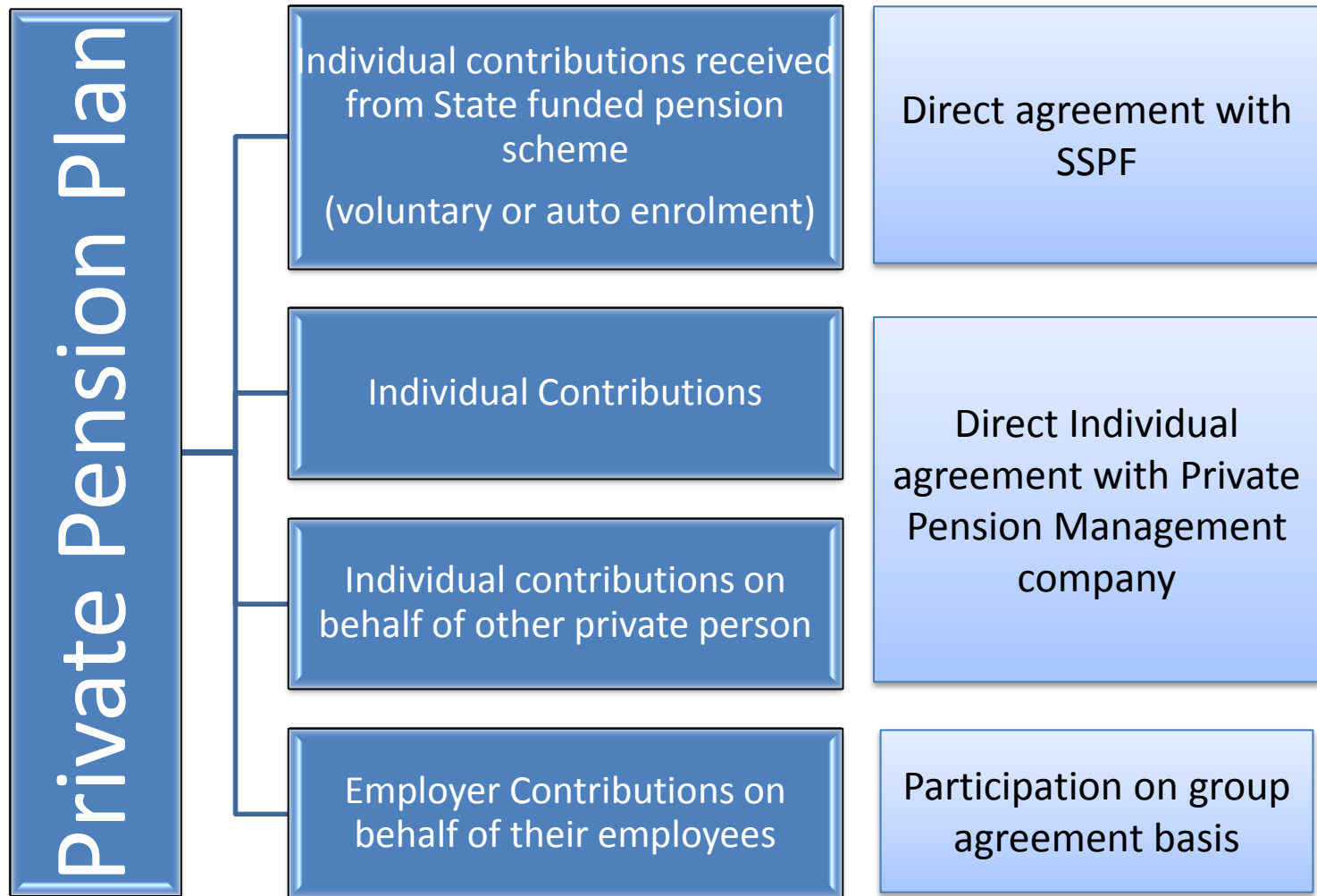
1. **Identification of responsibilities** – clear separation of operational and oversight responsibilities in the governance of a pension fund
2. **Governing body** – ultimately responsible for protection of the best interest of plan participants and beneficiaries
3. **Accountability** – 2 tier board system (managing board and supervisory board)
4. **Suitability** – necessary skills and knowledge
5. **Delegation and expert advice** – external service providers, quality and independence
6. **Auditor** - external audit
7. **Actuary** – for defined benefit plans
8. **Custodian** – assets should be legally separated from those of the custodian

GOVERNANCE MECHANISMS

1. **Risk based internal controls** – cover all basic organizational and administrative procedures
2. **Reporting** – between all persons and entities involved in governance
3. **Disclosure** – information relevant to all parties involved should be clear, accurate and timely fashion

4. Participation rules in Private Pension funds

Contributions and agreements in pension plans



Individual accounts and guaranties to participants

Statement of accounts /min requirements/

- All contributions separately by type and contributor
- Commissions and fees addressed to Pension Management company, State supervisory authority, custodian
- Investment result
- Profit distributed to participants

Guaranties to pension plan participants

- All contributions paid in individual account belongs only to participant – **full private property**
- Debt collection – in case if participant has done losses to third parties in **criminal case**
- All contributions made in individual account should be accounted no later than **next business day** by Pension Management Company
- Assets of pension plans **should be kept separately** from assets of Pension Management company, asset manager (if outsourced), custodian - can not be used to cover liabilities of these companies in case of insolvency
- Any investment guaranty should be considered by private provider

Pay-out options for pension benefits

How to convert pension savings into retirement income
– most important decision by participants

Main financial risks has to be managed and mitigate:

- Inflation risk
- Investment risk
- Longevity risk

Basic Retirement Payout options:

- 1) Purchase of a Payout Life Annuity
- 2) Following an Systematic Income Drawdown Plan
- 3) Building a Portfolio of Life Annuities and Income Drawdown Plans (hybrid solutions)

Inheritance issue for pension capital is crucial

Pay-out of funded pension benefits

State Funded Pension Capital – at the state pension age

- Add to labour pension or life annuity provided by Pension Management Company or Life Insurance Company
- Life annuity – could be with different payment periods to make it more attractive compare with state pension
- Inheritance of capital or beneficiary in case of participant death – in agreement / additional incentive

Private Pension Capital – at the age of 55 / or 5 years prior retirement

- Before age 55 years - In special professions adopted by Rules of Cabinet of Ministers (prepared by Ministry of Welfare); When participant becomes disabled person of 1st group for life
- Lump sum, regular payments or in parts provided by Pension Management Company
- Life annuity provided by Pension Management Company or Life Insurance Company – can be with different payment periods / optional in the beginning/ on later stage with structure which provide income for longer period
- Inheritance of capital or beneficiary in case of participant death – in agreement

Marketing rules of pension plans

Public communication and marketing of private pension savings can be done only regarding to terms and conditions set up in pension plans which are registered in State Supervisory Authority

In case of DC plans – investment return is not guaranteed – not be allowed to advertise any guaranty on investment result or promise that historical investment result result would be same in the future

Under consideration – to put some **some ceilings on costs of advertising** on later stage when assets are accumulated until «break – even» point and some profit sharing with participants would be applied. / percentage from total costs or assets under management/

5. Occupational pension arrangements

Occupational pensions key issues

- **Voluntary participation** or automatic enrolment / how to increase coverage?
- **Tax incentives** to employer and employee / cap up to 10% from gross salary
- **Employees and self-employed** persons should be covered
- **Pay-out phase** – the same as for individual savings or specific for occupational savings
- **Labour Law** – include definition that private pension savings are part of remuneration

6. Asset Management

Investment principles of pension assets

Prudent person rule

To invest in best interest of members, beneficiaries

To ensure security, quality, liquidity, profitability of the portfolio

Predominantly on regulated markets

Derivatives – to reduce risks and facilitate efficient portfolio management

Investment strategies

Investment category	Risk level	Return expectation	Typical investment allocation	Equity allocation
Conservative	Low	Low	High quality fixed income investments. No FX risk	0%
Balanced	Medium	Medium	Fixed income. Credit risk. Some FX risk. Moderate equity risk.	0-50%
Active	High	High	Fixed income. Credit risk. FX risk. Significant equity risk.	Above 50%

Asset classes and investment risks

Asset class	Description	Investment risks
Fixed income	Includes government T-bills and T-bonds, municipal bonds, agency securities, mortgage backed and asset backed securities, corporate securities, deposits etc.	Liquidity Investment horizon Risk tolerance Foreign exchange FX risks Political risks
Equities	Listed local and foreign equities. Equities can be further split by geography, developed countries vs. emerging markets, industries etc.	Country risks Credit risk – ratings should be used Conterparty risks
Alternative investments	Risk capital, real estate, infrastructure funds, hedge funds etc.	Operational risks

Hypothetical investment returns of pension plans

A

Asset Class	Expected Returns	Portfolio allocation			Expected pension plan return contributions		
		Conservative	Balanced	Active	Conservative	Balanced	Active
Cash	1,0%	5%	5%	5%	0,1%	0,1%	0,1%
Deposits	9,0%	50%	50%	40%	4,5%	4,5%	3,6%
Short term government bonds, mortgage bonds	3,0%	10%	0%	0%	0,3%	0,0%	0,0%
Medium term government bonds	4,5%	30%	20%	10%	1,4%	0,9%	0,5%
Local corporate bonds	11,0%	5%	5%	10%	0,6%	0,6%	1,1%
Developed market equities	7,5%		10%	17,5%		0,8%	1,3%
Developing market equities	9,5%		10%	17,5%		1,0%	1,7%
Fees					-1,5%	-2,0%	-2,0%
Total		100%	100%	100%	5,3%	5,7%	6,2%

**Return estimates are based on market returns as of January 2015 and expert assessment.*

Including risky local investments /deposits/

B

Asset Class	Expected Returns	Portfolio allocation			Expected pension plan return contributions		
		Conservative	Balanced	Active	Conservative	Balanced	Active
Cash	1,0%	5%	5%	5%	0,1%	0,1%	0,1%
Short term government bonds, mortgage bonds	3,0%	45%	35%	25%	1,4%	1,1%	0,8%
Medium term government bonds	4,5%	50%	40%	35%	2,3%	1,8%	1,6%
Developed market equities	7,5%		10%	17,5%		0,8%	1,3%
Developing market equities	9,0%		10%	17,5%		1,0%	1,7%
Fees					-1,5%	-2,0%	-2,0%
Total		100%	100%	100%	2,2%	2,6%	3,4%

**Return estimates are based on market returns as of January 2015 and expert assessment.*

Without higher credit risk

Documents for Investment rules

Pension Plan

- Investment rules
- Description of investment risks
- Specific investment limits to define pension plan investment strategy (balanced or active)
 - in fixed income and money market instruments,
 - in equities,
 - in real estate and risk capital

Investment policy of pension plan

- Investment strategy the same as in pension plan
- Asset allocation tactics by geography, markets, sectors, partners, currencies
- Investments quantitative restrictions and control
- Policy of using derivatives
- Investment risk control
- Criteria for asset valuation
- Voting policy regarding to investments
- Information about custodian and capital valuation methods
- Policy of prevention of conflicts of interest

Must be published in pension management company web page

Tax consideration

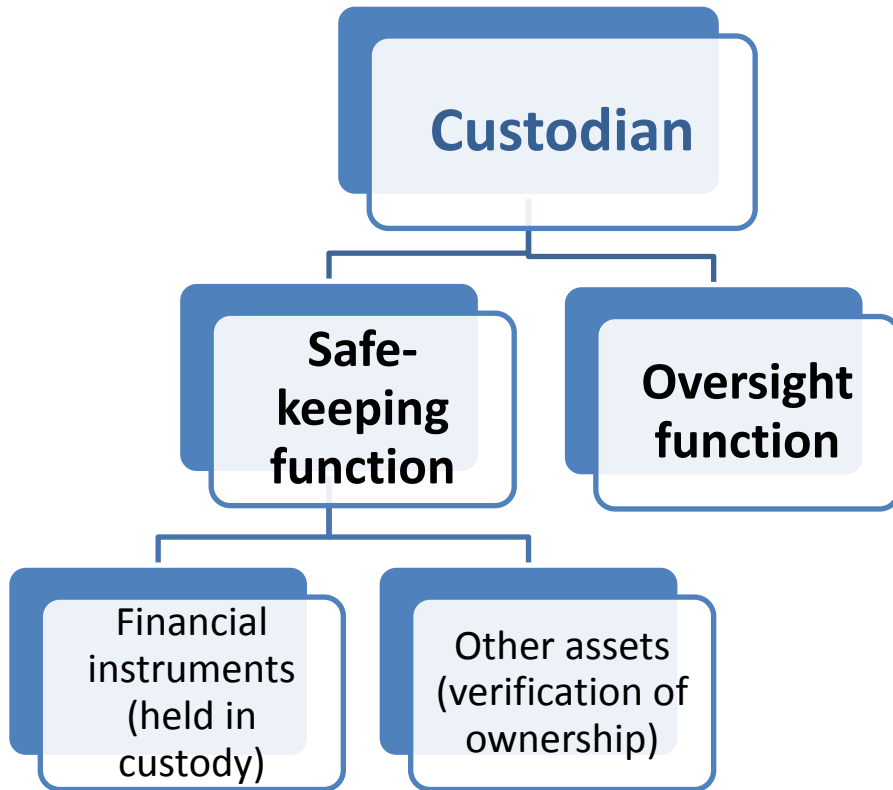
- **Capital gain tax** from investment result of pension plans should be decided
- Internationally **10% capital gain tax** is applicable in more developed markets
- In initial stage of development of capital markets - **capital gain tax exemption** would be advisable

State as an Asset Manager

- **Transitional period** 5Y for voluntary state funded pension scheme before assets would be managed by Private Pension management Company
- **Benefits** – primarily related to perceived security and lower cost of service
- **Some issues should be considered:**
 - Conflict of interest (issuing government bonds and investing rules)
 - Liabilities
 - Reputation
 - Capital market development
 - Agency (State Oil Fund, Central Bank or special state asset management company)

7. Custodian and it's role in Private Pension funds activities

Custodian – safeguard for participants and beneficiaries



The most important issue is to implement the legal tools requiring custodian always keep assets of the pension schemes separately from any other assets belonging to custodian itself or other clients of the respective custodian.

It is expected that the custodian should be required to at least:

- Ensure the **financial instruments are properly registered in segregated accounts** in order to be identified at all times as belonging to the pension plan;
- Exercise due care in relation to the financial instruments held in custody to **ensure a high level of protection;**
- **Assess and monitor all relevant custody risks.** In particular, custodians should be required to assess the custody risks related to settlement systems and inform pension fund of any material risk identified.

8. State supervision of Private Pension Funds activities

Main tasks of Supervisory Authorities

Sound, modern and independent supervision is an important component of the successful functioning of pension management function and protection of the interests of the members

Develop regulations

Carry out the supervision

Licensing

Protect the interests of the customers

Improve financial literacy level

Administer the financial stability fee

International cooperation

Statistics and analyses

Infrastructure of Financial and capital markets supervision in AZE

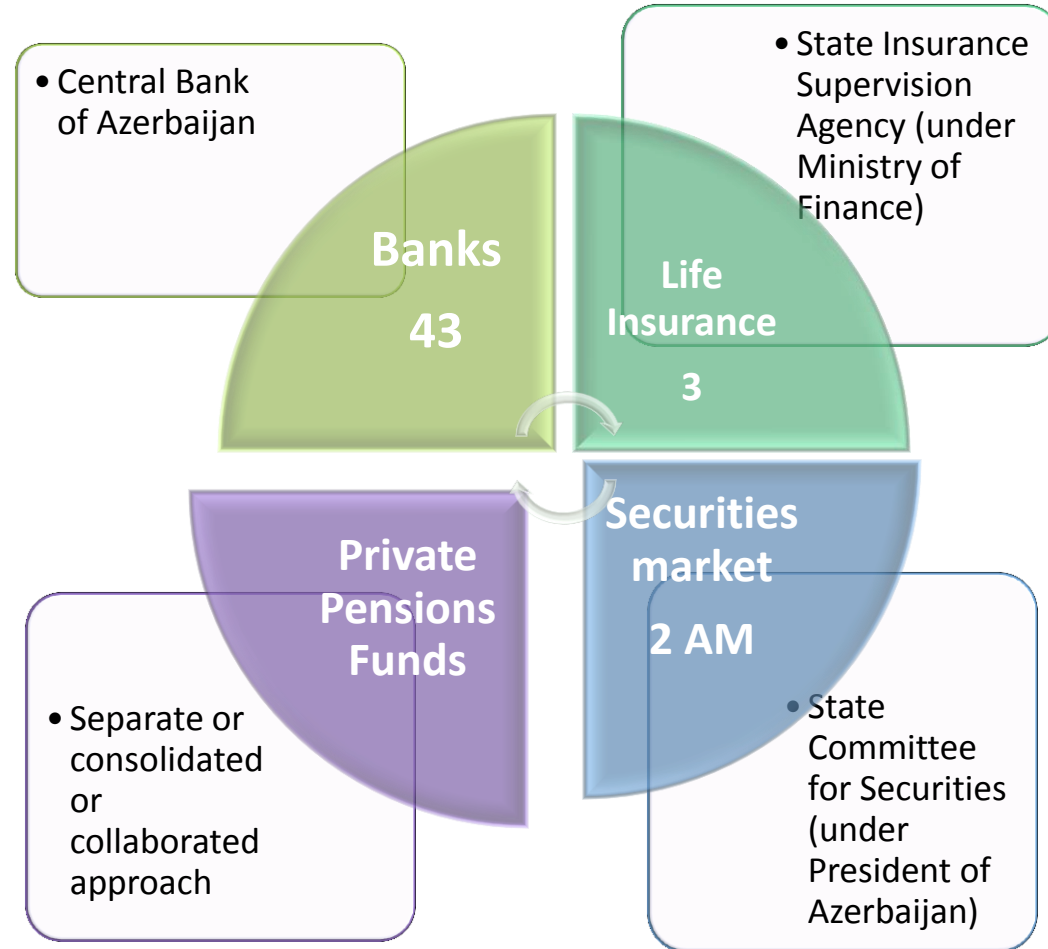
For the successful activities of the pension business there are three important components that should be considered:

- Administration
- Asset management
- Custodianship

For private pension funds

- 1) **Consolidation** of the supervision and creation of the single competent authority
- 2) **Partially integrated** authority between existing supervisory authorities
- 3) **Specialized authority** - current approach of sectorial division of the supervision

While single body could perform administration and asset management function, custody function should be ring fenced and outsourced to the banking sector.



Requirements for supervisory authority of Private Pension Funds

Protection of the rights of the members and beneficiaries of the pension plans

- The pension supervision should have an obligation to ensure that pension management companies perform with a professional approach and stability, as well as to protect the legitimate interests and rights of the members of the pension plans.

Politically and economically independent from any kind of impact

- Providing operational independence and stating that pension supervision authority is an autonomous / independent public authority that regulates and monitors the functioning of the pensions market and its participants, makes independent decisions within the limits of its authority, executes functions assigned to it by law, and is responsible for their implementation.

Adequate staff and access to resources

- Financing by market participants/ transitional period from state
- Fee structure should be transparent

Granted powers and capacity to exercise these powers

- The pension supervisory authority should have the power to conduct necessary supervisory functions, according to the nature of the pension system being supervised. Effective supervision of pension funds or plans should focus on legal compliance, financial soundness and control, minimum capital requirements, investment activity, good governance and integrity, actuarial examination, the supervision of pension plan or fund managers, and the provision for adequate disclosure of information to members.

9. Tax incentives for savings in Private Pension funds

Ultimate goal of tax relief to funded and privately managed pension schemes

..... is to **reward private saving** in order to ensure a higher standard of living in retirement, both **by encouraging more private saving** and **by contributing to the final sum**.

The efficiency and cost of these tools clearly depend on whether additional savings are made.

There are many differing factors that can influence peoples' pension saving such as **advice from financial advisers** and **encouragement from employers**.

.... several countries consider that **tax relief plays an important role** as an incentive for individuals to join and participate in pension schemes.

Incentives for pension savings

Tax incentives

Complicated nature of tax system **and tax relief**

Higher income population with access to financial advice

Direct State support

Matching contributions – easier to understand

Targeting of lower earners

General rules for tax incentives

E- Exempt
or
T- Taxed

Contributions

- When a contribution is made to the savings instrument

E- Exempt
or
T- Taxed

Capital Gains

- When investment income and capital gains accrue to the savings vehicle

E- Exempt
or
T- Taxed

Pension Benefits

- When funds are withdrawn

Personal Income Tax Incentives

Personal Income tax incentives for individuals with long term savings					
	Individual contributions	Employer contributions	Individual contributions	Employer contributions	Contributions for other private person
	Life insurance contracts 3Y+		Private pension savings in private pension funds		
	Up to 10% from gross salary		Up to 10% from gross salary		Up to 10% from gross salary
Contributions	Exempt	Exempt	Exempt	Exempt	Exempt
Capital gains	Exempt	Exempt	Exempt	Exempt	Exempt
Benefits*	Exempt	Taxed	Exempt	Taxed	Exempt
Tax regime	EEE	EET	EEE	EET	EEE

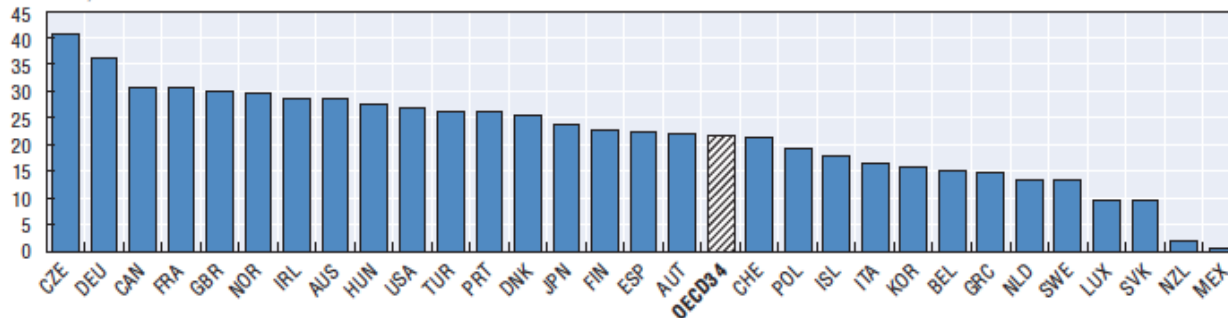
** only contributions part would be applied for personal income taxation*

Up to 30% from gross salary or income

Self – employed persons should be covered

6.6. Tax incentives for private pensions 2003 parameters and rules

Tax incentive, % of contribution



Source: Yoo and de Serres (2004).

Employer contributions and tax incentives

Employees

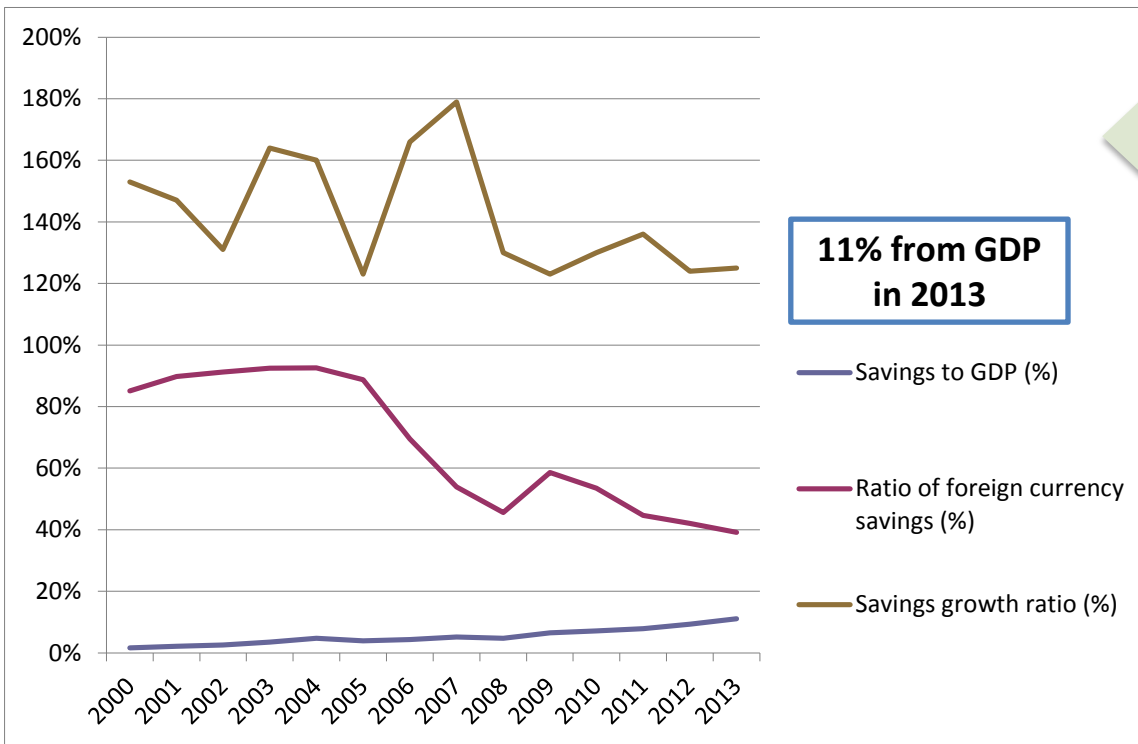
- Are tax exempt from personal income tax
 - **14% or 25% from gross salary**
- No state social insurance contributions should be paid
 - **5% from gross salary**

Employer contributions

- Are included in deductible expenses
 - object of **corporate income tax (20%)**
- No state social insurance contributions should be paid
 - **22% from gross salary**

10. Main challenges for establishing Private Pension funds in Azerbaijan

Savings development in Azerbaijan

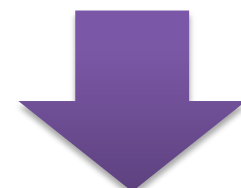


675 AZN – average savings sum

9-10% p.a. average deposit rate
Only short term

No banking products are popular due to rather high shadow economy

Financial literacy is crucial



Bank deposits 1Y
(30 000 AZN 9% p.a.)



Life Insurance
3Y



Main challenges for Azerbaijan to set up effective Private Savings Environment



How to promote voluntary participation?

- Voluntary vs. auto-enrolment for occupational participation
- Tax reliefs vs. matching contributions for individual participation
- Promoting of financial education / from state to private sector, communication, tools, web/
- Other incentives – like inheritance, beneficiaries, early retirement age 55 years or 5 years prior retirement, special professions, disability cases, investment guaranties



Financial and capital markets development

- Supervisory infrastructure – Private Pension Funds Supervisory authority and Single Supervisory approach for financial and capital markets
- Financial and capital market competition issues / International Bank of Azerbaijan /
- Development of Domestic Financial Market – financial instruments, investment restrictions, diversification in transitional period.



State role in Private Pensions Market

- State funded component on voluntary basis vs Private Pension Savings
- Transitional period 5 years - starting with voluntary State Funded Component and then switch to Private Pension Funds



THANK FOR YOUR ATTENTION!

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