Reforming the Funded Pension Scheme in the Russian Federation

An international perspective

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From pension reform to pension reform

- In 2002, the Russian Federation consolidated the multipillar pension scheme
  - Contributions were split between the Pension Fund of Russia and the funded component, with 16% and 6% of the wages respectively.
  - The presence of a default provider (VEB) was an important feature of the Russian scheme versus the systems existing in some Eastern European countries that followed that model
- Since 2016, the default option for new entrants to the pension system is to contribute only to the Pension Fund of Russia (22% of wages)

The effective use of default options in the Russian legislation creates room development of voluntary schemes

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Since the financial crisis many countries with multipillar pension schemes have changed the relative size of the funded component

- Argentina, Bolivia, Bulgaria, Hungary, Poland, Slovak Republic, the Russian Federation, Estonia, Latvia, and Lithuania.

What happened?

- The unwinding of the reforms is largely explained by fiscal reasons
- The creation of funded schemes, in most of the cases, imposes a transition cost that last at least 3 decades
- The transition cost requires a fiscal discipline that is more demanding than the one in countries with pure social security schemes
- Chile (1981) is the only country that has successfully completed the transition

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Financing the transition

- Countries have found difficult to maintain fiscal surpluses to finance the transition costs
- Current accounting system does not help:
  - Countries with funded schemes that finance the transition via government debt issuance would see their debt ratios increased and can be potentially penalized by the market (rating agencies, investment banks, etc.)
  - Countries with only first pillars do not need to finance a transition, but have contingent pension liabilities, which are not reported or penalized by the market (implicit pension debt)
- Thus, mandatory funded schemes are difficult to maintain politically
  - For countries trying to access the Eurozone, is even harder, given the requirements of the Stability and Growth Pact (fiscal deficit and debt rat
  - Starting 2017, EU countries will have to report contingent liabilities

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Lessons

- While the motivation for unwinding these reforms was fiscal, some countries have defended these measures by blaming the pension fund management companies:
  - High fees, lack of portfolio diversification, lack of competition
  - While some of these arguments were valid, remedies were at the reach of policymakers
  - Better to be transparent on the motivations
- Blaming the pension fund managers would backfire on the governments trying to implement voluntary funded pension schemes

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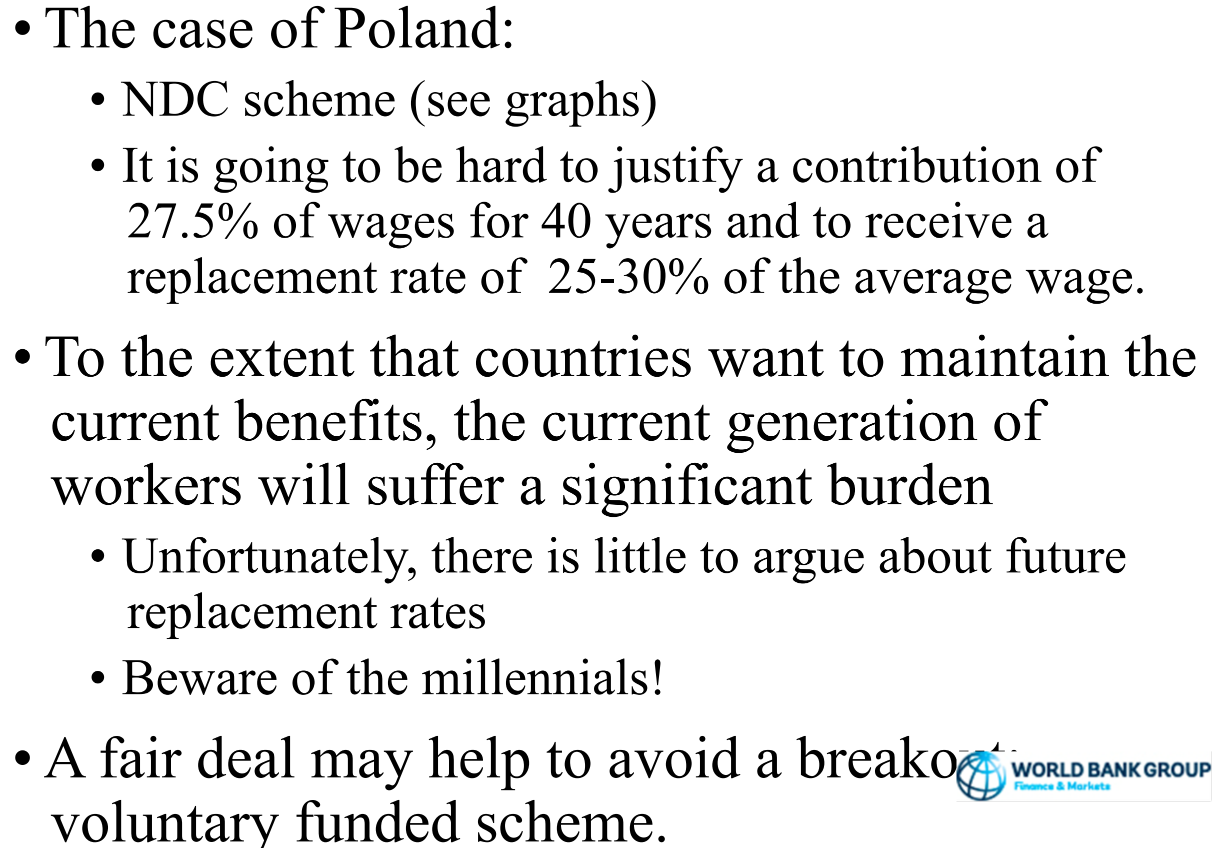
Why will countries need voluntary pension funds?



- The case of Poland:
  - NDC scheme (see graphs)
  - It is going to be hard to justify a contribution of 27.5% of wages for 40 years and to receive a replacement rate of 25-30% of the average wage.
- To the extent that countries want to maintain the current benefits, the current generation of workers will suffer a significant burden
  - Unfortunately, there is little to argue about future replacement rates
  - Beware of the millennials!
- A fair deal may help to avoid a breako[illegible] voluntary funded scheme.

Rethinking voluntary pension schemes

- They were typically perceived as saving mechanisms for a small number of individuals…
  - High end individuals
  - Typically motivated by tax incentives and with considerable savings substitution
- …until countries started to apply behavioral concepts in the implementation of these schemes
  - Libertarian paternalism: individuals are free to choose, but the alternatives are presented in a way that they privilege a welfare improving solution
  - A "do-nothing" response will bring the individuals toward the welfare improving outcome

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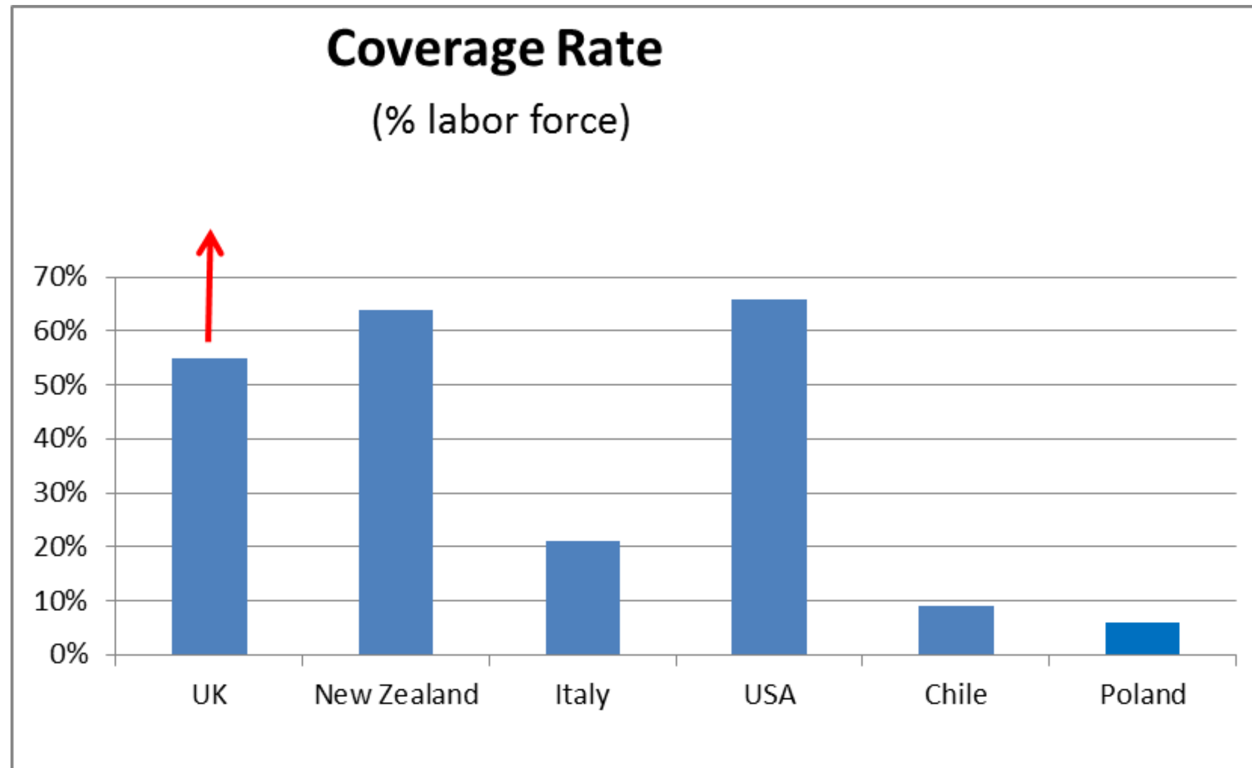
Automatic enrollment

- The employee decides whether he or she contributes to the pension system, but "do nothing" implies that he or she enrolls to the voluntary pension scheme
- In other words, employees that do not want to participate would need to make an explicit request (opt-out)
- With proper default incentives and educational campaign, it is possible to maintain contributors in the funded pension schemes
- Implementation can be smooth in order to avoid changes in net wage income of the contributors.
  - Need to offer a “fair deal”

Coverage in systems with automatic enrollment tends to be much higher than in "opt in" schemes



Source: World Bank database

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Automatic Enrollment

	United Kingdom	New Zealand	Italy	USA	Canada/Quebec	Chile	Poland
	(2012)	(2006)	(2007)	(2012)	(2014)	(2008)	(1999)
Automatic Enrollment	Mandatory	Mandatory	Mandatory, but implemented as "opt-in"	Optional, but considered a safe harbour (mandatory in Simple plans)	Mandatory	No, opt in	No, opt in. Plan to be offered to more than 50% of employees
Requirement on the minimum number of employees for opting for a plan	250+ 2012; 50+ 2014; 30+ 2016; 30- 2017	No	No	No, but 100- can opt for SIMPLE plans	5+	No	No
Period for opting out	30 days	Between 14 and 56 days	180 days	90 days	60 days	Not applicable	Not applicable
Collective plans	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Source: Rudolph (2016)

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It is all about default options…

	United Kingdom	New Zealand	Italy	USA	Canada/Quebec	Poland	Chile
Default Option: Manager	NEST	Selected by the government every 7 years	No	No	Yes, but still needs to be regulated	No	No
Default Option:Investments	Life Cycle	Conservative	Conservative	Not regulated	Life Cycle	No	No
Collective Plans	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Employee option for opting for an individual plan	No, but under consideration	Yes	No	No	No	No	No
Withdrawals	55+	65+	Retirement	59 1/2	Retirement	60/55	65/60
Liquidity options	Disability and major health issues	Severe financial hardship, major health issues, and purchase of a first house	Not Available	Loans and withdrawals in exceptional cases, including finacial hardship, disability and termination of employment	Employer contributions can be withrawn only in cases of financial hardship and disability. More flexibility is	No	Flexible, paying penalty tax
Penalty Tax for early withdrawal	No	No	No	10%+ income tax	No	No	Yes

Source: Rudolph (2016)

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Default rates

	United Kingdom	New Zealand	Italy	USA	Canada/Quebec	Poland	Chile
Contribution Rate Employer	1%	3%	6.91%	No, but 4% of pay for participants who defer at least 5% of their pay is a safe harbour	0%	Less than 7%	No
Automatic Escalation Employer	2% 2017-18; 3% 2018/10+		No	No	No	No	No
Contribution Rate Employee	1%	3%; 4% or 8%	-	No, but 3%+ is a safe harbor	2%	No	No
Automatic Escalation Employee	3% 2017-18; 5% 2019	No	No	No	2% 2014-2015; 3% 2016-2017; 4% 2018+	No	No

Source: Rudolph (2016)

There is no magic number, the default contribution rate is the driving force of the contribution rate of employers and employees

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However, the “fair deal” needs to ensure that fund managers have the right incentives

- Standardization of pension products
- Low cost and simple
  - Default providers
  - Allocation of new entrants
  - Fees
- Regulatory and supervisory framework that may cope with the challenges of a sophisticated market
  - No step should be given until the pension supervisor is prepared
  - Fit and proper of pension fund managers is essential to ensure that managers are acting in the best interests of their clients
- Default investment options are essential to ensure a fair deal

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The payout phase

- Most of the countries are getting the payout phase wrong
- Voluntary scheme does not mean that at retirement age individuals can get your money at any time
- Voluntary funded schemes are an essential component of the pension system, aimed at complementing retirement income.
- Tax incentives justify the use of savings for retirement income
- Thus, the menu of options should reflect the need of complementing retirement income
  - Default options
  - **Allow lump sums only in exceptional cases** (very small funds)

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Conclusions

- Putting aside the need of parametric reforms and fiscal space to sustain 2nd pillars, progress can be made in building voluntary funded schemes
  - There are no transition costs
  - It is mostly finance by employees
  - It is much more standardized than second pillars
- The Russian Federation is well positioned to implement a reform on the funded scheme that may take into consideration the vast experience of other countries.
  - Behavioral features
  - Pension savings are only for retirement purposes
  - Regulation and supervision designed to protect the interests of the contri
    and pensioners

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Thank you

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