Private Pensions Series

Reform and Challenges for Private Pensions in Russia

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

The Russian Federation, like an increasing number of the countries around the world, has undergone a major systemic reform of its pension system resulting in a shift from a single, publicly managed distributive system to one supplemented by a privately managed mandatory funded component. As a result, the pension system in Russia today is made up of: first, a pay-as-you-go financed pillar that provides a basic pension and an earnings-related pension administrated via notional individual accounts; second, a mandatory funded part, occupational and defined contribution in design, financed with age-related contributions; and, third, voluntary occupational and personal funded pension plans.

The reform aimed to ease Russia's transition to a market economy and remedy acute poverty of Russian pensioners - seen as a particularly crucial policy concern. It was designed to address early retirement subsidies and rights to special groups and strengthen the security of long-term retirement savings. The reform also reduced the role of the state in pension provision and encouraged employer and private pension provision by authorising participation of private entities in asset management and the administration of mandatory retirement funds.

This report presents the main characteristics and design parameters of the new private pension system in the Russian Federation and documents the recent evolution of the private pensions market in Russia. It provides an analysis of the regulation and supervisory regimes in force for both mandatory and voluntary pension plans and highlights the main obstacles and challenges posed by the transition to the new system. The report also draws attention to the need for further improvement of the regulatory framework to promote the development of a solid private pension industry in Russia.

Among the major immediate concerns that Russian policymakers have to tackle, the authors identify the need to further improve the institutional design, accountability and transparency of the pension system and strengthen its administrative capacity; to reinforce the safeguarding of pension rights and to strengthen the supervisory oversight of public and private entities responsible for the management of pension assets. They also recommend information campaigns

and financial education programmes about the private pension system. The authors underline that the long-run sustainability of the new pension system will also be tightly linked to the accomplishment of reforms in the social sphere and other areas of the economy, such as the development and regulation of capital markets and the implementation of a favourable and consistent tax policy.

This report is intended to contribute to the policy discussion on pension reform in Russia. It also supports 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 pension field. The report is part of the Insurance and Private Pensions Committee's co-operation with non-member OECD economies including policy dialogue and analysis of private pension systems outside the OECD area.

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The publication was prepared by Nina Paklina from the OECD Financial Affairs Division, Insurance and Private Pensions Unit with technical support from Edward Smiley.

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Reform and Challenges for Private Pensions in Russia

by

Lyudmila Sycheva and Leonid Mikhailov

Executive Summary

The current reform of the Russian pension system is aimed at adjusting the system to the realities of the market economy, taking into consideration demographic trends and forecasts. Particular emphasis in its design was placed on introducing the principle of actuarial fairness, whereby future pension benefits depend on prior pension contributions. In order to realise this idea, two mandatory pension components, the so-called insurance part (i.e. earning-related pension financed on a pay-as-you-go basis through notional individual accounts) and the funded part, were introduced. Pension benefits from these two components will be paid on top of flat benefit provided by the basic part of the public pension, which constituted one-third of the average pension as of the end of 2004. The insurance and the funded parts of the mandatory pension system are based on the defined contribution (DC) principle, so a system of individual accounts was introduced under the Pension Fund of the Russian Federation (PFR). The insurance part is based on notional accounts and the funded part is based on the investment of accumulated contributions by state and private investment managers. Since 2004 non-state pension funds, which previously engaged only in voluntary pension provision, can also participate in the mandatory funded pension component, while the management of pension assets can be outsourced to existing investment managers. However, the overwhelming part of investments is managed by the state investment manager and placed in federal government securities.

The introduction of a funded pillar required changes in government regulation and supervision of the pension system. The multi-agency structure of regulation and supervision in this sphere reflects characteristic features of funded pension plans but also particular features of the new approach to administrative matters in Russia that demand a segregation of regulative and supervisory functions.

The reform also addressed the problems of financing early-retirement benefits. To finance payouts for certain employee groups below the general retirement age but eligible to receive pension benefits due to the conditions in which they worked, professional pension plans will be introduced.

Besides the mandatory pension system, there are voluntary occupational/personal pension plans provided mainly by non-state pension funds (NPFs). Covering about 8 per cent of employees, they have experienced rapid

growth in contributions in recent years. The regulatory regime under which they function is liberal compared with that of the mandatory funded pension system. While this allows greater freedom in choosing investment strategies, it also leads to flaws in corporate governance, inadequate disclosure of information, and non-transparent terms of providing pension products.

Pension reform in this decade has gone ahead of other long-due reforms in the social sphere and therefore a number of problems inevitably will influence the pension system and its development in the near future. Among the basic challenges facing the pension system and policymakers, the authors emphasise the low income level of most pensioners; a very high degree of politicisation of issues relating to the principles, organisation and level of pension provisions; overall medium- and long-term macroeconomic uncertainties; inadequate development of non-state forms of pension provision; demographic problems; gaps in statistical data bases; a weak relationship between the rates of social taxes and benefits levels; inadequate development of the financial markets, and the problems of their regulation and supervision.

The present publication is structured as follows:

Chapter 1 discusses the background for pension reform undertaken in Russia in this decade, pension reform goals and framework, the latest developments and adjustments in the reform path.

Chapter 2 describes the general design of the new mandatory pension system, contribution rates, rights of participants in the mandatory funded pillar, the institutions involved in administering the mandatory pension system and investing the assets of the funded pillar, their responsibilities, and investment regulation in the mandatory funded pillar.

Information on voluntary occupational/personal pension plans, including the types of non-state pension funds and of pension schemes they provide, participants' rights and protections, investment regulation matters, data on market structure and recent developments in the market for voluntary pension provisions is provided in Chapter 3.

The regulatory and supervisory organisation of the pension system is reviewed in Chapter 4.

Pending problems and the potential for further reforms are discussed in the concluding section.

Chapter 1

BACKGROUND FOR PENSION REFORM

The Russian pension reform has been shaped, to a large extent, by socioeconomic preconditions, common to transition economies. Reform is being undertaken largely to shift the pension system to principles appropriate for a market economy and to remove unneeded functions imposed on it by the planned economy which are not inherent to a system for retirement benefit provision.

Previous attempts to adapt the pension system to the new economic reality were undertaken during the 1990s. The establishment of the contemporary pension system of the Russian Federation can be said to have started in 1990 with the adoption of the law "On Public Pensions in the Russian Federation", a framework law for pension legislation through 2002. Funds for financing pensions were separated at that time from the general budget, and the Pension Fund of the Russian Federation (PFR) was established to manage funds to provide retirement benefits. In later years, a unified system was created for registering insured persons, both employed and self-employed; a unified base was established for the salary (income) formula to be applied for retirement benefits calculations, and for calculating contributions to the Pension Fund of the Russian Federation; mechanisms were put in place for ensuring the balance of current revenues and liabilities of the state pension system; records on each insured person were introduced.

Still, the pension system remained an unfunded Pay As You Go (PAYG) arrangement. High inflation rates made it impossible to realise the declared principles of pension maintenance, including the principle of differentiating pension benefits by the service period and wages. At the same time, new unfunded pension rights were granted to various population categories. Attempts to stabilise the pension system within the framework of existing legislation consisted mainly of increasing the minimum pension at the expense of a decreased differentiation of other pension types. In the end, the system has become even more complicated, while the population has accumulated pension benefit rights that the government is unable to fulfil. Over 10 years, the law "On Public Pensions in the Russian Federation" was changed more than forty times, producing inconsistencies in the legislation. Separate laws and legal acts granted pensions for civil servants,

including members of Parliament, army pensioners, customs employees, judges, prosecutors, cosmonauts and others. The total number of beneficiaries of schemes other than the main pension system is not precisely known. World Bank experts[1] estimate it at 2 million to 6 million people. The average pension amounts received by pensioners in these categories exceed those allocated under the basic laws regulating pension provision. In 2001, more than 5 million people received pension increments, and more than 12 million received increased pensions, led by those who worked during World War II.

This policy of enlarging population categories eligible for pension benefits became, in the 1990s, an additional factor for the growth of the dependency ratio and for the rising number of retirees. This tendency developed amid falling employment and mass pension-contribution evasion, and inevitably produced mounting problems in the pension system. Arrears in contributions and hence in pension payments began rapidly increasing in the mid-1990s.[2] The crisis of 1998 aggravated these problems and added new ones, primarily that of a falling purchasing power of nominal pensions (Figure 1.1).

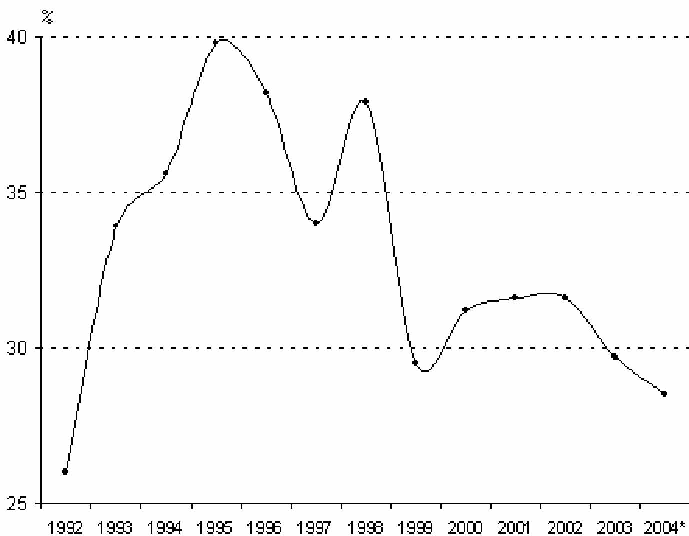
Figure 1.1. Yearly changes in the size of pension benefits in real terms (in percentages)

p – preliminary

Source: Rosstat (former Goscomstat, www.gks.ru)

The main problems with the pension system before the reform process were the low levels of pensions, in both absolute and relative terms, combined with a high rate of mandatory pension contributions (insurance contributions[3]) amounting to 29 per cent of payrolls paid from the total uniform social tax of 35.6 per cent (the remaining 6.6 per cent was channelled to other social benefits including contributions to mandatory medical insurance and unemployment insurance). This phenomenon, in turn, was caused by low wage levels which are used in calculating the uniform social tax.[4] As a result, a considerable amount of the pension system's financial resources were used for redistributing, in order to maintain the minimum income level of pensioner groups with inadequate means. Pension benefits became virtually flat-rate, with a strong redistribution towards low-income earners. According to the World Bank (2002), the ratio of minimum to maximum pensions was approximately 1:1.8. The replacement rate for low income earners exceeded 100 per cent, while that for high income earners fell below 10 per cent of wages. The actual average replacement rate was very volatile during the 1990s, as seen in Figure 1.2.

Figure 1.2. The replacement rate of the Russian pension system



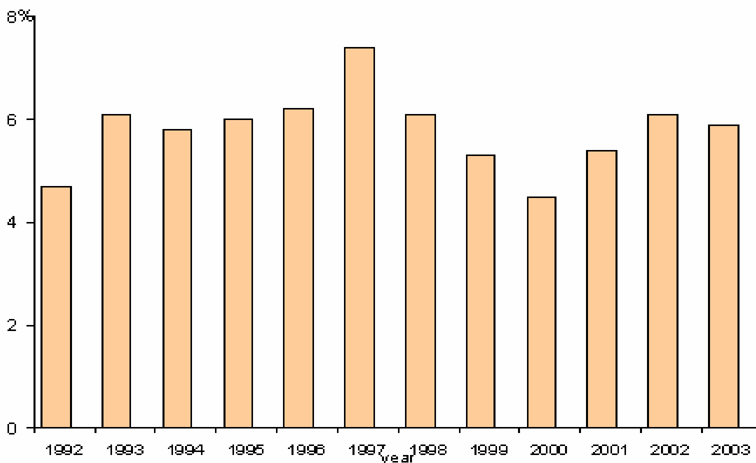
* First half-year

Note. The replacement rate is calculated as the ratio of average pensions paid by the PFR to average pre-tax wages. As pensions are not taxed, the ratio in the figure would be somewhat higher if wages were after-tax, but after-tax data was regretfully unavailable. The income tax rate is currently flat (13 per cent of earned income), but during the 1990s a progressive scale was in effect. The ratio of average pension to average after-tax wage could be roughly estimated as 33.3 per cent for 2003.

Source: Rosstat

An early retirement system was preserved for certain citizen categories, having been created in the Soviet Union to attract people to low-paid jobs or to work in unfavourable conditions. The retirement age for those working under unfavourable conditions in the Far North was 5 to 15 years lower than the statutory retirement age (set at 55 for women and 60 for men). Certain employment categories, such as civil-aviation pilots, educators, medical personnel, performing staff of theatres and other theatrical and entertaining institutions and groups have the right to early retirement, based on length of service. Early-retirement pensions are granted to an estimated 1 in 4 new retirees. Most numerous are those whose jobs are associated with unfavourable conditions. Among these, experts estimate, one-third of early-retirement pensions are granted to those working under normal conditions, as certain occupations and jobs grant the right to this pension category. Due to the lack of a separate funding source for these additional pension rights, the early-retirement pensions are granted at the expense of the uniform social tax. Those employers offering jobs associated with unfavourable conditions bear no additional tax burden such as might have permitted the funding of additional benefits. In 2001, the pensioners who received pensions due to specific working conditions constituted about 13 per cent of the total.

Figure 1.3. Pension expenditures as percentage of GDP



Note. Pension expenditures are calculated as the expenditures of the Pension Fund of the Russian Federation on the payments of pensions and benefits.

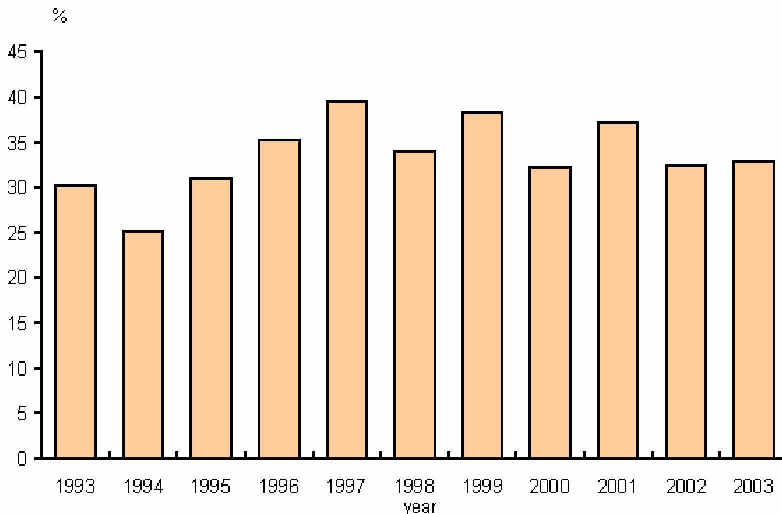
Source: Calculations based on data from Rosstat and the MEDT.

The prevalence of early-retirement pensions is also reflected in the employed-to-pensioner ratio. The low ratio of the numbers of working-age persons to pensioners stems not only from demographic factors and low employment levels, but also from the younger retirement age established for females (as compared to those in developed countries) and by the prevalence of early retirement.

All of these reasons led to the need to reform the pension system of the Russian Federation by changing its underlying principles.

In 2001, before the current pension reforms started, some 39 million people received pension benefits (27 per cent of the population). The category with the highest number of beneficiaries was that of old-age pensioners. Survivorship benefits were received by 5.5 per cent of total pensioners, and disability benefits by 12.5 per cent. Federal government spending on pension benefits provision in 2001 amounted to 5.4 per cent of GDP (Figure 1.3), only slightly lower than the average for 1992-2001, when the ratio was 5.7 per cent. Figure 1.4 presents the evolution of the ratio of the expenditures of the Pension Fund of Russia to federal budget expenditures, which has remained relatively stable at around one third since the mid-90s.

Figure 1.4. Ratio of the expenditures of the Pension Fund of the Russian Federation to federal budget expenditures.



Source: Calculations based on data from Rosstat and Bank of Russia.

1.1. Pension reform goals and framework

A new wave of reforms was implemented starting from 2001, which aimed at adjusting the pension system to the realities of a market economy, taking into consideration demographic trends and forecasts.

The reforms should lead to a new model of risk sharing and redistribution. Their aim is to subject citizens' pension entitlements to the enhanced financial stability of the pension system, taking into account the evolution of wages and salaries and the overall conditions of the labour market.[5] Particular emphasis was placed on introducing into the pension system actuarial principles linking future pensions to contributions: the amount of a person's pension benefits will depend on the amount of funds the employer has earlier transferred to the PFR in that person's name and the pensioner's life expectancy. This will be accomplished through the two components (the so-called insurance part and the funded part) of a pension. The introduction of the funded component is also considered an instrument of long-term financial stabilisation of the pension system; sufficient pension savings would reduce the financial dependency of the pension system on the ratio of the number of working-age persons to the number of pensioners. This would significantly increase the system's stability in the face of unfavourable demographic changes.

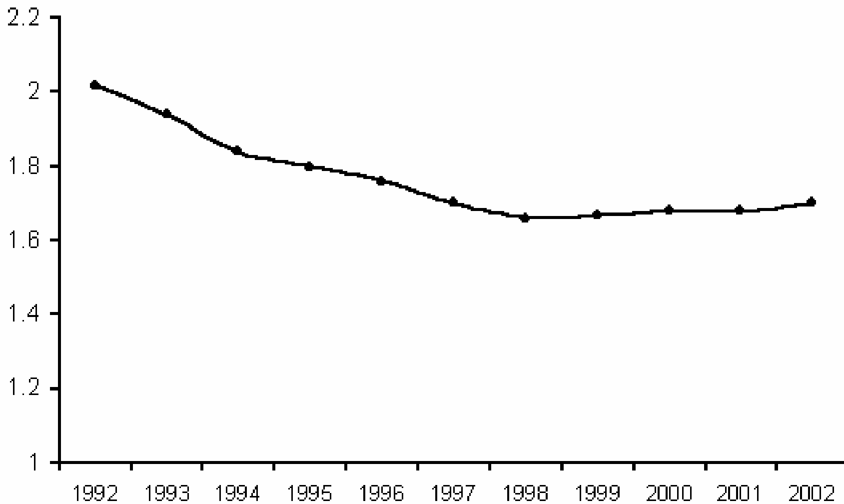
The demographic background of the reform has both short-term and long-term aspects. As shown in Figure 1.5, in the 1990s, Russia experienced a decrease in the ratio of the working-age population to pensioners, and thus a rise in the dependency ratio. The stabilisation of these indices since 1999 is only temporary. An increase in the number of working-age citizens is expected to end in 2006. During this period, the relatively small generation of those born during and shortly after World War II will retire (Annex 1). So the dependency ratio in these two years will decrease. According to Rosstat data, in 2001 there were 343 people beyond retirement age for every 1,000 of working age; in 2006, this is expected to reach 326 per 1,000, a rate lower than in 1991, when the ratio stood at 336 per 1,000. However, after 2006 the pace of population ageing will increase. According to the Rosstat forecast,[6] by 2016 there will be as many as 417 persons beyond working age per 1,000 of working age. These trends are aggravated by the mature structure of the working-age population: by 2015 about one-third of the working-age population will be 45 or over.

The relatively favourable short-term economic conditions of the late 1990s and the early 2000s helped mitigate the negative effects of reform, playing a significant role in determining its timing and schedule.

Several laws adopted since 1999 constitute the legal framework for reform. They include "On the Principles of Mandatory Social Insurance"[7], "On Labour

Pensions in the Russian Federation"[8], "On Public Pensions in the Russian Federation"[9], "On Mandatory Pension Insurance in the Russian Federation"[10], and "On Investment of Funds for Financing the Funded Part of Labour Pension in the Russian Federation"[11]. Their adoption allowed the beginning of a shift from the PAYG defined benefit (DB) pension system to a mixed system that combines PAYG principles with funded elements and includes a notional defined contribution (DC) component. The new design has three main pillars.[12]

Figure 1.5. Ratio of working persons to pensioners, 1992-2002.



Source: Calculations based on Rosstat data.

The first pillar is the publicly managed PAYG DB scheme, which is the largest of the three components. The second pillar is the mandatory DC pension scheme, with mixed public/private management. The third pillar is the voluntary privately managed component. Both the second and third pillars are based on fully-funded individual accounts.

1.2. Main elements of the new mandatory labour pension system

The mandatory pension system is now called the *labour* pension. It consists of three components: the basic, insurance and funded parts. The first two of these can be considered to be based on the PAYG principle; the third, the funded part, is based on individual accumulation. Both the insurance and funded parts are organised using DC pension plan principles and employ individual accounts to register pension entitlements. Based on the criterion of financing, the modern Russian mandatory pension system has two main pillars.

The first pillar (PAYG) comprises the basic (a redistributive flat-rate pension benefit) and insurance parts. The design of the insurance part resembles the notional defined contribution (NDC) systems of other European countries, such as Italy, Latvia, Poland and Sweden.

Second-pillar (funded DC) pensions will complement first-pillar benefits for those employed persons who participate. Besides the state mandatory pension insurance, the second pillar will include so-called occupational (professional) pensions, which were introduced to provide pensions for persons eligible for early retirement.

The funded part of the mandatory pension system supposes the participation of both government and non-government (private sector) entities. But there are neither corporate nor industry-wide (multi-employer) mandatory pension plans. Contributions for the funded part of the labour pension are accumulated in the PFR, which is also responsible for record-keeping. Since 2004, employees have had the option of choosing where to accumulate funds – with the PFR or with a non-state pension fund (NPF). Those who prefer the non-government component of the second pillar may choose an NPF. Those who stay with the PFR may choose an investment portfolio (investment manager). The savings of those who have not selected a private investment manager are transferred by the PFR to the State Management Company. Thus, investment in the mandatory funded part has a mixed nature. Participants may choose non-state investment managers or the state asset management company. The overwhelming part of funds so far has been invested by the state asset management company.

NPFs are to outsource all second-pillar funds to non-state investment managers. In both cases, investment managers are selected amongst existing companies managing the assets of collective investors. No special licenses are required to manage pension accumulations.

NPFs are also supposed to participate in the benefit payout phase.

The introduction of the insurance and funded parts of the pension system hinged on the creation of a system of centralised record-keeping in respect to contributions and payments in the Pension Fund of the Russian Federation (personalised records on every insured person for the purpose of state pension insurance, including received contributions, the amount of the insured persons' calculated pension capital, investment income and payments effected).

The new system covers all the main categories of employees, including civil servants, those in public and private enterprises, and the self-employed.

First-pillar benefits take the form of untaxed monthly pensions. The basic pension is indexed to inflation in amounts set for this purpose in the federal budget and the PFR budget for the appropriate financial year. The insurance pension is paid on top of the basic part. It is indexed to the inflation rate, but also reflects the rate of increase of average monthly wages. The total size of first-pillar benefits is limited by a set level of a person's wage.

Second-pillar benefits also take the form of monthly pensions, the size of which is determined by the amount of funds accumulated in individual accounts and the expected period of payment. Payments of benefits in this pillar have not yet started. They are to be paid on top of the basic and insurance parts of the labour pension.

Those disabled persons not entitled to a labour pension receive social pensions set at 85-100 per cent of the basic pension depending on their category.

As part of the pension reform, a new mechanism is expected to be introduced to finance the early retirement pensions for those employed in the non-governmental sector on jobs with hard or special labour conditions. These pensions will be financed by developing professional pension plans based on funded principles. Thus, those employees who have completely or partly secured the right to a pension advantage would preserve the possibility of realising that advantage under the old PAYG system; and participation in the new system would be guaranteed to those employees starting in corresponding jobs once the draft law takes force, or to those whose duration of service on the date of enactment would be less than half that of the pensionable service required for entitlement to early pensions. After the State Duma passed the draft law in its first reading, it was decided in the discussion stage to extend its application to teachers working at primary non-governmental educational establishments, to employees of non-governmental health-care institutions, and to persons performing on the stages of private theatres or engaged in artistic activities at non-governmental organisations. The majority of employees to be covered by the new regulations would have an option either to participate in the professional pension plan, or to receive wage increments equal to the

contribution amounts that the employer would otherwise have paid to the pension scheme.

The mandatory component of the pension system is complemented by voluntary occupational and individual pension plans. NPFs are the main providers in this market. Insurance companies may provide pension products, too, but few do. NPFs have about 5.5 million participants (8 per cent of the total number of employed) and pay benefits to fewer than 0.5 million persons.

1.3. Adjustments in the reform path

For several reasons, pension reform implementation preceded other social, fiscal and administrative reforms. In 2004, as social policy priorities underwent some change and administrative reform started, there emerged a question of adjusting the second pillar of the pension system and reorganising government regulation and supervision of the pension system, which mainly concerns the second pillar but also includes changes in the PFR's status and reorganisation in the system of supervising NPFs. As of mid-2004, administrative changes were still under way.

Changes in the mandatory funded pillar will lead to a lowering of the age for mandatory contributions for pensions by 15 years for men and 10 years for women; and contribution rates will reach their maximum level two years later than originally planned (see Tables A2.3 and A2.4 in Annex 2). The announced changes in the second pillar of the system evolved as a tool to resolve problems with the same origin as the aforementioned problem of widening the categories of citizens entitled to early retirement and to increments to the generally specified size of pension benefits. In the late 1990s, a number of legislative acts were passed at the federal and regional levels establishing advantages for various categories of citizens, including free passes for retirees on public transport, reduced payments for communal utilities and telephone communications, etc. Yet, the budget expenditures aimed at compensating the organisations providing such services generally did not cover the full size of the expenses they incurred. And not all the advantages granted could have been used by the citizens, again due to underfinancing.[13]

The federal government estimated the amount necessary for a partial conversion of granted advantages into the monetary form at approximately Rb170 billion (USD5.9 billion). Some pensioner benefits, including communal utilities payments, will be preserved, while some will be left for consideration by regional authorities.

At the same time, from 2005 onwards, the maximum uniform social tax rate will be reduced from 35.6 per cent to 26 per cent. Therefore, the rate of tax

channelled to basic pension benefits payments declined from 14 per cent to 6 per cent. Currently, of the 26 per cent of the total uniform social tax, 20 per cent of payroll is paid for mandatory pension contributions, of which 6 per cent finances basic pensions and 14 per cent is split between insurance and funded parts of labour pension depending on the age of the participants. The remaining 6 per cent is allocated to mandatory medical insurance and unemployment insurance (maximum of 2.8 per cent and 3.2 per cent respectively). Changes in the second pillar are intended to help finance the gap in the PAYG budget of the PFR that is expected due to the diminishing of the uniform social tax rate and the conversion of certain privileges granted to retirees from natural form to monetary form.

The exclusion of middle-aged citizens from the funded part of compulsory pension insurance means that the share of contributions previously paid by employers in the name of the employed to finance the funded part of labour pensions would be used now to finance the pension system under the first pillar, namely the insurance part of labour pension (see the Chapter on General design of the mandatory pension system and Tables A2.3 and A2.4 in Annex 2).

NOTES

1 World Bank (2002), *Pension Reform in Russia: Design and Implementation*, November, World Bank, Washington, D.C.

2 Arrears in contributions resulted in delayed pension payments, which were eliminated only in 1999 – see World Bank (2002), *Pension Reform in Russia: Design and Implementation*, November, World Bank, Washington, D.C.

3 "Insurance contributions" is a term used in Russian pension law in regard to mandatory payments by employers to the PFR. The PFR is called "the insurer", as the mandatory pension system is called mandatory pension insurance. Russian law considers entering old age to be a kind of social risk, an approach that is not unique. In publications on the Swedish pension system, for example, you may encounter the term "premiums" applied to contributions to the Premium Pension Authority (PPM).

4 According to calculations for the draft Pension Reform Program, contributions paid in the name of employed persons as of 2001 would not provide a subsistence-level pension in about 30 per cent of cases; in half of all cases pensions would amount to 100 per cent to 200 per cent of subsistence level; and only in 20 per

cent of cases did contributions cover pensions amounting to more than twice a pensioner's subsistence level.

5 Draft Program of Pension Reform in the Russian Federation, 2001.

6 State Committee of the Russian Federation on Statistics (2002), *Predpolozhitel'naia chislennost' naseleniia Rossiiskoi federatsii do 2016 goda* , Statisicheskii biulleten (Provisional Estimates of the Population of the Russian Federation Through 2016, Statistics Bulletin, Moscow,.

7 The Federal Law *On the principles of Mandatory Social Insurance*, N° 165-Fz of July 16, 1999. The amendments and additions to the Law were introduced on December 23, 2003 and March 5, 2004.

8 The Federal Law *On Labour pensions in the Russian Federation*, N° 173-FZ of December 17, 2001, was passed by the State Duma on November 30, 2001 and approved by the Federation Council on December 5, 2001. The amendments and additions to the Law were introduced on July 25, December 31, 2002, November 29, 2003, June 29, August 22, 2004, February 14, 2005.

9 The Federal Law *On public pensions in the Russian Federation*, N° 166-Fz of December 15, 2001. The amendments and additions to the Law were introduced on July 25, 2002, June 30 and November 11, 2003, May 8 and August 22, 2004.

10 The Federal Law *On Mandatory Pension Insurance in the Russian Federation* N°. 167-FZ of December 15, 2001 was passed by the State Duma on November 30, 2001 and approved by the Federation Council on December 5, 2001. The amendments and additions to the Law were introduced on May 29, December 31, 2002, December 23, 2003, June 29, July 20, December 2 and 28, 2004.

11 The Federal Law *On Investment of Funds for Financing the Funded Part of Labour Pension in the Russian Federation*, N°111-Fz of July 24, 2002. The amendments and additions to the Law were introduced on December 31, 2002, November 10, 2003, July 28 and December 28, 2004 and May 9, 2004.

12 The new Russian system follows the classification of pension systems proposed by the World Bank.

13 As an example of an advantage granted that was not always available, cut-price medicines were not always available at drugstores. Underfinancing generally took the form of "budget reservation" – the state budget law would stipulate that certain sections of a given law were suspended (not applicable) for the relevant year as no budgetary funds were assigned for their fulfillment. Overall, unfunded budget mandates are estimated at Rb6 trillion (USD206 billion) – see Komsomol'skaia Pravda (2004), 2 September..

Chapter 2

THE GENERAL DESIGN OF THE MANDATORY PENSION SYSTEM

2.1. The PAYG system

All citizens of the Russian Federation are entitled to the *basic part* of the labour (mandatory) pension on the condition that they have a minimum of five years labour on record. The old-age basic part of the labour pension is granted upon reaching the statutory pension age (55 for women and 60 for men). It is a flat benefit and 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 PFR. The rate of tax channelled to basic pension benefits payments has declined from 14 per cent to 6 per cent of payroll since 2005.

Initially, the *basic part* of the labour pension was set at Rb450 (USD15), but since March 2005 it has amounted to Rb900 (USD32). Several retiree categories receive larger benefit amounts. For example, the flat benefit is higher for disabled individuals aged 80 and above. The highest possible basic pension was set initially at Rb1,350 (USD45), and in 2004 it reached Rb1,980 (USD68).

The *insurance part* of the labour pension is based on the notional accounts concept (also PAYG financed) and thus depends on the employee's employment and wage history, on employer-paid contributions to the PFR and on the expected period of payment of benefits. The insurance part of the old-age labour pension is determined using the formula 1:

Formula 1:

$$IP = PC / T$$

where IP is the insurance part of the labour pension,

PC is the estimated pension capital of the insured person[1], and

T is the expected payments period of the insurance part of the labour pension.

Initially, the expected period of payments of the insurance part of the labour pension (T) is set at 12 years (144 months). It will increase annually by six months until it reaches 16 years. After that, it will rise by one year annually until it reaches 19 years. Gender differences are not taken into account.

This part of the pension is financed by insurance contributions paid by employers to the PFR (though technically they are collected by tax authorities and then transferred to the PFR accounts).

The maximum rate of contributions for the *insurance part* of the labour pension is set at 14 per cent of payroll. As with basic pensions, employers in the agrarian sector and in some other categories[2] enjoy lower contribution rates for the insurance part of the labour pension, and the rate scale is regressive (the contributions rate declines with the increase in employee wages). Otherwise, the rate depends on the employee's age. If it is higher than that established for participation in the second pillar, then contributions are paid only on the insurance part of the labour pension at the maximum rate for the given wage amount (see Annex 2). The maximum contribution rate for the insurance part of the labour pension ranges from 8 per cent to 14 per cent depending on the age group.

The following contribution rates applied when the new pension system was put into effect in 2002:

- Men over 50 and women over 45 as of 1 January 2002. This category does not participate in the mandatory funded pillar and contributions are paid only to the insurance part of labour pension at a maximum rate of 14 per cent.

- Men aged 35 to 50 and women aged 36 to 45 as of 1 January 2002. Contributions of this category were divided between insurance and funded parts of labour pension. Maximum contribution rate for the insurance part of labour pension for this category was set at 12 per cent and 2 per cent going to funded pillar.

- Persons aged under 35 as of 1 January 2002. It was established that the maximum contribution rate for insurance part of labour pension for this category should be 8 per cent, but it was to be introduced gradually. It was decided to lower the maximum contribution rate for the insurance part of labour pension for this category from 11 per cent in 2002-2003 to 10 per cent in 2004, 9 per cent in 2005 and to 8 per cent in 2006 (see Tables A2.1 and A2.2 in Annex 2).

But before the transitional period was over the established rules were revised. In 2004 the contribution rates to be paid for the insurance and funded parts of the labour pension were rearranged so that contributions paid for persons born before 1967 (older than 35 in 2002) were channelled to finance the insurance part only (see Tables A2.3 and A2.4 in Annex 2). From the beginning of 2005, the contributions of the third age group were collected according to the rates shown in the table A2.4. They are intended to be provisional until the year 2008. In 2008, the rules and rates displayed in Table A2.3 of Annex 2 should become effective for this age group.

Self-employed persons also participate in the system, but their regular contributions are fixed in size, set at Rb100 per month (USD3.4) as of 2004.

The labour pension has become the main type of pension, granted not only to those who retire after the effective date of the law "On Labour Pensions" but to those who retired earlier. As there were no contributions for the insurance part of the labour pension before 2002, special formulas (formulas 2 and 3 below) were used to account for the pension rights acquired by insured persons under the old pension system. These formulas were introduced by the Law on Labour pensions (article 30, sections 1 and 2). In particular, formula 2 is used to calculate the initial size of pension benefits in the new pension system for those who retired prior to 1 January 2002.

Formula 2:

$$AP = RC \times ME/MW \times AMW$$

where AP is the estimated labour pension amount;

RC is the record of employment coefficient equal to 0.55, which is further increased by 0.01 for each full year of employment history in excess of 25 years for males and in excess of 20 years for females, but no more than by 0.20;

ME is the average monthly earnings of an insured person in the years 2000-01, or during any uninterrupted 60-month period of employment;

MW is the average monthly wage in the Russian Federation during the same period; and

AMW is the average monthly wage in the Russian Federation from 1 July to 30 September 2001, applied in calculating the amounts of state pensions, approved by the Government of the Russian Federation as being equal to Rb1,671 (USD57).

The ratio of average monthly earnings of an insured person to average monthly wages in the Russian Federation (ME/MW) is taken into account at a value not to exceed 1.2.[3]

For workers who had not yet retired on 1 January 2002, benefits accrued prior to this date were calculated by transforming the estimated labour pension amount into the pension capital of the new notional defined contribution system, as shown in formula 3.

Formula 3:

$$PC = (AP - BP) \times T$$

where PC is the estimated pension capital of an insured person who had employment record prior to 1 January 2002;

AP is the estimated labour pension amount calculated using formula 2;

BP is the amount of the basic part of the labour pension; and

T is the expected period of payment of the labour pension.

After 1 January 2002, estimated pension capital is measured by contributions actually paid for the insurance part of the labour pension.

The insurance pension is to be indexed to inflation, but the rate of increase of the average monthly wage is also to be taken into account. During a worker's career, the accumulated pension capital is indexed, but there is no guaranteed rate of return. The coefficient of indexation of accumulated pension capital is defined annually by a government decree. As of 1 January 2004, the government has approved coefficient of indexation at the rate of 1.114.[4]

The survivors and disability benefits in the new system are also provided by PFR. Disability benefits include all three parts of the labour pension (on condition that the person participated in the funded component and has accumulations in his or her pension account), and survivors benefits consist of the basic and insurance parts and cannot be less than Rb660 (USD23) per month.

The new rules for granting PAYG pensions were aimed partly at reducing the complexity of the formula used for calculating pension payments while increasing the transparency of the conditions required for entitlement to a pension.[5]

As of April 2004, the average labour pension amounted to Rb1,900 per month (USD66). Old-age labour pensions were received by 29 million people; 4.4 million received disability labour pensions; 2.8 million received survivorship benefits. Social pensions (paid to those disabled persons not entitled to a labour pension) were received by 1.6 million people. The average social pension was Rb1,180 (USD41). The minimum monthly pension benefit is set at Rb660 (USD23). The average pension was Rb1,765 (USD61.5). Overall, 19 per cent of beneficiaries were continuing to work.[6]

The PFR has the right to invest a part of the resources of the pension system's PAYG pillar, limited by the so-called temporarily free funds of the pension system. The investment procedure is to be determined by the Government of the Russian Federation. In managing these resources, the PFR does not outsource them to external asset managers but places them directly in government securities.

The Government has determined that the agents of the PFR to be used in investing the temporarily free funds should be the Bank of Russia and the Bank for Foreign Economic Affairs (Vnesheconombank performs investment functions of the State Management Company in the mandatory funded pillar of the pension system). Operations effected with the temporarily free funds, including decision-making on the volumes and structure of the purchase and sale of government securities, must be coordinated by the PFR with the Ministry of Finance. As of the end of 2003, the PFR estimated the volume of temporarily free resources invested in securities as being equal to Rb51.2 billion (USD1.7 billion). The resources are invested in both rouble-denominated government securities (marketable and non-marketable) and in foreign-currency-denominated ones (Eurobonds of the Russian Federation).

2.2. The mandatory funded pillar

Benefits design

The funded part of the labour pension will be granted in addition to the basic and insurance parts upon reaching the statutory pension age and from pension accumulations formed for the benefit of the insured. Thus, it can be granted only on condition that there are pension accumulations in the individual account, though no minimum amount is set. According to the law "On Labour Pensions", second-pillar benefits are to take the form of a variable life annuity with a nominal rate of investment return assumed to be zero. The only form of pension benefits paid by the PFR is a monthly pension, the size of which is determined by the amount of funds accumulated in an individual account and the expected period of payment, in months. Neither lump-sum withdrawals nor phased withdrawals are authorised.

There is no mandatory maximum age for annuitising pension accumulations. It should be mentioned that from the moment pension accumulations are annuitised (the funded part of the labour pension is granted), the person cannot bequeath them. The expected payment period does not differ for men and women, and there are no provisions for combining spouses' accumulations or for joint and survivor annuities. Granting the funded part of the old-age labour pension should be determined using the formula:

$$FP = PN / T$$

where FP is the funded part of a labour pension;

PN is the sum of the insured person's pension accumulations, recorded in the special part of his or her individual account as of the date he or she is granted the funded part of an old-age labour pension; and

T is the number of months in the expected period of payment.

As distinct from the insurance part of the labour pension, the value of the expected period of payment is not set for the funded part of the labour pension in the "Law on Labour Pensions" (initially, the expected period of payments of the insurance part of the labour pension was set at 12 years, or 144 months, and it is to increase annually by six months until it reaches 16 years, after which it will rise annually by one year until it reaches 19 years). So there is scope to take into consideration actual mortality data and make corresponding actuarial assumptions. The size of the funded part of a labour pension is subject to an annual recalculation to take into account investment returns and a change in the expected period of the payments (when the benefits size is initially calculated, future possible investment returns are not taken into account).

Under the rules for the mandatory funded system, when an insured person dies, the person's pension savings may be inherited by his or her legal successors in as far as the funded part of the labour pension is granted to the insured. After benefit payments begin, accumulated savings are not subject to inheritance. Unlike with pension plans of the provident type, participants may not borrow from or withdraw accumulated pension funds before the statutory retirement age.

More detailed questions on the design of payouts under the second pillar are still in the draft-law stage for persons accumulating funds in PFR[7] and in the development stage for persons who choose non-state pension funds (NPFs), the private sector pension providers that are an alternative to the PFR.

An analysis of norms regulating the organisation of payments in the second pillar of the pension system, as stipulated in the federal law "On Labour Pensions in the

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Russian Federation", allows the conclusion that its fundamental concept is based on the principles of group self-annuitisation, which have not yet been used as a way of compulsory annuitisation in the second-pillar pension systems on a national scale.[8]

As regards the non-traditional approach to the possible investment return[9] (PIR), it is likely that behind the approach in the federal law "On Labour Pensions in the Russian Federation" was the desire to avoid any correction of the pension amount for a given year that would result in its reduction if actual investment revenue fell below expectations.

This approach has advantages and disadvantages. On the one hand, it leads to a reduction in the calculated pension in the first years of payment and it shifts payments to a later period. On the other, it simplifies the tasks accompanying the investment of pension accumulations at this stage, and lessens the responsibilities of actuaries (one of their major functions is to adequately forecast the PIR).

As concerns the details of calculating and establishing the expected payment period for the funded component of the labour pension, the draft law "On the Procedure for Financing the Payment of the Funded Component of Labour Pension and the Specificities of Investing the Pension Accumulations Formed for the Benefit of Persons of Retirement Age in the Russian Federation" envisages that the calculations shall be carried out with the obligatory participation of an independent actuary, who also conducts an annual estimation of the annuity reserve, and that all results shall be approved by the Government.

Participation and contribution rates

The *financing* of the mandatory funded pillar is organised such that the employer pays mandatory insurance contributions for the insured person and receives, for the sum paid, a tax deduction for the unified social tax due to the federal budget.

Contribution rates vary, depending on the age of the employee and his wage. Rates are set with a regressive scale, and contributions were not to be paid for the part of the wage that exceeds Rb600,000 per year (USD19,933 at the exchange rate when the law was adopted). Maximum rates were set at 2 per cent for men born from 1953 to 1966 and for women born from 1957 to 1966, and at 6 per cent for persons born in 1967 and later. Introduction of the insurance contribution rate for persons 35 years and younger as of 1 January 2002 was to be realised step-by-step over five years. Within this period, the tariff at the initial interval of a regressive scale was to increase from 3 per cent in 2002 to 6 per cent by 2006.

Self-employed persons also participate in this pillar of the pension system, but their regular contributions are of fixed size – currently, Rb50 per month (USD1.7). Participation is mandatory.

Men born in 1952 and earlier and women born in 1956 and earlier do not participate in the mandatory funded pillar apart from the self-employed, for whom no age limits were set. Thus, approximately 40 million persons (more than 60 per cent of all employed persons) became participants in this pillar.

At today's retirement ages in Russia (60 for men and 55 for women), payments were to start in 2012. In late June 2004, the State Duma amended the law "On Mandatory Pension Insurance in the Russian Federation" to exclude from the second pillar persons born before 1967. Accordingly, payments in this pillar will start 10 years later than called for by the initial version of pension reform.[10] This decision has rather contradictory consequences. The Government justified this step by the need to finance the PFR budget deficit forecast from 2005 onward. However, apart from the short-term financial effect, this step has another aspect: it undermines trust in the new system by revising its rules substantially so soon after their establishment. Another basic goal of the pension reform is also under threat – the differentiation of pension amounts depending on the insured person's earnings. The main burden of solving this problem will be borne by the funded component. For while the insurance component of the labour pension does depend on an insured person's length of service and salary levels, the total size of benefits envisaged in the mandatory PAYG part of the pension system is limited. By lowering the age limit of participants in the funded pillar, any solution to this problem is postponed by at least 15 years -- and the number of participants in the system goes down by more than 20 million (one-third of all employed).

The new rates of contributions to finance the funded part of the labour pension, introduced in 2005, can be found in Tables A2.3 and A2.4 of Annex 2. From 2008 the maximum rate will be set at 6 per cent; up to then it is set at 4 per cent for all participants. Thus, the rate of contributions to the mandatory funded pension system will remain below that of, for example, Poland -- where the contribution rate to the mandatory funded pension system is 7.3 per cent of salary -- and far below that of, say, Kazakhstan, where the contribution rate to the mandatory funded pension system is 10 per cent.[11]

According to data provided by PFR, in 2002, Rb38 billion (USD1.2 billion) of contributions were collected for the mandatory funded pillar; in 2003, Rb47 billion (USD1.5 billion) were collected; and in the four first months of 2004, Rb27 billion (USD0.5 billion). At the end of the first quarter of 2004, PFR transferred Rb47.2 billion (USD1.65 billion at the average exchange rate of March 2004), consisting of

contributions collected in 2002 and an investment return of Rb13.5 billion (USD450 million) to management companies. PFR did not manage to attribute to personal accounts the rather significant part of the total contributions it received in 2002, considering it as unidentified contributions. The total amount of accumulations in the mandatory funded pillar was estimated by PFR at Rb90 billion (USD3 billion) as of the end of 2003.

Rights of participants

A specific feature of the general design of the mandatory funded part of the pension system is the right of members to choose between the PFR and NPFs. The only restriction is that this choice can be exercised no more than once a year. There is no legal obstacle to returning to the PFR after staying with a NPF.

Those who prefer the non-governmental component of the mandatory funded system may choose an NPF (they may choose a new NPF only once a year). Those who stay with the PFR may choose an asset manager. This effectively involves also choosing an investment portfolio as generally each asset manager offers one portfolio.[12] To do this, they must submit an appropriate application to the PFR before a specified deadline (here, too, they may make their choice only once a year). The savings of those who have not expressed a wish to select a private asset manager are to be transferred by the PFR to the State Management Company. The original intention was that if an insured person had chosen a private asset manager, he or she was not to return to the State Management Company; however, the law was amended to permit the choice of the State Management Company.

The rationale for admitting NPFs to participate in the mandatory funded pillar was not to introduce competition between them and investment managers in asset management, as investment managers are supposed to manage the pension savings transferred to NPFs as well. The idea was to enhance the participation of non-state entities in the second pillar of the pension system. NPFs were considered an alternative to the PFR, not investment managers. This reflected the conviction of a part of society that private institutes can perform functions performed by the PFR in the mandatory funded pension system as well as it does, and no worse.

Organising the election by insured persons of asset managers and NPFs

To be functionally efficient, the model selected by Russian policymakers requires that the PFR and the supervisory body undertake a fairly ambitious promotional and organisational campaign. One problem associated with this campaign has been the asset managers’ form of ownership. The PFR decided that distribution of the list of companies --winners in the tender – constituted a

promotion of private businesses, and therefore limited its activity to distributing the application forms. The procedure for submitting the applications to the PFR is also rather intricate. In accordance with legislation, the insured person's application for selection of an investment portfolio (investment manager) shall be filed with the PFR no later than 1 October of each year. The insured individual may personally deliver the application for selection of an investment portfolio (asset manager) to a territorial office of the PFR. If submitting it otherwise, the identity and signature of the insured individual shall be certified by:

- a notary public or under procedures defined in the Civil Code of the Russian Federation;
- executive officers of consulates of the Russian Federation where the insured individual is located outside the Russian Federation;
- an agency (organisation) under an agreement with the Pension Fund of the Russian Federation for reciprocal certification of signatures.

In 2003, the PFR declared organisations that had signed an agreement for reciprocal certification of signatures to be transfer agents, and they became the main channel for sending applications to the PFR. The PFR concluded transfer-agency contracts not only with employers but with major banks having branch networks. Transfer agents accepted applications from insured persons and transferred them electronically to the PFR.

During the accumulation phase, insured persons have the right to information on accumulation and the investment of pension assets, the balance of the special part of their personal accounts in the personalised record keeping system, and the investment declarations of asset managers. The standards for disclosure of information on the investment of pension assets shall be approved by the authorised federal executive agency (Ministry of Finance).

Arrangements for informing insured persons

In funded DC pension schemes, information disclosure plays a very important role. This is especially true in a nationwide system in a country with no tradition for personal investments in securities markets. That is why the basic obligations of the PFR and NPFs in this area were set by law.

Whether or not an insured person realised his or her right to choose an asset manager or a NPF in accordance with the law, the PFR is obliged to do the following:

- Each year provide insured persons with information on the balance of the special part of their personal accounts, investment returns and documents required to choose an investment portfolio (asset manager) or a non-state pension fund;

- If terminating the agreement with an asset manager, notify the insured persons who selected this asset manager, simultaneous with providing annual information.

In practice, the PFR faced several problems, especially in 2003 when insured persons were, for the first time, informed of the status of their personal accounts in relation to both the insurance and funded parts of labour pension, and more than 40 million letters had to be sent out. As a result, the deadline for the insured persons to submit their applications to select an asset manager was extended.

In 2004, information on the contributions paid for insured persons was distributed within the appropriate period. The PFR made its announcements on investment results through the mass media, at a cost for the year of Rb500 million (about 1 per cent of the amount of contributions to the funded part of labour pension received by the PFR in 2003), according to the Minister of Health Care and Social Development.

Record keeping and portability

The issues of portability are settled by centralising the collection of contributions and savings records in the PFR. All employed participants in the pension system have received insurance certificates with identification codes (not only participants in the funded part of the labour pension, but those for whom employers pay contributions only to the insurance part). This avoids any problems stemming from changing jobs or contributions being paid for persons with several jobs. However, this degree of portability comes at a price; a longer period is needed to identify (by recording incoming amounts to personal accounts) contributions to the PFR (if compared with the design in which employers pay contributions directly to pension funds). Associated with this delay is a lowering of investment income.

Certain technical problems may arise among those participants who leave the PFR for an NPF, but it is likely that these will arise not due to a changed place of work but due to a change of NPF or the return to the PFR; the PFR is not obliged to keep records of investment returns and, consequently, of the current value of the pension savings being accumulated for the benefit of NPF participants. The PFR keeps records only of contributions received and the distribution to accounts of

investment returns on these contributions before their personification, and of the transfers of funds to NPFs.

Taxation and dispute resolution

There are no special legal provisions for resolving complaints or disputes between beneficiaries and the NPF(s) or the PFR, but the authorised federal executive body (now the Federal Service for Financial Markets) has the capacity to appeal to the courts to protect the legitimate rights and interests of the owner of pension assets, to eliminate the consequences of, and compensate for, damage caused by legal agents for accumulation and investment of pension assets as a result of violation of the law of the Russian Federation.

Contributions are not taxed, nor are investment income or pension benefits in either the PAYG or funded pillars.

Professional pension plans

A professional pension plan[13] may be initiated both in the PFR and in an NPF after the appropriate law takes effect. An NPF, in order to be allowed to act on the professional pension market, must comply with the requirements established for such participation in the second pillar of the pension system.

Professional pension plans are funded by means of employers paying the insurance contributions to finance professional pension plans to the PFR or a NPF. Contribution rates are still under discussion between employers and the government; representing one of the factors delaying the adoption of the draft law.

The investment of pension savings accumulated within the framework of professional pension plans is intended to be carried out with the same restrictions established for investments in the second pillar of the pension system. However, the choice of an asset manager in the event an employer concludes an agreement with the PFR is made not by the participant but by the employer.

Professional pensions will be paid until the end of the early-retirement pension period, that is, until a person reaches the official pension age. The amount of a professional pension is based on the amount of pension savings accumulated in the name of an employee and the duration of the pre-retirement pension period. (For a list of the categories of individuals entitled to professional pension plans, see Annex 3.)

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2.3. Administration and regulation of the mandatory pension system

The Pension Fund of the Russian Federation (PFR)

The PFR plays a central role in the administration of the labour pension (both PAYG and funded components). It accumulates sums paid by employers as the uniform social tax that are designated for payment of pension benefits and as insurance contributions for labour pensions. It keeps records and provides benefit payments. It invests collected contributions in the mandatory funded system until they are attributed to personal accounts.[14] As part of its responsibilities, it effects control, along with the tax authorities, over incoming insurance contributions to the PFR; over the disbursement of its funds; over the organisation and operation of a state data bank on all categories of payers of insurance contributions to the PFR; over research in the field of state pension insurance; and over consulting the population and juridical persons on issues placed within the PFR's competence. The PFR may also participate in the financing of programmes for social protection of the elderly and disabled persons.

In addition to the central apparatus, the PFR has 85 regional branches. The central apparatus includes the board, the executive directorate, the auditing commission and the information centre for personified records. The organisational structure of the PRF's branches consists of boards, departments and centres for pension payment.

The PFR's administration is governed by the board and its executive body – the executive directorate. The board is composed as follows: chairperson, first deputy chairperson, deputy chairpersons of the board and the PFR's executive director, as well as the managers of the twelve branches. The PFR board may also include the representatives of those public, religious and state organisations, unions, institutions and enterprises whose activity is associated with the protection of the interests of pensioners, disabled persons and children.

In accordance with the approved statute, the PFR's board does the following:

- bears responsibility for the performance of the functions within the competence of the PFR;
- determines the prospective and current goals of the PFR;
- approves the budget and expenses of the PFR and its bodies, and reports on their execution, as well as its structure and personnel;

- nominates and dismisses the executive director and deputy executive directors, the chairperson of the auditing board and the managers of its departments;

- approves the provisions concerning the executive directorate, the auditing board and the PFR's regional bodies;

- issues, within the limits of its powers, the normative acts relating to the PFR's activity.

As of October 2004, the PFR's board consisted of the chairperson of the PFR's board, first deputy of the chairperson, four deputy chairpersons, the PFR's executive director, PFR branch managers representing nine large regions, the representative of the Federation of Independent Trade Unions and the representative of the Council of the All-Russian Organisation of the Veterans of War, Labour, the Armed Forces and Law-Enforcement Agencies.

Since 2004, PFR activities have been coordinated by the Ministry for Health Care and Social Development of the Russian Federation, which does the following:

- submits to the Government of the Russian Federation proposals concerning the appointment and dismissal of the PFR's chief executive officers;

- adopts normative legal acts concerning the PFR's spheres of activity;

- submits to the Government of the Russian Federation draft normative legal acts regulating PFR activities;

- submits to the Government of the Russian Federation, on the representation by the PFR's chief executive officer, draft federal laws concerning PFR budgets and the execution of these budgets;

- orders audits of PFR activities in instances determined by the federal law.

PFR budgets and execution are subject to annual approval by the State Duma of the Federal Assembly of the Russian Federation in the form of a federal law. The law envisages sufficiently autonomous activity of the central apparatus and of regional branches.

The organisation of the investment process for mandatory pension funds is presented schematically in Annex 4.

Other institutions involved in the mandatory funded pension system

Tax authorities

Tax authorities collect mandatory contributions and transfer them to the accounts of PFR with the Treasury.

Non-state pension funds

To exercise mandatory pension insurance, NPFs must obtain new licenses and notify the Federal Service for Financial Markets (FSFM) of their intention to exercise mandatory pension insurance. As of 1 October 2004, 77 NPFs had registered such applications. NPFs have until mid-2009 to obtain licenses. During this period, existing entities must bring the size of the property formed to provide for charter activity (PPCA) and some other characteristics into compliance with requirements set by amendments to the law "On Non-State Pension Funds". The Government may set additional requirements. As it stands, to obtain a license for the pension provision and pension insurance activities, a fund must comply with the following requirements:

- The director of the fund's executive body must have: at least three years' experience in top managerial positions operating funds or insurance companies or other financial organisations; a higher-education degree in law or finances and economics (or, if he or she holds a degree in another field, a special course in professional education); no record of conviction for crimes in the economic sphere, or for crimes of medium gravity or greater.

- The fund's accountant general must have: at least three years' experience in this specialty; a higher-education degree; no record of conviction for crimes in the economic sphere, or for crimes of medium gravity or greater.

- The monetary valuation of the capital designed to provide for the fund's charter activity must be no less than Rb3 million (USD104 000); from 1 January 2005, of no less than Rb30 million; and from 1 July 2009, of no less than Rb50 million. The aggregate contribution of the fund's founders must amount to no less than Rb3 million, and from 1 January 2005, of no less than Rb30 million.

Asset management companies

The design of the second pillar of the pension system restrains the powers of the PFR in investing collected contributions to the period before the collected sums are attributed to the personal accounts of insured persons. The PFR then transfers collected contributions and investment gains to asset management companies and NPFs. Asset management companies not only require appropriate licenses but must meet additional requirements to take part in the mandatory funded pillar of the pension system. The selection of investment managers to invest funds for the PFR is organised via tender, but the State Management Company is picked by the Government. Asset management companies also invest all funds transferred to NPFs under the mandatory funded system. NPFs may choose among management companies that comply with legal requirements set for investment of funds for the PFR. Foreign-owned financial institutions may participate if they have an appropriate FSFM license.

As a result of a tender organised in 2003, the PFR signed agreements for discretional management with 55 management companies and one State Management Company. The Government appointed Vnesheconombank to perform functions of the State Management Company, to which savings of those who have not expressed their wish to select a private asset manager are transferred. A second tender was organised in 2004, but the organiser, FSFM, received no applications.

By the end of 2004, Vnesheconombank was managing nearly Rb95 billion (USD3.4 billion) of pension assets, while private asset managers were handling only Rb3 billion (USD0.1 billion).

Specialised depositaries

Daily control over pension accumulations is performed by a specialised depositary. In the “public” segment of the mandatory funded pillar, one specialised depositary renders services to all investment managers. In the segment with NPFs, the main condition is that the NPF should have an agreement with only one specialised depositary. In addition to control functions, the specialised depositary keeps records of rights on securities and performs safekeeping, unless otherwise prescribed, for certain kinds of securities by statutory legal acts of the Russian Federation.

The specialised depositary for the PFR is selected on a competitive basis. Tenders should be organised by the supervising body (FSFM). The first tender was won by Ob'jedinennaya depositarnaya companiya (ODC).

NPFs may select asset managers and the specialised depositary among companies that meet the requirements established by the Law "On Investments for Financing of the Funded Part of Labour Pensions in the Russian Federation".

Brokers

Investment managers shall use the services of independent brokers to perform transactions with respect to pension assets transferred for management by the Pension Fund of the Russian Federation. To act as a broker, a management company must be licensed as a broker by the FSFM and comply with certain legal requirements.

Auditors

Operations of investment managers and specialised depositaries with pension accumulations are subject to annual audits by independent auditors. NPFs are obliged to undergo an independent audit each year. The activities of the PFR relating to the pension system's mandatory funded pillar are subject to review by the Schetnaja Palata (state auditor).

Insurance Companies

Both asset managers and the specialised depositary should insure against liability risk for violations of agreements caused by errors, carelessness or deliberate unlawful actions (or inaction) of employees of the specialised depositary, or deliberate unlawful actions of asset managers. The said illegal actions (or inactions) include: crimes in the sphere of computer information, crimes against the interests of service in commercial and other organisations; crimes in the economic sphere; and other violations of the law.

The rates for liability insurance (their margin levels) are set by the Government of the Russian Federation. Specific requirements have been established for the insurance companies involved in this business on capital levels (no less than Rb3 billion, or USD104 million) and concerning experience in insuring corresponding risks (no less than three years).

For the Russian securities market, this is a relatively new kind of insurance, and insurance companies are not large. Therefore, the industry and its regulator have had to make much effort to be able to provide necessary services. Two pools of insurance companies were formed to insure the risks prescribed under the law "On Investment of Funds for Financing of the Funded Part of Labour Pensions in the Russian Federation" -- one consisting of six insurance companies, the other of 10.

All investment managers and the specialised depositary have concluded agreements with one of the two pools.

Asset managers, specialised depositaries and NPFs under law should develop codes of professional ethics aimed at securing rights and interests of the owner of pension accumulations (that is, the Russian Federation) and insured persons. This is especially important because there is no legislation regulating the use of insider information in Russia. The government devised a sample code of professional ethics for organisations participating in the pension accumulations investment process.

No special guarantee or compensation funds are provided in the mandatory pension system. But the system has safeguards of several kinds. The risk of mismanagement is controlled by the specialised depositary, to which investment managers must report daily on their operations. The specialised depositary monitors the composition and structure of assets being managed by the asset manager and notifies the PFR and the supervising authority (FSFM) of violations of limits set by law or investment declaration. Both asset managers and the specialised depositary servicing the PFR must acquire insurance covering risks of damages caused by mistakes by personnel, fraud, etc. NPFs, asset managers and specialised depositaries have to maintain certain capital adequacy requirements. The adequacy ratio currently set by the FSFM for investment managers and specialised depositaries is quite liberal, and not binding, but this may be changed by the supervisor.

For investment managers, asset management should be the only licensed activity. The only exception is the State Management Company, as Vnesheconombank is a universal credit institution. To manage any risks or potential conflicts of interest that arise (Vnesheconombank acts as an agent for the Ministry of Finance on government securities denominated in foreign currencies) it was asked to organise a separate subdivision for discretional asset management.

2.4. Investment regulation of the mandatory funded pillar

Russian legislation imposes several kinds of limits on the investment of second-pillar pension accumulations. The investment of pension accumulations is allowed in the following *types of assets*:

- government securities of the Russian Federation;
- government securities of subjects of the Russian Federation and municipal bonds;
- corporate bonds of Russian issuers;

- stocks of Russian open joint-stock companies;
- mortgage securities;
- current accounts in roubles and foreign currency with lending institutions;
- deposits in roubles with lending institutions;
- units (shares, allotments) of foreign index investment funds.

This list applies to both asset managers (under Russian law they are called "management companies"), which have signed agreements with the PFR, and to management companies, which have concluded agreements with NPFs. Investments of the state management company are limited to government securities of the Russian Federation, mortgage securities guaranteed by the Government of the Russian Federation and current accounts in roubles and foreign currency with lending institutions. Yet, these kinds of mortgage securities do not exist while investment in cash with lending institutions is regarded as a low-return investment. Hence, the overwhelming share of assets is invested, de facto, in debt instruments of the Russian Federation. This is stipulated both by the configuration of the system and the fact that it is in the initial stage of implementation. The PFR transfers collected contributions to a management company or a NPF only after attributing them to personal accounts and performing this on the basis of totals for a calendar year. This procedure, in turn, takes more than a half-year due to terms set by legislation for providing tax declarations by employers, and the time needed for interaction of the PFR and tax authorities. When the participants of the mandatory pension system have performed their choice over asset management companies or NPFs, it takes the PFR several months to collect and process their applications. Therefore, for a period of about two years, the PFR is investing contributions itself; the list of assets is limited to government securities. In fact, the PFR and the state management company, to which the assets of those insured persons who did not exercise their right of choice of a management company are transferred, have the same composition of instruments to invest in. When the first round of elections of management companies was conducted late in 2003, 98 per cent of insured persons chose to stay with the state management company. Non-state pension funds joined the system only in 2004.

There are a number of *limits aimed at diversification of investments*. A few are set by law (such as the maximum share of the investment portfolio that can be held at banks (20 per cent) or invested abroad (20 per cent from 2010)), while others are set by the Government and are potentially more flexible. (For detailed limits on the

investment of pension accumulations, see Annex 5.) It should be mentioned that no minimum limits are set for any class of assets and no maximum limits are set for federal government securities. A number of limits aim to control risks connected with investments in the securities of one issuer. In particular, securities of one issuer or a group of connected issuers in the investment portfolio should not exceed 5 per cent. All these limits should be observed by each management company; for the aggregate investment portfolio of the PFR, an ownership limit is set at 30 per cent of the total volume of securities in circulation of any one issuer. Securities issued by affiliated companies of the management company and the specialised depositary should not exceed 5 per cent of assets under management.

There are also requirements aimed at the liquidity of securities. The management company may buy them only on an organised market. The only exceptions concern federal government bonds issued especially for institutional investors, and units of foreign index investment funds. Securities should be listed on a stock exchange, and their issuers should comply with a number of qualitative and quantitative requirements (Table A5.3 of Annex 5).

Investment in foreign-issue securities is allowed only in the form of units of foreign index investment funds. There are several reasons for this approach. First, it imposes cost restrictions. Considering the established restrictions on expenditures on pension savings investment and on those amounts that initially may be allocated by Russian asset managers for foreign investments, only those products that are based on the principle of passive investment can be available to them. Second, the lack of an adequately developed practice of foreign investments by the institutions designed to manage collective investors' assets has influenced the restrictions imposed on the investment instruments. The orientation towards investment funds is probably only temporary. As the Russian stock market's integration in international structures grows and Russian investment managers acquire more experience of foreign investments, the mechanisms for interacting with foreign entities will become smoother, emerging taxation problems will be solved, and restrictions on the investing abroad of pension savings will be relaxed.

For now, the Law "On Investments for Financing of the Funded Part of Labour Pensions in the Russian Federation" requires that a Russian asset manager sign an agreement with the asset manager of a foreign investment fund. The law also sets the criteria for selecting foreign managers. The requirements to the manager of an index investment fund for investment of pension accumulations in foreign-issue securities include:

- license (authorisation) for operations related to managing assets of investment funds under the law of the country of their incorporation;

- minimum five years' index investment experience for at least one of the stock market indices eligible for investment of pension accumulations;

- minimum 10 years' experience of managing assets of institutional investors, including pension funds;

- compliance with capital adequacy requirements established for asset managers in countries of the European Union;

- compliance with requirements on the minimum amount of assets under management, as defined by the Ministry of Finance in co-ordination with the Federal Service for Financial Markets.

The contract cannot be entered if the manager or investment fund is incorporated in a country or territory which provides privileged tax treatment and/or does not envisage disclosure and provision of information in performing financial transactions (offshore jurisdictions).

Material terms of contracts with the manager of an index investment fund shall be defined by the Government of the Russian Federation. Regulating authorities may approve a list of managers of index investment funds that comply with set requirements.

The regulating authorities are also entrusted with establishing the list of indices for the investment of pension assets, and the list of rating agencies. The list of rating agencies is necessary because pension accumulations shall not be invested into indices incorporating bonds of foreign issuers without an investment-grade credit rating awarded by acknowledged international rating agencies.

Asset managers are not requested to generate a minimum rate of return on pension assets.

Pension savings in the mandatory funded pension system are considered as property of the Russian Federation while they are accumulating in the PFR,[15] and this affects the design of the second pillar. In particular, this determined the appearance, within the system, of an entity such as the State Management Company. The choice of an asset manager is regarded as the choice by an insured person of a private form of managing the savings being accumulated in his or her name. If a particular person has not stated his or her will, it is presumed that the insured person has no trust in private business and prefers the state to manage his or her savings. The same approach determined the set of instruments allowed for investment by the State Management Company. As people distrust the private sector, investments

should be limited to securities issued by the federal government, or mortgage securities guaranteed by the federal government. This approach, realised in the law "On Investment of Funds for Financing the Funded Part of Labour Pension in the Russian Federation", not only differs from the solutions to the problem of passive participation in the mandatory funded pension system, such as in countries where similar reforms were being implemented, but contradicts the economic considerations on which the range of instruments for investment of pension savings was initially based, and which, according to the law "On Investment of Funds for Financing the Funded Part of Labour Pension in the Russian Federation", remained open only to private investment managers. Nevertheless, it was this approach that was finally implemented.

At the payout stage, the intent is to centralise the investing of pension savings within the State Management Company (the company responsible for managing annuity reserves). At the same time, there are plans to ensure a wider spectrum of authorised assets as compared to those authorised for the State Management Company in accordance with the federal law "On Investments for Financing of the Funded Part of Labour Pensions in the Russian Federation". The annuity reserve assets authorised for investing are represented by all those assets which are authorised for the asset managers selected by tender for the investment of pension savings, except stocks.

The fees charged on the pension savings to cover investment related services are restricted by law. These cannot exceed 1.1 per cent of the net asset value managed by an asset manager, while payment for the services of a specialised depositary cannot exceed 0.1 per cent of net asset value. The asset manager is also entitled to reimbursement at the expense of investment income received, but not in excess of 10 per cent.

NOTES

1 The estimated pension capital for defining the insurance part of labour pensions is calculated in accordance with the legislative provisions as stipulated in the Law on Labour Pensions.

2 Tribal and family communes of small-population Northern peoples engaged in traditional branches of the economy, and peasant (farmer's) economies.

3 For persons residing in the regions of the Far North and in localities of an equal status, where regional wage coefficients are established, the ratio of the average monthly earnings of an insured person to the average monthly wage (ME/MW) is recorded with an upward index between 1.4 and 1.9.

4 Government decree of 11 July 2005, N 417 "On approval of coefficient of indexation of accumulated pension capital of the insurance part of labour pension". The decree came into effect on 1 August 2005.

5 Initially, pensions were paid in accordance with a single formula under which any pension was to amount to 55 per cent of the previous wage (during the "best" five years or the last two years of employment) plus 1 per cent for every additional year of service, but not in excess of 75 per cent of the wage. In 1997, another formula for calculating pensions was introduced to increase the differentiation of pension payments. The new formula was based on the so-called individual coefficient of a pensioner. It was calculated as follows: the percentage of accumulated pension, derived from the employment record, was multiplied by the ratio of the average monthly wage (derived for the whole period of contributory payments) to the average monthly wage in the country during the same period. The new formula did not nullify the previous one; people could choose the formula to be used for calculating their pensions (most pensioners selected the new formula). This made the structure of pension payments more complicated. Still more complexity was added by the intricate payment system which supplemented the basic pension.

6 V*estnik pensionnogo fonda Rossii (2004)* (Herald of the Pension Fund of the Russian Federation), No. 2.

7 The draft law *On the Procedure for Financing the Payment of the Funded Component of Labour Pension and the Specificities of Investing the Pension*

Accumulations Formed for the Benefit of Persons of Retirement Age in the Russian Federation was approved by the Government in September 2004.

8 Martineau, J.-N. (2001), "*The Proposed Pillar-2 Pension Capital Liquidation Mechanism: A Special Case of Variable Annuities Self-Annuitisation*"., Draft.

9 Rate of interest generally used to calculate the payout on an annuity contract.

10 The fate of pension accumulations formed during 2002-04 to the benefit of excluded persons is yet to be clarified.

11 Dariusz Stanko (2003), "Polish Pension Funds: Does the System Work? Cost, Efficiency and Performance Measurement Issues", materials presented at the 4th International Research Conference on Social Security; Investment Pension Europe, September 2004.

12 The investment law does not explicitly prohibit investment managers to offer more than one portfolio. Some asset management companies (currently three companies) decided to propose more than one portfolio (i.e. 2-3 investment choices).

13 Plans are meant for funding pensions related to working conditions (called professional pensions), which were introduced to solve the problem of pension maintenance of persons eligible for early retirement. Pensions are to be paid during the limited period (before the common retirement age). Legislation governing how these plans are to function has yet to be adopted. The text below is based on the draft law.

14 As this activity takes more than a year for each year the contributions are paid for, the PFR actually invests contributions during the year they are collected and for several months thereafter (these assets are invested only in government securities and the returns are assigned to the personal accounts). Currently, it has separate investment portfolios of funds collected, in 2004 and not yet transferred to investment managers as well as funds collected in 2005.

15 If an insured person has selected a NPF, then the pension savings being accumulated in his or her name become property of the NPF. Those insured persons who have chosen an NPF must submit to the PFR an application stating their refusal to form the funded part of their labour pension through the PFR.

Chapter 3

VOLUNTARY OCCUPATIONAL AND PERSONAL PENSION PLANS

3.1. Design and operation of voluntary private pension systems in Russia

Legal framework

Voluntary retirement provision is available both to public/private corporations and to individuals and is mostly provided by non-state pension funds (NPF). The Federal Law, No. 75-Fz of May 7, 1998 “On Non-State Pensions Funds” (with the Amendments and Additions of February 12, 2001, March 21, 2002, January 10, 2003, December 2, 2004) regulates the establishment and operation of NPFs. Insurance companies may provide pension products but few do.[1] The configuration of this voluntary, funded pillar differs from that of other countries with three-pillar pension systems. The development of NPFs started in 1991, ahead of the establishment of the main principles and design for the regulatory framework. This still influences the role the NPFs play in the Russian pension system. The majority of NPFs are multi-sponsored entities. NPFs have some 5.5 million participants (8 per cent of the total employed) and pay benefits to fewer than 0.5 million persons.

NPFs are organised as separate legal entities. To do business they must have a license granted by a government authority. Up to 2004, supervision of NPFs fell under the Ministry of Labour and Social Development. That year the supervisory functions were transferred to the authority in charge of supervising financial markets, the Federal Service for Financial Markets (FSFM).

The safekeeping of NPFs’ assets is effected by depositaries. The depositaries also perform the functions of everyday control of the investing of pension reserves. To do this, they must obtain a special license as a specialised depositary. An NPF may have an agreement with no more than one specialised depositary.

The number of non-state pension funds is approaching 300 (after decreasing to 257 in 2001, following the cancellation of more than 50 licenses, the total number of funds resumed growth in 2002).

Contributions to non-state pension funds may be made both by employees and by their employers. NPFs are subdivided, based on this criterion, into the following categories:

- the so-called corporate NPFs, where the fund's main contributor is the employer-enterprise (this category also includes some industry-wide funds, for example, those in electric power engineering or railways);

- regional NPFs, where the fund's main contributor is the employer - local administration;

- open NPFs, where funds are oriented to retail businesses whose contributors are predominantly physical persons.

- Relatively few funds are oriented to servicing physical persons. Regarding contributions made during the first half of 2004, three-quarters or more of the contributions are received from physical persons by only 51 funds. Nonetheless, they are on average four times smaller than those funds oriented to servicing legal entities.

The main clients of regional funds are employees of local administrations and budgetary institutions.

The NPFs offer schemes of both the DB and DC types. As shown by an analysis of more than 100 schemes promoted by NPFs whose rules are available on the Internet, DC schemes prevail. The DC schemes provided by NPFs do not necessarily suppose individual pension accounts; if the contributions are paid by an employer, the scheme may well be organised on the bulk-account principle (with no individual accounts for employees; so-called joint account schemes).

The regulation of this side of NPF activities is rather loose, leaving considerable room for variation. There are no recommended sample pension schemes or rules, though the Government has set some requirements regarding pension schemes offered by NPFs. The legislation is more developed for DB schemes -- thus, the benefits of an NPF participant with a sufficiently long employment record to be granted a full state pension should be no less than half the minimum state old-age pension that existed when the pension agreement was signed. At the same time, legislation regulating the activities of NPFs sets no 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, etc.

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 may be paid.

Pay-out phase

Judging by existing fund rules, NPFs propose both life annuities and term annuities (or temporary annuities payable for a fixed period or until earlier death). Joint and survivor annuities may be encountered; spouse annuities were practically never offered (in the schemes analysed, this product was provided by only one fund). Schemes with phased withdrawal of accumulated funds are rarely seen, but a number of NPFs propose schemes involving the promise to pay the pension during an agreed period (most often five years, but other terms, for example three or 10 years, are also encountered), conditioned by the availability of funds in the participant's account. In a number of cases, the fund's rules do not determine clearly which payment modalities are available to a participant. The highest percentage of uncertainty is characteristic of DC schemes. In approximately 17 per cent of cases, the rules do not define clearly the form of annuity.

As for benefits, they can be paid both from individual pension accounts and from bulk accounts (employer's accounts involving no personal accounts for employees or members of the scheme). In both instances, the funds' rules may include a joint responsibility clause. Though this concept is not defined in legislation with respect to NPFs, the presence of this condition is interpreted as the responsibility of a contributor (employer) for the NPF complying with the terms of a pension agreement with a participant.

According to the law "On Non-State Pension Funds", a non-state pension is to be regularly paid to NPF participants on terms set in the pension agreement between the NPF and the participant. NPFs promote a number of benefit forms, but lump-sum payments are forbidden. Benefits paid by NPFs are not strictly bound to retirement age (according to the law "On Non-State Pension Funds", pension agreements may set additional grounds for obtaining the right to receive a non-state pension).

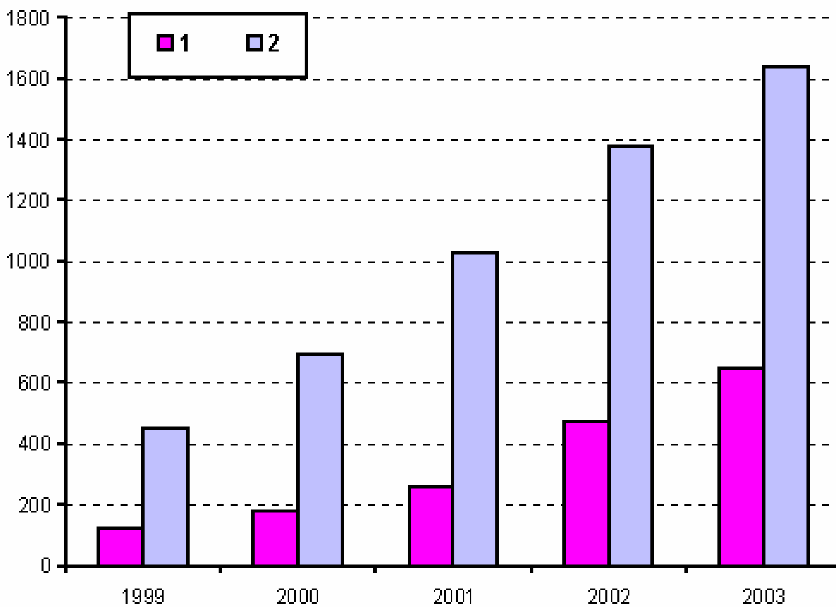
The average pension paid by NPFs constituted about 40 per cent of the average state labour pension in 2003, while in 1999-2001 it was only 25-26 per cent (Figure 3.1).

Inheritance

Savings accumulated in participants' accounts are not always subject to inheritance. Governmental requirements of NPF pension schemes state that NPFs are obliged only to declare the possibility or impossibility for fund participants to

inherit pension savings. The issue is complicated by the fact that legally, pension savings do not belong to a participant but are a fund's property; the law speaks not of inheritance but of legal succession. The norms of inheritance law are thus not applied automatically to this sphere. The requirements for participants in NPFs in terms of legal culture become much higher, because the realisation of legal successors' rights declared in the scheme depends upon the care and detail with which a given agreement between an NPF and its participant is formulated, and whether it specifies the appropriately formalised legal successors.

Figure 3.1. Average size of monthly pension benefits paid by the PFR and NPFs
(in roubles)



1- NPF
2- PFR
Source: Rosstat, inspection for non-state pension funds.

Of 100 schemes which could be analysed in terms of inheritance, 36 envisaged no form of inheritance. One in two DB schemes envisaged inheritance, and one in three DC schemes lacked a clause concerning inheritance. One-quarter of DC schemes limited inheritance to the period prior to payments beginning, and approximately the same proportion of schemes envisaged inheritance both prior to

and after the beginning of payments. Fairly seldom – in only seven schemes -- was inheritance envisaged only after the beginning of payments.

In those instances when a scheme does envisage inheritance of savings, it is not possible as a rule, to take the benefits as a lump sum. Instead, the surviving beneficiary enters an agreement with the fund that the pension be paid is to him or her. Such agreements fairly often envisage the payment of additional contributions in order to increase the amount of the expected pension.

However, analysis of the schemes provided no answer as to how widespread the bequeathing (inheritance) of savings actually is, because no data were available on the scheme-by-scheme distribution of participants. Moreover, the possibility of inheritance often depends on the presence of stipulations to this effect in the agreement between a participant and an NPF, and, more importantly, in the agreement between an NPF and a contributor (employer). Notably, inheritance terms do not relate closely either to the type of scheme (DB or DC) or to the form of annuity (life or term).

Governance

In accordance with the federal law "On Non-State Pension Funds", the composition and structure of the governing bodies of a NPF are to be determined by its charter. The structure of the fund's governing bodies must include a collegial body (the fund's council) and an executive body. It has been mandatory since 2003 for an NPF to create a council of trustees responsible for supervision and public control over the fund's activity. To ensure operative control over the activities of the fund's executive body, its charter must also stipulate that an auditing board be established.

The supreme body for the fund's management is the council. The fund's council is to ensure the general governance of the fund's activities. The structure, the procedure of its creation, the powers and the period of their effect are to be determined by the charter. The council's members may be reimbursed for the performance of their functions, if this is envisaged by the fund's charter. Such reimbursement is to be established as a fixed sum.

In practice, the fund's council is usually constituted by the representatives of the fund's founders (sponsors). However, the charters of different NPFs allow for wide variety in the mechanisms of its formation, member rotation, decision-making procedures, etc.; and many issues may be stated more exactly in the statutes forming the basis for its activities, which are adopted and amended by the council itself.

Operative management of the fund's activities may be effected either by the fund's single executive body (executive director, president), or by a single executive body and a collegial executive body (executive directorate). The fund's executive body performs its functions within the powers established by the fund's charter and acts on the basis of this charter and its own statutes, approvable by the fund's council. There are no legislative distinctions between the powers of the fund's council and the powers of the executive body. In practice, this may result in "distortions" in the fund's corporate management – both in favour of the fund's council and in favour of the executive body.

To supervise the fund's activities and to protect the interests of contributors and participants, the fund is to create a board of trustees. Procedures for its formation and its powers are to be determined by the fund's charter and the specific statutes of the board of trustees, approvable by the fund's council. The fund's board of trustees consists of empowered representatives of contributors, participants and insured persons, to whom no less than one-half of the decision-making votes are to belong. Members of the board of trustees perform their functions on a gratis basis. As noted, the creation of NPFs' boards of trustees became mandatory in 2003, although amendments to the law "On NPFs" did not specify the powers of the boards of trustees; moreover, according to R. Kokorev and S. Trukhachiov,[2] the law grants no real powers to a board of trustees. By law, the body responsible for supervising an NPF's activity becomes answerable to an NPF's supreme body and may be replaced by the latter in the event of a conflict. The dispositive legal capacity in such a situation turns out to be negligible.

Portability and other rights of beneficiaries

The law "On Non-State Pension Funds" does not regulate questions of the portability of pension rights. In cases when contributions are made by participants themselves and recorded in their personal accounts, problems do not arise. In cases of bulk contributions by employers, the situation has not changed significantly since D.Vittas and R.Michelitsch stated in 1995[3] that questions of vesting and portability are not properly addressed. The possibility for a participant to exercise the right to be granted a pension once grounds for a pension arise, and to receive the accumulations if he or she changes employers, depends on terms of the agreement between the NPF and the employer; the employee is no party thereto. Variants for solving these aspects can be found in the NPFs' pension rules:

- Deferred rights occur at the moment funds are transferred from the bulk account to an employee's personal account, this moment occurring only when a given employee retires;

- Deferred rights occur at the moment of transferring the funds from the bulk employer's account to an employee's personal pension account, this moment occurring when a given employee reaches a certain age, or if he or she has been employed at an enterprise for a specified period;

- Deferred rights do not occur even at the moment when a given employee retires, because the pension is paid from a bulk account;

- The employer pays contributions directly to an employee's personal account, but under the pension agreement the former retains the right to terminate the agreement and to take the money back without the participant's consent.

Portability is part of a more widespread problem of ensuring the rights of participants of NPFs. As R. Kokorev and S. Trukhachev noted:[4]

> "Russian legislation concerning NPFs certainly introduces no discrimination in the access to NPFs … but neither does it forbid employers to introduce it: the director of a contributor enterprise, should he want it, may finance at the enterprise's expense his own pension alone, or, for example, the pensions of CEOs, or the pensions of the employees who have worked for more than a specified period - the agreement with a NPF may contain any terms, it does not matter to the fund. Or, there may be no mention in the agreement of the pension rights of individual employees – it would be sufficient to specify that the NPF is to compute and pay a pension to this or that employee only on the basis of the so-called 'ordering letter' from the contributor, and the question as to in whose name to write such a letter is answered, again solely, by the contributor's director… Neither pension legislation, nor labour legislation regulate these issues."

Such issues are settled at the level of the contributor enterprise. The enterprise either develops and approves a corporate programme for supplementary pension provision, or includes provisions concerning pension provision in the collective contract, or (rarely) includes appropriate provisions in labour contracts. As a rule, these documents contain certain obligations of the employer to an employee relating to the amount of the future pension linked to parameters such as the salary received during a specified period, the length of service, the employee's job, etc.

Neither does legislation regulate more complex issues pertaining to the rights of NPFs' participants during the reorganisation or bankruptcy of a contributor enterprise and the NPF itself.

Taxation

As far as NPFs are concerned, taxation lacks predictability. The rules of taxation of contributions and payments made in accordance with voluntary pension plans have been changed fairly often and are not yet well-established.[5]

Presently, Russian legislation treats contributions to NPFs differently, depending on their source – employers or employees. Employees enjoy no exemptions in relation to voluntary pension plans. Contributions may be paid only out of after-tax income. Employers are exempt from the taxation of contributions paid under the agreements with both insurance companies and NPFs. If their contributions under those agreements do not exceed 12 per cent of the total payroll, these are treated as labour costs and are exempt from the profit tax. Nor is income tax paid. In this regard, the agreements concerning pension insurance and (or) non-state pension provision must state that life annuities are to be paid only after the insured person fully complies with the annuity requirements envisaged by legislation of the Russian Federation which grants the right to a state pension.

If the agreements envisage that pension contributions are to be transferred from a joint (corporate) pension account of a contributor (employer) to participants' pension accounts, tax exemptions are preserved within the annual limit of Rb5,000 per employee (USD174). Amounts in excess of this are subject to income tax.

As for the exemption of contributions from the uniform social tax, no clear interpretation of the legislation has emerged. The tax code contains no direct stipulation that employers' contributions to NPFs should or should not be taken into account when computing the amount of the uniform social tax. Tax authorities treat contributions to NPFs as labour costs and consider that the uniform social tax is to be imposed on the contributions paid to NPFs.[6]

The investment returns received by a NPF are subject to taxation, though the taxation regime differs depending on the source of funds. Returns resulting from pension savings investment are subject to reduced tax rates: only investment returns in excess of the Bank of Russia's refinance rate are taxed (that rate currently is 13 per cent). For taxation purposes, investment returns are decreased by the amount of the costs of investment (fees to the asset manager, the specialised depositary, the costs of safe-keeping and evaluation of the property in which pension savings are invested, etc.), and also by the amount charged by NPFs to provide for charter activity (up to 15 per cent of investment returns).

On the income received as a result of investment of property formed to provide for charter activity (PPCA), NPFs are to pay the profit tax in accordance with the established procedure, the tax rate being 24 per cent.

The taxation regime of the voluntary pensions paid by NPFs is subject to discussion. Up to 2003, pensions were not subject to the personal income tax. Since 2003, pensions paid by NPFs have become subject to taxation, and income tax is to be charged on them. The original plan was that from 2004 onward, income tax was to be imposed on pensions paid from the bulk pension account (that of employer-contributor as opposed to individual pension account) of a contributor (employer), while the non-state pensions paid from a participant's personal account were not to be subject to personal income tax. However, the enactment of these tax-code provisions was suspended for 2004.

The tax exemption of pensions paid by NPFs requires that a participant meet the conditions for granting a pension set by legislation of the Russian Federation. If the agreement with an NPF is terminated prior to the expiration of the five-year period (except when such termination takes place for reasons beyond the will of either party), the income received, after deducting the amount of contributions paid by the participant, is to be recognised as the latter's income and thus as taxable. This provision of the tax code is designed to eliminate the possibility of applying NPFs within the so-called salary schemes used by some employers to decrease their payroll tax burden.

3.2. Recent developments in the voluntary pensions market

The total value of pension reserves of non-state pension funds amounted to Rb91.7 billion (USD3 billion) as of the end of 2003.[7] As shown in Figure 3.2, they grew rapidly for several years, and over a four-year period (2000-03) increased almost eight times when measured in dollars. But their size relative to GDP has remained at less than 1 per cent.

Market structure

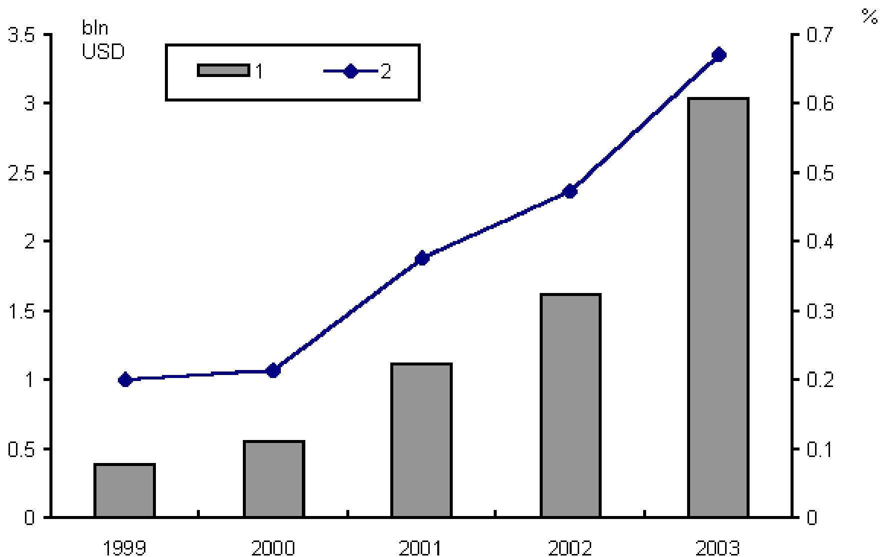
As of the end of 2003, the average amount of pension reserves per NPF was Rb349 million (less than USD12 million). By this criterion, funds varied from zero to Rb45 billion (USD1.5 billion).

While the funds at the disposal of an average NPF are rather small, the structure of the sectoral market is characterised by a very high degree of concentration. As of the end of 2003, the largest NPF accounted for one-half of all pension reserves. The following four accounted for an additional 19 per cent,

meaning that the five largest non-state pension funds accounted for about 70 per cent of all pension reserves in the third pillar of the pension system. The largest NPF (Gazfond), measured by the amount of pension reserves, led the next largest by a factor of approximately five. All five leading NPFs belong to the corporate type.

The market's geographical structure is also characterised by a high degree of concentration, as is typical of the Russian financial market. Almost half of all the funds which had submitted reports as of the end of 2003 to the Inspection for NPFs were registered in Moscow. The Moscow funds account for more than 80 per cent of the total value of pension reserves. Even excluding Gazfond from the sample, the picture will not be remarkably different – the share of funds situated in the capital will remain very high (more than 70 per cent). However, the branch network of NPFs is not particularly wide. If we exclude the Sberbank NPF, which can promote its products via the parent company's branch network, then the leaders will be the NPFs Elektroenergetika (19 branches) and Blagosostoianiie (18 branches).

Figure 3.2. Pension reserves of NPFs



1 – Pension savings as of end of year in billion USD (left axis)
2 - Pension reserves as percentage of GDP (right axis)
Source: Calculations based on the inspection for NPF data and Kokorev, R.A., and Trukhachiov, S.A. *Regulirivaniie negosudarsvnnykh pensionnykh fondov: sopostavleniie rossiiskoi praktiki i mirovogo opyta* (Regulation of Non-State Pension Funds: A Comparison Between the Russian Practice and International Experience) – Informatsionno-analyticheskii bulleten' BEA (Informational and analytical bulletin of BEA), No. 50. December 2003.

The NPF Blagosostoianiie has been the absolute leader in number of participants[8] (1.4 million, or more than 25 per cent of total NPF participants, as of mid-2004). The second-largest fund (in number of participants) has 5 per cent of the total. On average, each NPF services more than 20,000 participants (or 15 000 if the leader is excluded).

To estimate the real role of non-state pension funds in the financial markets, one must take into account not only the value of the pension reserves that they manage, but the fact that a considerable proportion of the resources at their disposal are not pension reserves but property intended for the provision of charter activity (PPCA). The closest analogue of this category is capital. These resources are received by the funds from their founders (sponsors). However, by law the founders have no ownership right in respect to these resources – that right belongs to the NPFs.[9]

On average, the PPCA constitutes 25 per cent of NPFs' passive investments, and if Gazfond is excluded, 36 per cent. The law requires that these resources be invested separately from pension reserves, and they are not subject to the limits imposed on investment of pension reserves.

NPFs' costs

Due to their small size, most NPFs do not have low administrative costs. Statistics on this issue are sparse; nevertheless, it may be presumed that the costs of the charter activity in the system of voluntary pension provision constitute about 2.5-3 per cent of the amount of pension reserves. Some light on the efficiency of NPFs' activity is cast in a study by Kokorev R.A. and Trukhachiov S.A.[10] As their data show (Table 3.1), the relevant expenses of NPFs, as a percentage of contributions, have varied between 9.4 per cent in 2001 and 12.1 per cent in 1999.

Table 3.1. NPFs' administrative costs

Year	Costs of charter activity	
	As % of collected pension contributions	Per participant (roubles)
1999	12.1	96.68
2000	9.5	116.67
2001	9.4	158.49
2002	10.9	284.8
2003	10.4	432

Source: *Informatsionno-analyticheskij bulleten' BEA* (Informational and analytical bulletin of BEA), No. 50. December 2003; and calculations based on data from the Inspection for Non-State Pension Funds.

It is evident that the growth of contributions and pension reserves of NPFs has not been accompanied by a relative lowering of administration costs; they are growing noticeably per participant. Kokorev R.A. and Trukhachiov S.A. (2003) name three groups of factors among the reasons for this situation. First, some cost components have grown objectively: personnel salaries, rental payments, auditors' and actuaries' services, participation in various conferences and workshops, etc. Second, as NPFs develop, some costs can become explicit after being latent for some time: for example, a sponsor who previously allowed "his own" NPF to occupy its premises free of charge may decide to make the NPF pay rent. Finally, in the event of inadequate control on the part of sponsors, the managers of some funds can resort to artificially inflating their costs to create more comfortable conditions for their work or to "pumping" some of the fund's resources for their own benefit (including to companies under their control). This is facilitated by an NPF's status as a non-commercial organisation.

Finally, when discussing the efficiency of NPF activities, it should be noted that total administrative costs are somewhat higher than the costs of charter activities, because some expenses are categorised as "other costs". These costs, according to data cited in Kokorev R.A., Trukhachiov S.A. (2003), varied from 12.6 to 26.6 per cent of NPFs' total administrative costs in the period from 1999 to mid-2003; as a percentage of the amount of pension reserves they were, accordingly, from 0.4 to 1.1 per cent. Thus, total NPF administrative costs as a percentage of pension reserves varied between 2.9 and 4.1 per cent. The data vary from fund to fund, with large size not necessarily providing economies of scale. When the largest fund is excluded, the average value of the ratio declines to 6.5 per cent for 2003.

NPFs' marketing strategy is oriented mostly at attracting (signing up) contributors that are legal entities. Indirectly confirming the higher efficacy of this strategy, as compared to an individual-oriented approach, has been the organisation of promotion and marketing campaigns when NPFs were included in the second pillar. Though the results concerning the choices made by insured persons in 2004 in favour of particular NPFs have yet to be announced, preliminary data show that NPFs have managed to attract a number of citizens comparable to the number attracted in 2003 by private asset managers, and at incomparably lower cost of promotion by mass media.[11]

3.3. Investment regulation

NPFs may invest assets of the voluntary pension pillar directly or by using management companies' services. Neither insurance companies nor banks may perform investment management functions for NPFs. Only those types of assets which NPFs may invest directly are restricted by law. The restrictions are set in

greater detail by the Government and the Inspection of Non-State Pension Funds. For in-house investments of NPFs, a list of permitted assets[12] for investing is established. Management companies will be better guided by types of assets and operations, which are considered as inadmissible by the supervising authority. In particular, pension reserves cannot be used for providing loans (credits), acquiring derivatives, or forward and futures transactions. The Inspection of Non-State Pension Funds also issued requirements for the allocation pension reserves. Under current rules, the maximum share in the investment portfolio is set at 50 per cent for the following types of assets: federal government securities, subfederal and municipal securities, stocks and bonds of enterprises, bank deposits and real estate. Securities issued by NPF sponsors and depositors must not exceed 30 per cent (see Annex 6).

However, the actual amount of investments made by certain funds may exceed these limits, because the regulator practiced the so-called special procedure (individual rules) for investment, granting the largest NPFs exceptions to set limits. According to available data, the deviations could be substantial. Thus, in 2002 the percentage of investments in shares exceeded 50 per cent in five funds, including some market leaders (Gazfond, Surgutneftegaz).[13] In such instances, a large part of the fund's investment portfolios was often constituted by the founders' stocks. By late 2003, the situation had changed somewhat: investments in shares exceeded 50 per cent in two funds, and 40 per cent in nine funds.[14] On average, investments in shares amounted to 43 per cent (average weighted index); with the exclusion of Gazfond, this index declined to 10 per cent and approximated the average percentage of corporate debentures -- 11.6 per cent.

This type of assets constituted one-half and more of the portfolios held by nine funds, but these were mainly small and medium-size NPFs, whose indices did not produce any distorting effect on the overall picture. To some extent, corporate debentures were present in the portfolios of more than one-half of the funds which had submitted appropriate data to the Inspection for NPFs as of the end of 2003. However, this instrument in itself is characterised in Russia by certain peculiarities that make it closer to short-term securities. The majority of companies have so far been issuing bonds with short maturities, including debentures with maturities of less than one year.

Another risky form of investment policy pursued by several funds is to concentrate their assets in bills. In 2002, investment in bills exceeded 50 per cent of total investments in 10 funds. The situation had changed little by late 2003: Investment in bills constituted half or more of the portfolios of 11 funds, whereas the average percentage of bills in NPFs' portfolios was 17.6 per cent. About

30 funds did not disclose the structure of their pension reserves, since more than one-third of their portfolios was specified as “other areas of investment”. In most cases, a high share of unspecified “other investments” is associated with having a special procedure of investment.

Real estate has remained a rather unpopular instrument. As of the end of 2003, direct investments in real estate had been made by just over 30 funds, the average share being 0.6 per cent (down from 3.3 per cent at the end of 1996).

Units of unit investment funds (UIFs) also belong to the category of assets allowed for investment, but their percentage was 0.2, and fewer than 40 funds actually had investments in UIF units.

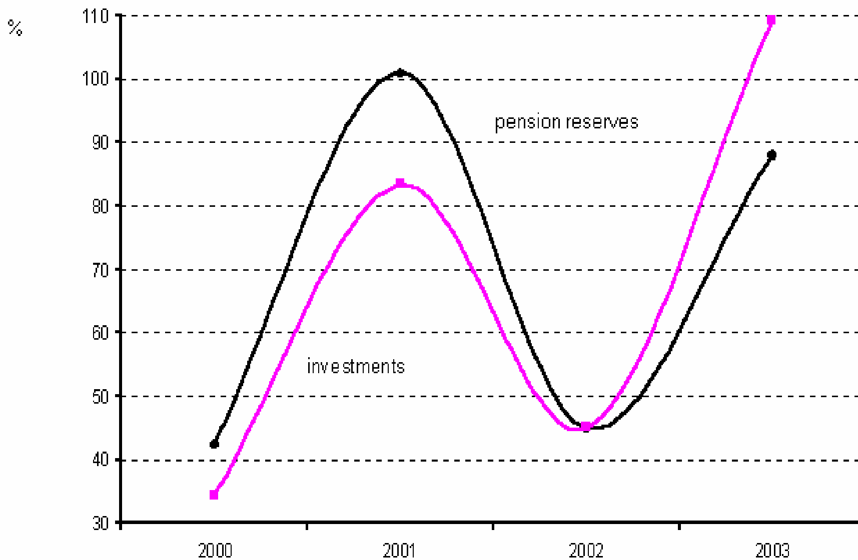
The small scale of investments in UIF units, the NPFs being relatively small, can be explained by several reasons. The funds cannot buy these stakes on their own – they need the services of asset managers. The asset managers, in turn, cannot legally offer their own funds to NPFs but are obliged to buy UIF units managed by other asset managers. This is not a very attractive proposition, partly due to the high costs associated with this scheme of investing. Besides, investing in UIF units does not, for NPFs and other institutional investors, have the advantages offered by investment funds intended for institutional investors in other countries; in Russia, investment funds have yet to be subdivided into retail funds and those serving institutional investors.

When interpreting the data on the structure of NPFs’ investments, it should be remembered that the funds on their own disclose only data on the structure of investments made at the expense of pension reserves. As noted, restrictions on investing involve only the investment of pension reserves and pension savings, whereas a considerable portion of the resources of some funds is represented by property intended to provide for their charter activity.

Investing in foreign assets is not forbidden but is made difficult by the regulation regime for capital operations.

Asset managers are not restricted by legislation as regards charges related to the investment of NPFs’ pension resources, but the source of these expenditures, as a rule,[15] is the investment returns. This principle results in a situation where investment managers are oriented primarily to a short-term rate of return of securities; and NPFs tend to stipulate, in their discretionary management agreements, the minimum guaranteed rate of returns to be ensured by the investment manager, another factor contributing to the asset managers forming more conservative portfolios for NPFs.

Figure 3.3. Growth of pension reserves and investments of NPFs (as calculated in USD)

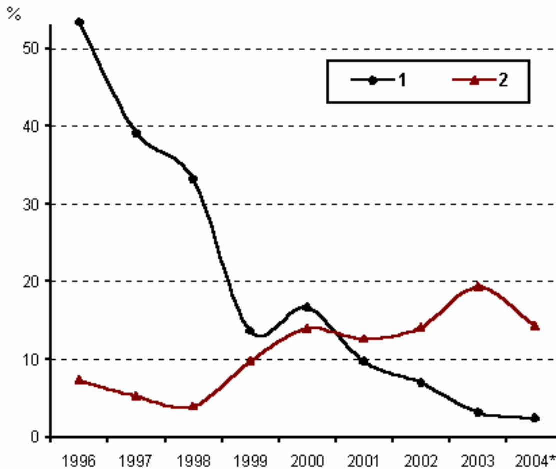


Source: Calculations based on data from the Inspection for NPFs

The growth of the investments of NPFs has been occurring at a very high rate in recent years, but last year this rate became considerably higher that that of the growth of pension reserves (Figure 3.3).

By mid-2004, investments in equities constituted 44 per cent of aggregate investment portfolio, government bonds (of the federal government and subfederal ones) constituted 10 per cent; deposits in banks, 14 per cent; corporate debentures, 11 per cent; promissory notes, 13 per cent; real estate, 0.5 per cent; and other, 7 per cent. This investment structure differs significantly from the investments of pension savings in the mandatory funded pillar. In particular, one notices the low percentage of investment in federal government bonds -- a strategy associated partly with the problems encountered by NPFs because of the 1998 default and financial crisis. At the end of 1997, the share of federal government bonds in investments of NPFs stood at 39 per cent. As Figure 3.4 demonstrates, this ratio fell to 3 per cent by the end of 2003, and it declined further in the first half of 2004. The main cause of the trend is the negative real returns of these securities.

Figure 3.4. Share of federal government bonds and of deposits with banks in the aggregate investment portfolio of NPFs.



* As of the end of June 2004
1 – Share of federal government bonds
2 - Share of deposits with banks
Source: Inspection for Non-State Pension Funds.
Kokorev R.A., Trukhachiov S.A. *Regulirivaniie negosudarsvnnykh pensionnykh fondov: sopostavleniie rossiiskoi praktiki i mirovogo opyta* (Regulation of Non-State Pension Funds: A Comparison Between the Russian Practice and International Experience) – *Informatsionno-analyticheskii bulleten' BEA* (Informational and analytical bulletin of BEA), No. 50. December 2003.
Pensionnye fondy i investitsii (Pension funds and investments), No. 1. 2004.

Gazfond was the leader in invested resources; but the gap in this index over second place is considerably narrower than that in the pension reserves index: the market leader's share was 40.6 per cent, that of the second-place fund was 18 per cent, while the aggregate share of the five largest funds by investment amounts was 72.3 per cent. All five leading NPFs belong to the "corporate" category; the concentration level by the investment amount index is near the concentration level by the pension reserves index.

A characteristic feature of recent years has been the rising share of deposits with banks; this was interrupted only by the bank liquidity crunch in mid-2004. Due to inconsistencies in historical data, the share of stocks cannot be traced as far as that for government bonds or bank deposits. In recent years, the ratio was 40 to 44 per cent, but the way it is calculated has misleading peculiarities (see the section "Investment regulation"). Fixed income non-government securities in the investment portfolios of NPFs are represented by debentures and promissory notes.

Managing the assets of collective investors, under Russian legislation, must be an exclusive activity. The assets of unit investment funds, stockholder investment funds, NPFs, second-pillar pension savings and insurance-company assets may be managed only by specially created companies called management companies in the capital of which the state cannot be a participant. There exist more than 100 such companies, including an especially high number registered in 2002 and 2003 (after the enactment of the law "On the Investment of Funds for Financing the Funded Part of Labour Pension in the Russian Federation" and the amendments to the law "On Non-State Pension Funds").

Insurance companies may invest assets on their own, but cannot manage NPFs' pension reserves or second-pillar pension savings.

Banks do play a limited role in the market for managing the assets of collective investors, offering a product called General Funds of Banking Management (GFBM), but this segment has not developed significantly.

The leader in the market for investing NPFs' pension reserves is the asset management company Leader, which services the largest NPF, Gazfond (Table 3.2).

Table 3.2. Asset managers –largest NPFs by assets under management

Place	Asset manager	City	Amount of net NPF assets managed, mln roubles as of 30 June 2004	Number of NPFs
1	Leader	Moscow	43 691	3
2	Asset management company Kapital	Moscow	25 748	26
3	Asset management company Troika-Dialog	Moscow	12 768	40
4	PioGlobal Asset Management	Moscow	4 057	11
5	The Uralsib group of asset management companies	Moscow	3 735	10
6	Asset management company RN-Trust	Moscow	3 395	2
7	Asset management company Aton-Management	Moscow	3 368	35
8	Promyshlennye traditsii	Moscow	3 099	4
9	RTK-Invest	Moscow	2 318	1
10	Asset management company Alfa-Kapital	Moscow	2 287	12

Source: Rating Agency of NAUFOR

NOTES

1 The statistical data concerning pension insurance provided by insurance companies is incomplete and irregular; however, even the available data allow the conclusion that insurance companies have little interest in this type of insurance. In 2003, the All-Russian Union of Insurers conducted a poll among insurance companies. Respondents represented 174 companies responsible for about 40 per cent of total premiums collected. Among these, only about 20 companies were promoting pension products, while pension contributions amounted to less than 1 per cent of the total premiums collected by the insurance companies participating in the poll – see Tsyganov, A.A., *Rossiiskii strakhovoi rynok za pervye deviat' mesiatsev 2003 goda* (The Russian insurance market during the first nine months of 2003), www.ins-union.ru.

2 Kokorev, R.A., Trukhachiov S.A. (2003), *"Regulirivaniie negosudarsvnnykh pensionnykh fondov: sopostavleniie rossiiskoi praktiki i mirovogo opyta"* (Regulation of Non-State Pension Funds: A Comparison Between the Russian Practice and International Experience), *Informatsionno-analyticheskii bulleten*, BEA (Informational and analytical bulletin of BEA), No. 50, December 2003.

3 Vittas, D. and R. Michelitsch (1995), "*Pension Funds in Central Europe and Russia: Their Prospects and Potential Role in Corporate Governance"*, The World Bank Financial Sector Development Department, May 1995, Policy Research Working Paper 1459, The World Bank, Washington, D.C.

4 Kokorev, R.A., Trukhachiov S.A. (2003), "Regulirivaniie negosudarsvnnykh pensionnykh fondov: sopostavleniie rossiiskoi praktiki i mirovogo opyta" (Regulation of Non-State Pension Funds: A Comparison Between the Russian Practice and International Experience), *Informatsionno-analyticheskii bulleten' BEA* (Informational and analytical bulletin of BEA), No. 50, December 2003.

5 The latest changes were introduced at the end of 2004 and are not considered in the text below.

6 Malakhova, L. V. (2004), *Voprosy nalogooblozheniia v sisteme negosudarstvennogo pensionnogo obespecheniia* (Issues of Taxation in the Sphere of Non-State Pension Provision), www.npfimperia.ru, Pistsov, G. (2004)

"Ischisleniie nalogov po vznosam v negosudarsvnnyi pensionnyi fond" (Computing Taxes on Contributions to a Non-State Pension Fund), *Finansovaiia gazeta* (Financial Newspaper), 24 September 2004; Rudenkova, N. (2003), "S pensiei po zhizni" (With a Pension Through Life), *Raschiot*, September 2003.

7 USD3.4 billion as of the end of June 2004.

8 The NPF's main contributor is "Russian railways".

9 The same is true for pension reserves. In accordance with legislation, they constitute an NPF's own property.

10 Kokorev R.A., Trukhachiov S.A. (2003), "Regulirivaniie negosudarsvnnykh pensionnykh fondov: sopostavleniie rossiiskoi praktiki i mirovogo opyta" (Regulation of Non-State Pension Funds: A Comparison Between the Russian Practice and International Experience),, *Informatsionno-analyticheskii bulleten'* BEA (Informational and analytical bulletin of BEA), No. 50.,December 2003.

11 Among private asset managers, in 2003 those oriented toward signing up via employers or using the administrative resources of regional authorities became more successful in terms of attracting participants of the second pillar of the pension system.

12 NPFs may invest pension reserves in-house in federal government securities, government securities of subjects of the Russian Federation, municipal securities, bank deposits and real estate. Requirements for the qualification of NPF investment staff for such an activity are not settled.

13 *Kommersant-Den'gi* (Commersant - Money), 13 May 2003.

14 *Pensionnye fondy i investitsii* (Pension funds and investments) (2004), No. 1.

15 The expenses of NPFs on payments for services relating to investing pension reserves are subject to no special regulation; however, there exists one general restriction: deductions made by an NPF to form the property designed to provide for a fund's charter activity and to cover the costs of providing for its charter activity must not exceed the total of 15 per cent of the income received from the investing of pension reserves and 15 per cent of the income received from investing pension savings, after deducting fees of the asset managers and the specialised depositary, plus tax payments. NPFs, with the consent of contributors, have the right to use up to 3 per cent of the amount of contributions for these purposes.

Chapter 4

ORGANISATION OF SUPERVISION IN THE FUNDED COMPONENTS OF THE PENSION SYSTEM

A characteristic feature of the way supervision was organised in the pension system's funded components (mandatory and voluntary) was the division of responsibilities between several government bodies. The principal reason for that is the nature of the funded pension system itself, which is an element of a social security system but relies on financial markets where pension funds become major institutional players.

Russian legislation treats non-state pension funds as a special institutional legal form of a non-profit social security organisation. The supervisory authority, the Inspection of Non-State Pension Funds, was organised originally under the Ministry of Social Protection (later, the Ministry of Labour and Social Development). At the same time, management companies and specialised depositaries – entities directly involved in the process of investment of NPFs' funds -- were supervised by the Federal Commission on Securities Markets (FCSM), which was reorganised in 2004 into the Federal Service for Financial Markets (FSFM). In the course of an administrative reform in 2004, the supervision of NPFs was transferred to a subdivision of FSFM.

The transfer of the supervisory functions over NPFs to the FSFM should help improve the supervision of NPF activities, because, unlike the Inspection for NPFs, FSFM has a network of regional subdivisions. However, the efficiency of supervisory oversight will remain limited, because only a limited range of sanctions can be imposed in the event of violations. The license of an NPF could not be withdrawn by decision of the supervisory authority-- from 2001, this can be done only by a court decision, and the courts are rarely willing to recall licenses. In any case, suspension of a license does not present a serious impediment to a fund's activities. The fund in such a position is forbidden only to conclude new pension agreements, while it is obliged to fulfil its obligations under old agreements. Thus, its activities continue, only within certain limits.

The system of government regulation, control and supervision for the mandatory funded part of the pension system has been designed so as to allow the government to define which governmental body would accomplish the supervisory and regulatory functions after adoption of the framework laws. These functions ultimately were entrusted to the Ministry of Finance. However, some functions concerning the investment regulation are performed by the FSFM.

In particular, when the legislative framework is adopted the authorised federal body shall cover the following:

- Control compliance of subjects involved in forming and investing pension accumulations (i.e. the PFR, management companies, specialised depositaries) with Russian Federation legislation on formation and investment of pension accumulations;

- Adopt statutory legal acts on regulation, control and supervision of formation and investment of pension accumulations;

- Organise tenders to select specialised depositary and management companies;

- Review PFR reports on collecting insurance contributions and allocation of pension accumulations for investment, on resources recorded in the special part of individual personal accounts of insured persons and payments made out of pension accumulations, and on the results of investing pension accumulations;

- Review auditor's conclusions on reports of management companies and specialised depositary;

- Establish, within the limits of its authority and in consultation with the federal body of the executive government having authority to regulate activities of the relevant subjects of relations and the supervision and control thereof, the procedure, formats and due dates for reports of those involved in forming and investing pension accumulations;

- Publish annually in the media reports on pension accumulations and the financial results of their investment, and auditors' conclusions on reports of those involved in forming and investing pension accumulations;

- Bring to court actions concerning the rights and lawful interests of the owner of pension accumulations (i.e. the Russian Federation), eliminate the results of law violations and provide compensation for damages caused by those violations by subjects involved in forming and investing pension accumulations reserves.

It has taken some time to delimit powers between the authorised federal body, whose functions were performed by the Section for the Pension Reform created within the structure of the Ministry of Finance, and the FSCM. However, in the preparatory phase before funds were actually transferred to asset management companies in the spring of 2004, this produced no significant negative impact on the course of reform. Far greater problems emerged in dealing with the selection of asset managers and the specialised depositary, and in informing and instructing participants in the new system. The development of the normative base was greatly delayed.

The specific feature of the law “On the Investment of Funds for Financing the Funded Part of the Labour Pension in the Russian Federation”, which established the overall framework for investing second-pillar pension savings, was the great number of references to the acts to be adopted by the Government. This approach partially counterbalances the negative impact of the multi-agency organisation of performing regulatory and supervisory functions in this pillar of the pension system, since several ministries and agencies participated in developing the normative acts (the Ministry of Finance, the Ministry of Labour, the Ministry of Economic Development and Trade, the FSCM, and the PFR); thus, the necessary coordination has been achieved, at least in the approaches to resolving these problems. However, reaching agreement was not easy. Coordinating different standpoints was time-consuming, and the inevitable compromises sometimes affected the quality of documents adopted, while some necessary acts had not yet been passed by the time resources were transferred to management companies.

Public monitoring over accumulation and investment of pension funds is performed by the Public Council on Investment of Pension accumulations. The Public Council shall be formed on an equal footing of representatives of all-Russian trade union associations and all-Russian employer associations. At present, it is headed by the employers’ representative.

It is too early to assess the effectiveness of the chosen multi-agency configuration for regulating and supervising the funded components of the pension system. In the process of carrying out the administrative reform in 2004, various functions of government control over the second and third pillars of the pension system have been shifted to the newly created Federal Service for Financial Markets (FSFM).

The reorganisation process is yet to be completed. For now, matters of state oversight and supervision over the mandatory and voluntary funded pillars of the pension system are concentrated in the FSFM, the Inspection for Non-State Pension Funds having been closed. Regulatory matters are divided between two ministries – the Ministry of Finance for the second pillar and the Ministry for Health Care and Social Development for the third pillar of the pension system. The new status of the PFR is still under debate. A new approach based on segregating the regulatory and supervisory functions is yet to be elaborated in order to avoid both overlaps and gaps in the activities of those government bodies responsible for the functioning of the pension system, and especially its funded part.

Chapter 5

CONCLUSIONS AND POLICY RECOMMENDATIONS

5.1. Conclusions

New design of the pension system

Governmental reform efforts undertaken since 2001 resulted in a new design for the Russian pension system. Its mandatory component, called the labour pension, which covers all public and private sector employees, now consists of pay-as-you-go and funded elements.

Pay-as-you-go element

- The PAYG element comprises a redistributive or a basic part (a flat pension benefit) and a so-called insurance part, based on notional defined contributions;

Funded element

- The funded DC element, payouts of which will complement PAYG benefits for participating employees and a parallel system of occupational (professional) pensions, which were introduced to solve the problem of pension maintenance for persons eligible for early retirement.

The reform design placed particular emphasis on the introduction of a principle under which the future pension would depend on contributions made for the employee during his or her work life; that is, the size of pension benefits would depend on the amount of funds transferred to the PFR in the person's name by his or her employer. Another new principle is the consideration of life expectancy in calculating the size of the insurance and funded parts of the labour pension.

The investment of pension accumulations is organised so as to give participants a right to choose an investment strategy by choosing investment managers. Existing non-state pension funds were incorporated in the newly introduced component and

received a right to sign agreements with employees participating in the mandatory funded part of the pension system.

Total amount of pension assets under mandatory funded pension scheme reached Rb136 billion (USD4.7 billion) by the end of the third quarter of 2004[1].

Voluntary funded pillar

Voluntary retirement provision is available both to corporations and to individuals since 1991 and currently covers about 8 per cent of the workforce. Non-state pension funds are the main providers of these services. The total value of the pension reserves of non-state pension funds operating under the voluntary scheme has grown rapidly, amounting to Rb98 billion (USD 3.4 billion) by the end of July 2004, representing less than 1 per cent of GDP. Corporate pension plans dominate the market, and the leader's market share remains at 50 per cent. The legislative framework for the functioning of voluntary pension plans was essentially formed by the end of the 1990s, before the ongoing reform of the mandatory pension system began.

Problems and challenges

Despite the reforms already implemented, the pension system is still not completely free of certain functions and principles incongruous to it, the legacy of the planned economy. In assessing the sustainability of the system's current design, this should be regarded as a substantial risk factor. Reforming the Russian pension system is part of a more extensive complex of reforms aimed at transforming the social sphere in accordance with the principles of contemporary market economics.

The incomes of the majority of pensioners are very low (the average monthly pension in August 2004 was Rb2,020 per month (USD70), which exceeds by only a few percentage points a pensioner's official subsistence level). This situation, on the one hand, reduces options for choosing more radical ways to solve the problems of pension provision, even if in the long term those approaches promise better results than those variants being implemented. On the other hand, it makes society especially sensitive to any changes in this sphere,[2] while the decisions being taken and measures being implemented are clearly subject to political influences.

The demographic situation also poses an uneasy dilemma for the Government. There is, on the one hand, an objective necessity to increase the established retirement age as a means to decrease the dependency ratio. This task would seem to be made easier by the fact that the retirement age in Russia is lower than that in

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many other countries (60 years for men, 55 for women). On the other hand, the average life expectancy for Russian men at birth is lower than the retirement age.[3]

The reform programs do not fully take into consideration opportunities offered by private business. The programs effectively reflect the lack of trust in non-state economic forms, and as a result, the orientation toward the state-based forms of social security. The state takes it upon itself not only to provide basic pension benefits, but also other types of pension -- not only for those employed in the state sector, but for all employed citizens.

The pension-reform programs did not envisage any serious steps to create forms of mandatory pension provision similar to the mandatory occupational pension plans implemented in many other countries and based on employer-sponsored pension plans. Purely private sector forms of pension provision are limited to the voluntary pension pillar. The participation of private sector structures in the pension system's mandatory pillar is limited to performing certain functions (investing a part of pension savings, keeping savings records, and in future, possibly, paying pensions to those insured persons who have chosen NPFs). The collection of contributions, their administration, payment of benefits and, to a large extent, investing remain the state's prerogative.

The institutional structure of the pension-provision agencies is not yet well established, and has room for further improvement of efficiency. As noted, by the beginning of this decade, the collection of contributions to fund the payment of pensions had been organisationally separated from the process of granting, recalculating and paying benefits to pensioners. The task of collecting the contributions was delegated to the PFR, and that of organising payments to the agencies for social provision under the Ministry for Labour and Social Security. In view of certain Soviet-era principles of budget formation that were partially inherited by the pension system, such a breakdown of functions did not improve the system's financial stability or contribute to tying up expenses and revenues in the short-, medium- or long-term. The uniting of both aspects of the process -- the accumulation of contributions and the organisation of payments – may be regarded as an important step toward improving the pension system's efficiency. But another range of administrative problems has emerged. These are associated with the transfer of the task of contributions collection to the tax authorities, which necessitated the build-up of a system for interaction between the PFR and the Ministry for Taxes and Levies,[4] both at the level of the central apparatus and at the local level.

The implementation of the funded principles of organising the pension system is associated closely with the development of the capital markets. In organising the

mandatory, funded pension system in Russia, decision-makers assumed that it should not be postponed until such time as the capital market in Russia had become well-developed. The presence of a long-term investor should substantially increase the capacity and stability of the Russian market and, consequently, its attractiveness to private domestic and foreign capital, contributing in turn to the market's expansion.

An additional social and economic benefit would arise when the relatively high incomes earned as the markets developed would be accumulated not only by big Russian and foreign investors but by employees who had become participants in the funded system.

At the same time, ideologists behind the reform were aware that the funded pension system itself is connected closely with existing capital markets and that its success would depend largely on the organisation, regulation and behaviour of the latter. Therefore, it is extremely important that the transition to a funded pension system be carried out in coordination with financial-sector reforms. To realise such an approach, the legislative base, and above all the law "On the Investment of Funds for Financing the Funded Part of Labour Pension in the Russian Federation", along with the package of normative acts necessary for its implementation, include several principles and what purported to be technical norms consolidating best foreign practices in organising the investment of collective investors' resources and controlling the aforementioned process. These norms are more demanding than those applied to investment participants in Russia; nevertheless, the realisation of this approach featured some inconsistencies.

As mentioned in regards to the institutional aspect, the mandatory, funded pillar of the pension system has been focused largely on state structures while the investment of accumulations has been substantially limited to government securities. At the same time, the number of asset managers that signed agreements with the PFR turned out to be much higher than would have been reasonable, based on the minimum efficient amount of resources in discretional management required to create and professionally manage a diversified portfolio. Thus, the volume of funds represented by the pension accumulations managed by companies entering this market proved too small to produce a considerable impact on the stock market.

At the same time, a number of restrictions, dealing primarily with the repayment of investment costs and premiums, were introduced. This was done in the anticipation that asset managers would have at their disposal funds that, by Russian standards, would be considerable in real terms, and that they would be able to conduct transactions on terms more favourable than the tariffs then existing on the Russian market for collective investors.

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The focus on investing in government securities would inevitably have a negative effect on the rate of accumulation growth, as compared to forecasts (investment return at the level of 7 per cent). It also reduces the potential for a favourable influence to be exercised by pension reform on the Russian financial market. The reason for this is not the fact that the PFR, as an investor of pension accumulations, almost immediately became a leader in the market for government bonds, alongside the Savings Bank. The ratio of the amount of funds that could be invested in federal securities to the volume of these securities circulating in Russia is no higher than that, for example, in Great Britain. The major problem is the way this process is carried out. Unfortunately, the methods being applied do not suggest that pension accumulations have positively influenced the liquidity of the rouble segment of this market or improved the competitive environment.

Another knot of problems emerged during the initial stage of implementation of the reforms. Those asset managers who, as a result of "voting" by the system's participants, were left with insignificant resources under management, could not voluntarily exit this market. The PFR does not consider the impossibility of organising a diversified portfolio or a failure to generate positive investment returns for insured persons as sufficient cause to terminate the contract with the asset management company.

The funded pillar of the pension system also faces other challenges: the financial stability in the benefit payout stage; the quality of the long-term economic forecasts that underpin pension system reform; and the need to consider potential conflicts of interest and duties among institutions involved in the development and implementation of the pension system.

The funded pension system is financed by an apportionment of contributions originally earmarked to be paid as pensions to present-day pensioners, a part of the PAYG system. This loss of revenue by the PAYG system has not been compensated. This approach was based on the expectation that payroll growth would create the basis for growth of the unified social tax, and that it would be possible to use a fiscal window of opportunity during which the behaviour of the dependency ratio would be favourable. But this approach, while attractive from the tax burden viewpoint, had drawbacks. It made it impossible to set the rate of contributions to the funded pillar of the pension system at a level that could guarantee a significant increase in the aggregate amount of pension benefits for those who were joining the new system. The reform itself has been criticised as infringing on the rights of present-day pensioners. Bearing in mind the existing rather low level of pensions, this criticism cannot but strike a chord in society.

The reform has not become more popular with the introduction of another new measure, when one-third of participants were excluded from the mandatory funded pillar of the pension system. The stated reason for this step is the inadequacy of the funds that persons of senior and middle employable age would be capable of saving by retirement age. Bearing in mind the level of contributions to the system set for these age categories, this is certainly true. But it was equally clear at the time when the parameters of the reform were being approved. And it should be remembered that even for those who remain in the system and will receive the funded part of labour pension from 2022 onward, savings may be as small as USD10,000.

The rather small influence that the funded part of the labour pension is expected to exert on the total income of future pensioners, could be one reason for the low interest demonstrated by the population at the initial stage of the reform. But other factors were probably more important: organisational shortcomings in informing participants, difficulties in realising the right to choose asset managers (or NPFs) for employees; and, as well-established from American and Swedish practice,[5] the relative disinclination of pension-plan participants to make decisions concerning any changes in the strategy of investment of pension savings.

Taxation issues pertaining to the second pillar of the pension system are being solved, though with some delay when compared to other issues because of specific features of the organisation of the legislative process. The laws forming the normative basis for the introduction of this component of the pension system do not regulate the aspects of taxation that should be specified in the tax code.

Contributions to the system are exempt from taxation. As regards the payouts, the issue can rather confidently be said to have been solved in respect to benefits to be paid out as the funded part of the labour pension for those persons remaining in the PFR. State pensions are not subject to taxation. But this provision does not extend to payment of the same funded part of the labour pension by NPFs, because they are not state-owned entities and cannot pay state pensions.

It is more difficult to say which model will be authorised in respect to taxation during the investment phase. The Ministry of Finance has not finalised its position, but an understanding has emerged that investment returns must be subject to a single regime of taxation, irrespective of the place where funds accumulate, be it an NPF or the PFR.

Apart from aspects of taxation, the most urgent task to be solved in reforming the Russian pension system has become the development of efficient voluntary pension arrangements, especially for the older workers (born before 1967) excluded from the mandatory funded system. In this respect, the Ministry for Health Care and

Social Development has proposed to introduce additional voluntary contributions to the funded part of the labour pension for this group of workers up to 4 per cent of wages.

It is suggested that such voluntary contributions be stimulated by a certain increase in the insurance part of the labour pension, at the expense of the state budget. The estimated pension capital of an insured person will be increased, using money from the federal budget, in the amount of one-half of the additional insurance contributions paid during the corresponding year. The new reform proposals will also stipulate some measures encouraging people to access their pension benefits after the official retirement age. However, at this point in time it is too early to predict when and by which modality these proposals will be put into effect.

5.2. Policy recommendations

There is a widespread view among Russian officials and policymakers that pension reform is practically completed. All that remains are some already prepared draft laws to be passed by parliament. Yet, the experience of other countries shows that reforming pensions often turns into an ongoing process. This will be even more so for Russia, where reforms in the social sphere as a whole are far from complete, and a number of problems will influence the pension system and its development trends.

Among the basic challenges facing the pension system that will confront policymakers are the following:

- Incompleteness of the reforms undertaken in social spheres;
- The low income levels of most pensioners;
- The high degree of politicisation of issues relating to the principles, organisation and levels of pension provision;
- The inadequate development of private sector forms of pension provision;
- Demographic ageing;
- Gaps in statistical data bases, which weaken the quality of forecasts and actuarial assumptions;
- Medium- and long-term macroeconomic uncertainty conditioned by the sectoral structure of the economy and a high dependence on the export of energy carriers;

- Differing rates of implementing reforms in the economic and social spheres;
- A weak relationship between the rates of social taxes and benefits levels, and resulting problems associated with the medium- and long-term financial stability of the pension system;
- Inadequate development of the financial markets, with regulatory and supervisory problems;
- Institutional challenges; unsettled issues of taxation, especially concerning payroll taxes and taxation of voluntary pension schemes;
- Widespread opposition to pension reforms among retirees;
- And confusion and growing disappointment with the implementation of the mandatory funded component of the pension system among its participants.

The following policy recommendations could be suggested:

- New reform initiatives in the social sphere should be better coordinated.
- Long-term priorities in the social sphere, and especially pensions, should be defined clearly to avoid situations where decisions, once made and implemented, are revised in a short time for reasons not always obvious to the public, and where elements built are often dismantled in order to find solutions for other problems in the social sphere.
- The link between the rates of social taxes and benefits levels should be strengthened and used to manage the financial adequacy of the pension system.
- The pension system and its institutions should be steadily liberated from exercising additional functions.
- Pension-reform initiatives should incorporate steps toward creating forms of mandatory pension provision similar to the mandatory occupational pension plans implemented in many other countries and based on employer-sponsored pension plans.
- Voluntary pension schemes should receive much more attention from policymakers, and be subject to strengthened regulation and supervision.

- To positively influence the implementation of the funded component of the pension system of the financial markets, their regulation and supervision should be enhanced.
- In order to use the potential of financial markets, efforts to diversify investments should be undertaken.
- The market structure and behaviour of non-state pension funds and asset managers should be closely monitored with a view to improving competition and efficiency and to avoid conflicts of interest problems.

NOTES

1 The figure includes aggregate assets accumulated by the PFR and asset management companies.

2 A 2004 survey requested by the PFR found that only 51 per cent of respondents agreed that any pension-system reforms were necessary. Retirees dominated among those opposing reforms.

3 Life expectancy at birth was estimated by Rosstat in 2002 as 58.9 years for men and 72.6 for women. In 2001, residual life expectancy for men aged 60 was estimated at 13.22 years, and for women, 22.48 years.

4 The Federal Tax Service (FTS), within the structure of the Ministry of Finance after the reorganisation in 2004.

5 Benartzi, S. and R.H. Thaler (2001), "Naive Diversification Strategies in Defined Contribution Saving Plans", *The American Economic Review*, March 2001. Elsmark, C and P. Almond (2003), "When More Choice Is Too Much", *Investment Pension Europe*, December 2003.

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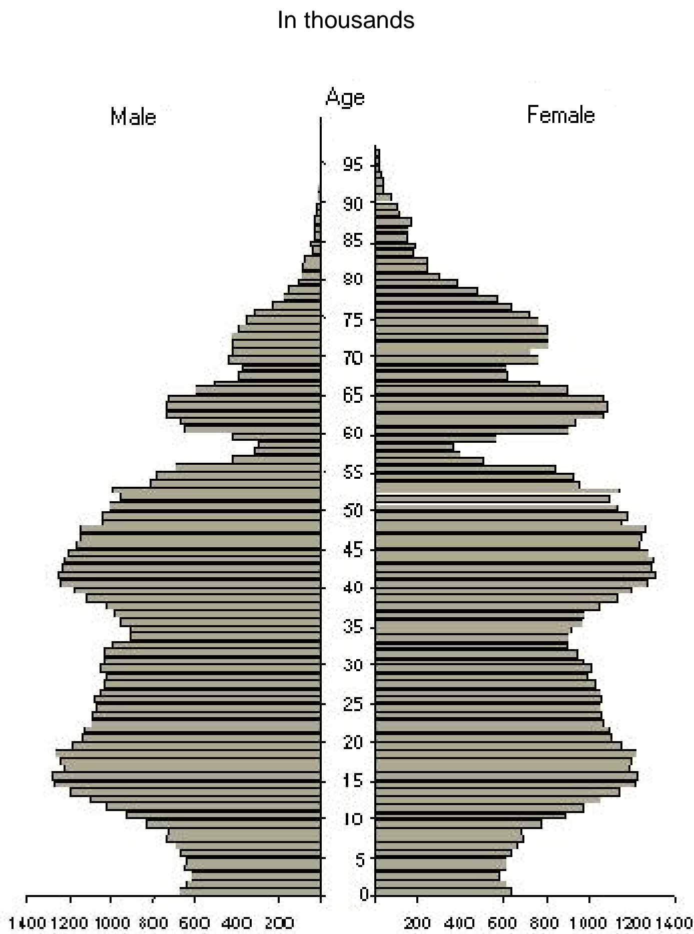
Annex 1

Population Data

Figure A1.1: Composition of population by age and sex as of 1 January 1 2002

In thousands



Source: Goskomstat

Figure A1.2: Population of the Russian Federation
As of beginning of the year

Year	Total	Of the total			Dependency ratio (per 1,000)
		Of working age	Beyond working age	Younger than working age	
	Thousands				
1991	148164	83976	28195	35993	336
1992	148326	83892	28714	35720	342
1993	148295	83748	29348	35199	350
1994	147817	83767	29696	34354	355
1995	147938	84059	29931	33948	356
1996	147609	84209	30197	33203	359
1997	147137	84337	30500	32300	362
1998	146740	84786	30587	31367	361
1999	146328	85548	30445	30335	356
2000	145559	86332	30175	29052	350
2001	144819	87054	29885	27880	343
2002	143954 *	87329	29860	26765	342
2003	143097 **	87856	29612	25629	337
2004	144168	89896	29259	25014	325

Sources:
Rossijskij statisticheskij ejegodnik 1997-99, 2001, 2003, 2004
Demograficheskij ejegodnik Rossij России 2002, 2004

Footnotes:
* 145,167 as of 9 October 2002, according to population census of 2002
** 144,964, if adjusted by population census data

Annex 2

Contribution Rates to Finance the Insurance and Funded Parts of Labour Pension

1. Contribution rates established to finance the insurance and funded parts of the labour pension (under the law "On Mandatory Pension Insurance in the Russian Federation", 2001 edition)

Table A2.1: Basic contribution rates

Amount of worker's income on which insurance contributions are charged (as progressive total from year's beginning)	Contribution rates					
	For men born in 1952 and before, and for women born in 1956 and before		For men born between 1953 and 1966, and for women born between 1957 and 1966		For persons born in 1967 and younger (were to be put in effect in 2006)	
	on insurance part	on funded part	on insurance part	on funded part	on insurance part	on funded part
Under Rb100 000	14%	0.0%	12.0%	2.0%	8.0%	6.0%
Rb100 001-300 000	Rb14 000 + 7.9% of amount in excess of Rb100 000	0.0%	Rb12 000 + 6.8% of amount in excess of Rb100 000	Rb2 000 + 1.1% of amount in excess of Rb100 000	Rb8 000 + 4.5% of amount in excess of Rb100 000	Rb6 000 + 3.4% of amount in excess of Rb100 000
Rb300 001-600 000	Rb29 800 + 3.95% of amount in excess of Rb300 000	0.0%	Rb25 600 + 3.39% of amount in excess of Rb300 000	Rb4 200 + 0.56% of amount in excess of Rb300 000	Rb17 000 + 2.26% of amount in excess of Rb300 000	Rb12 800 + 1.69% of amount in excess of Rb300 000
Over 600 000 roubles	Rb41 650	0.0%	Rb35 770	Rb5 880	Rb23 780	Rb17 870

Table A2.2: Contribution rates established initially during the transition period (2002-2005) for persons born in 1967 and after

Amount of worker's income on which insurance contributions are charged (as progressive total from year's beginning)	Contribution rates					
	2002-03		2004		2005	
	on insurance part	on funded part	on insurance part	on funded part	on insurance part	on funded part
Under Rb100 000	11.0%	3.0%	10.0%	4.0%	9.0%	5.0%
Rb100 001-300 000	Rb11 000 + 6.21% of amount in excess of Rb100 000	Rb3 000 + 1.69% of amount in excess of Rb100 000	Rb10 000 + 5.64% of amount in excess of Rb100 000	Rb4 000 + 2.26% of amount in excess of Rb100 000	Rb9 000 + 5.08% of amount in excess of Rb100 000	Rb5 000 + 2.84% of amount in excess of Rb100 000
Rb300 001-600 000	Rb23 420 + 3.1% of amount in excess of Rb300 000	Rb6 380 + 0.85% of amount in excess of Rb300 000	Rb21 280 + 2.82% of amount in excess of Rb300 000	Rb8 520 + 1.13% of amount in excess of Rb300 000	Rb19 160 + 2.54% of amount in excess of Rb300 000	Rb10 640 + 1.41% of amount in excess of Rb300 000
Over Rb600 000	Rb32 720	Rb8 930	Rb29 740	Rb11 910	Rb26 780	Rb14 870

2. The new contribution rates to finance the insurance and funded parts of labour pension introduced from 2005

Table A2.3: Basic contribution rates

Amount of worker's income on which insurance contributions are charged (as progressive total from year's beginning)	Contribution rates		
	For persons born in 1966 and before (already apply from 2005)	For persons born in 1967 and after (to be put into effect in 2008)	
	on insurance part	on insurance part	on funded part
Under Rb280 000	14.0%	8.0%	6.0%
Rb280 001-600 000	Rb39 200 + 5.5% of amount in excess of Rb280 000	Rb22 400 + 3.1% of amount in excess of Rb280 000	Rb16 800 + 2.4% of amount in excess of Rb280 000
Over Rb600 000	Rb56 800	Rb32 320	Rb24 480

Table A2.4: Contribution rates established during the transition period (2005-2007) for persons born in 1967 and after

Amount of worker's income on which insurance contributions are charged (as progressive total from year's beginning)	Contribution rates for 2005 - 2007 years	
	on insurance part	on funded part
Under Rb280 000	10.0%	4.0%
Rb280 001-600 000	Rb28 000 + 3.9% of amount in excess of Rb280 000	Rb11 200 + 1.6% of amount in excess of Rb280 000
Over Rb600 000	Rb40 480	Rb16 320

Annex 3

Categories of Persons Entitled to Participate in Professional Pension Plans

Within the professional pension system, the following persons employed at jobs with specific conditions may be insured:

1. individuals employed at underground work sites, work sites with hazardous working conditions, and in hot shops;

2. individuals employed at work sites with difficult working conditions;

3. women employed as tractor drivers in agriculture and other sectors of the economy, or as building-, roadway-, or handling-machine operators;

4. women employed in the textile industry at high-intensity and difficult jobs;

5. locomotive team workers; certain categories of workers directly involved in transportation organisation and traffic-safety protection for railway transport or the metro; truck drivers directly involved in technological work at mines or pits, or at open excavations and open-cast collieries in removing coal, slate, ore and rock;

6. individuals employed in expeditions, field crews and groups, on sites and in teams directly involved in field geological prospecting and exploration, topographic and geodetic, geophysical, hydrographic and hydrological work, forest management work, and surveying work;

7. workers, foremen and senior foremen employed directly at logging and timber-rafting work, including mechanism and equipment maintenance;

8. mechanics (docker-mechanics) in crews employed handling work in ports;

9. crews on sea-fleet vessels, river-fleet vessels and fishery-fleet vessels (except vessels operated in the port-water area, auxiliary, travel, suburban and urban communication vessels);

10. bus, tram, and trolleybus drivers on regular urban passenger routes;

11. individuals employed as air traffic controllers in civil aviation;

12. individuals employed as engineering and technical crews directly servicing aircraft in civil aviation;

13. individuals directly employed full-time at underground and open mining jobs (including mine-rescue personnel), in excavation of coal, slate ore and other mineral resources, and in mine-construction;

14. breakage-face miners, drifters, coal cutters on jack hammers, or extracting mining machine operators at underground and open mining works designed for extraction of coal, slate, ore and other mineral resources, or at mine-construction;

15. individuals employed on fishing sea fleets in fish and seafood production, processing and finished-product acceptance, and on certain types of sea fleet vessels, river fleet vessels, or fishing fleet vessels;

16. individuals employed in pilot crews in civil aviation;

17. individuals engaged in pedagogic activity at non-state and non-municipal institutions for children;

18. individuals engaged in curative and other activities aimed at public health care at non-state and non-municipal health care institutions;

19. individuals engaged in on-stage theatrical activities at non-state and non-municipal theatres and entertaining organisations.

The number of insured persons shall include the individuals specified in subunits a-through-p, with the exception of individuals employed at state and municipal institutions funded from budgets of all levels, if they have been employed at the works specified in Items 1 and 2 of Article 27 of the federal law “On Labour Pensions in the Russian Federation” for less than half the period specified in Item 1 of Article 27 of the federal law “On Labour Pensions in the Russian Federation” as of 1 January 2003, or were admitted for employment at these works during the

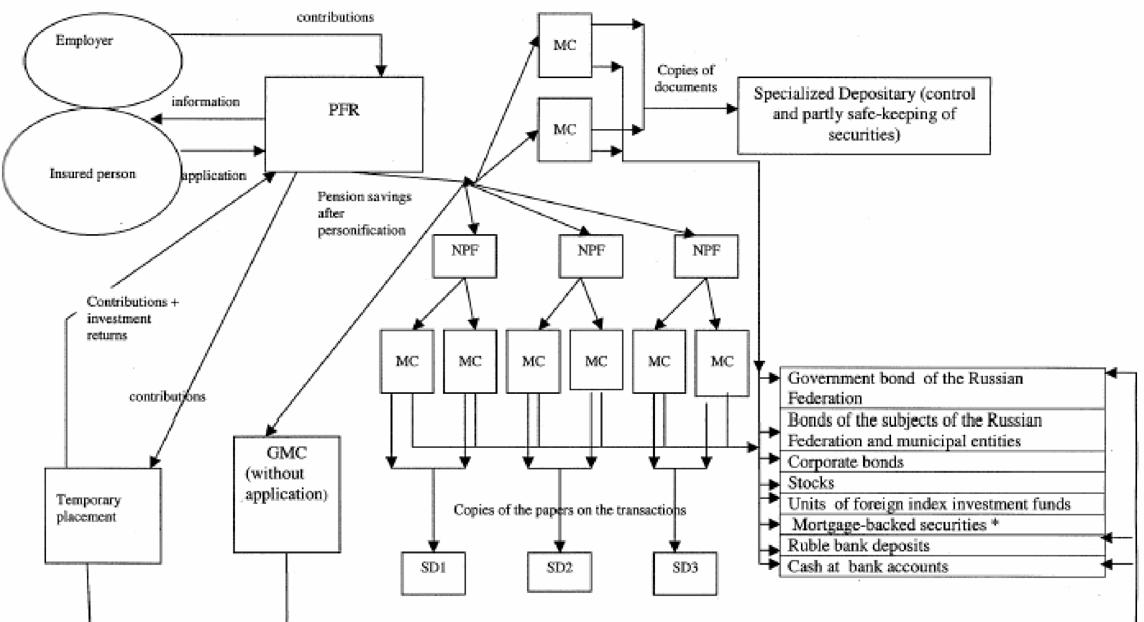
period from 1 January 2003 to 31 December 2004, as well as those individuals admitted for employment at the works specified in Item 1 after 1 January 2005.

The individuals specified in items q-through-s are categorised as insured persons, if they have been employed at the works specified in subitems 10-12 of Item 1 of Article 28 of the federal law "On Labour Pensions in the Russian Federation", irrespective of the form of ownership of the corresponding institutions (or organisations), for less than half the period specified in subitems 10-12 of Item 1 of Article 28 of the federal law "On Labour Pensions in the Russian Federation" as of 1 January 2003, or were admitted for employment at these works during the period from 1 January 2003 to 31 December 2004, as well as those individuals admitted for employment at the works specified in sub items a-through-s after 1 January 2005.

Annex 4

General Scheme of Investment of Pension Accumulations in the Mandatory Funded Pension System

General scheme of investment of pension accumulations (with participation of PFR and non-state pension funds)



* - for Government management company (GMC) mortgage-backed securities must be guaranteed by the Government
MC –management company
SD – specialized depositary

Annex 5

Investment Limits in the Mandatory Funded Pension System

Table A5.1: Requirements for the structure of the investment portfolio of the investment manager selected at tender

Type of assets	Maximum limit, % of assets
Government securities of the RF	no
Government securities of subjects of the RF, municipal bonds	40
Bonds of Russian issuers (besides federal government securities of the RF and the subjects of the RF)	in 2004 – 50 in 2005 – 60 in 2006 – 70 from 2007 – 80
Stocks of Russian issuers created in the form of open joint-stock companies	in 2004 – 40 in 2005 – 45 in 2006 – 55 from 2007 – 65
Units (shares, allotments) in foreign index investment funds	in 2004–05 – 5 in 2006-07 – 10 in 2008-09 – 15 from 2010 – 20
Mortgage securities	40
Deposits in roubles and balances in accounts with lending institutions	20

Table A5.2: Other quantitative requirements

	Maximum limit
Securities of one issuer or a group of connected issuers in the investment portfolio	5% of assets*
Deposits placed with lending institution (or members of one bank group) and securities issued by this lending institution (members of one bank group), in total	10% of assets
Securities issued by affiliated companies of management company and the specialised depositary	5% of assets
Stocks of one issuer	10% of issuer's capitalisation
Bonds of one issuer	10% of the aggregate volume of the issuer's bonds in circulation *
Securities of one issuer in the aggregate investment portfolio	30% of the total volume of securities in circulation of one issuer *
Government bonds of the RF of one issue	35% of assets

* Limit does not apply to government securities of the Russian Federation

Table A5.3: Requirements for issuers of securities that can be included in pension fund portfolio

	Requirement
Number of shareholders of an economic society and open-ended joint-stock company	At least 1,000
Value of net assets of the company	At least Rb500 million
Share of common stocks of OJSC*, owned by single person and/or its affiliated persons	Not more than 75%
Market value of all issuer's securities:	
Stocks	At least Rb300 million
Bonds	At least Rb30 million
Average monthly total of market transactions in stocks of OJSC, calculated over the last 6 months	At least Rb2 million
Average monthly total of market transactions, calculated over the last 6 months**	At least Rb400 000

* Open Joint-Stock Company

** Applies to government securities of the subject of the RF, municipal and corporate bonds

Table A5.4: Qualitative requirements

Type of security	Inclusion in listing of stock exchange	Quarterly publication of issuers' reports	Absence of losses * for issuer of securities	Secured by government guarantee of the RF
Government securities o subjects of the RF	+	+**	-	-
municipal bonds	+	+***	-	-
Corporate bonds	+	+****	+	-
Stocks of OJSCs	+	+*****	+	-
Mortgage securities	+	-	-	+

* The issuer has had no losses over two of the last three years, and, if the issuer has existed less than three years, over the entire period of activity.

** Reports on the execution of the budget of the Russian Federation's subject, as well as reports on the execution of the obligations that have arisen as a result of the issue of these securities.

*** On the execution of the budget of a municipal entity, as well as reports on the execution of the obligations that have arisen as a result of the issue of these securities.

**** The issuer of these securities submits to stock exchange quarterly reports, notifications on essential facts (events, actions) affecting the issuer's financial and economic activities.

***** The issuer submits to the stock exchange quarterly reports, notifications of essential facts (events, actions) affecting the issuer's financial and economic activities, information on the number of the issuer's shareholders, and information that one legal person and/or its affiliated persons have become owners of more than 75 per cent of the issuer's registered common stocks.

Note. The form wherein the limitations specified in Tables A5.4 and A5.5 were established was altered in September 2004. The changes introduced in the regulatory norms were purely technical. The said limitations reproduced the requirements for including securities on the supreme quotation list of the exchange. However, their direct introduction by the government ordinance regulating accumulated pension funds' investment placed responsibility for compliance with the asset management companies, without specifying the responsibilities of issuers to disclose this information to the asset management companies. Therefore, the asset management companies faced certain problems when selecting securities for investing. Especially serious problems arose due to the requirement concerning the minimum number of shareholders for issuers of bonds. Now, management companies may acquire only securities already included on the supreme quotation list of the exchanges.

Table A5.5: Limits on deposits with lending institutions

	Requirement
Capital of lending institution	At least 5 bln. rubles
Period of activity since registration date	At least 5 years
Level of interest rate of deposit (as of date of signing an agreement)	Not less than yield to maturity of issue of government securities of the Russian Federation nominated in rubles, which maturity date is the nearest to the date of end of term of deposit

Table A5.6: Restrictions on investing pension accumulations by the state asset management company.

Type of assets	Maximum Limit
Government securities of the Russian Federation (rubles- or foreign currency denominated)	80 % of assets
Mortgage securities	40 % of assets
Balances at accounts with lending institutions in rubles and foreign currencies (USD and/or euro)	20 % of assets
Government securities of the Russian Federation:	
- circulating securities of one issue	35 % of issue in circulation
- purchased by closed subscription (including those specially issued for investing funds of institutional investors)	100% of offered issue
Mortgage securities of one issue	35 % of issue in circulation

Annex 6

Investment Limits in the Voluntary Pension System: Requirements for Composition and Structure of the Pension Reserves of Non-State Pension Funds (3rd Pillar)

Types of assets	Maximum share of pension reserves (% of total value of invested pension reserves)	Note
Limits by types of assets		
Federal securities of the RF *	50	Except when acquired as a result of novation
Subfederal bonds of the RF and municipal securities	50	
Stocks and corporate bonds	50*	
Promissory notes	50	
Bank deposits** and real estate (in total)	50	
Limits, depending on the degree of risk		
Investments into allowed securities with market income	Not less than 50	The yield on these investments is defined by market conjuncture
Risky investment items	10	The risk of losses is more than 50%
Items with increased risk and risky items of investments.	20	The risk of losses is between 25 and 50%
Other limits		
Invested into one item	20	
Securities with no recognized quotations	20	
Securities issued by NPF sponsors and depositors (self investment)	30	

* average actual exposure to stocks and corporate bonds is higher as regulator practices so called individual rules for investment granting largest NPFs exceptions of set limits

** The limits are not imposed, if the value of invested pension reserves of the NPF does not exceed five million roubles

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This report of pension policy in Russia was undertaken as a part of the initiative to provide analysis of private pension policies of non-members economies. It is a part of the OECD's ongoing co-operation with the Russian Federation.

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