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REPORT No 2

LEGAL ANALYSIS OF "THE CONCEPT STRATEGY ON PENSION REFORM IN ARMENIA" AND OF CONCEPT PAPER ON "THE LAW ON MANDATORY PENSION INSURANCE"

Prepared for

The Ministry of Social Security of Armenia

Prepared by

PADCO Armenia Social Transition Program

October 30, 2000

PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL

Development Solutions for the 21st Century

PREFACE

Under USAD Contract No. 111-C-00-00-00114-00, PADCO is providing assistance to the Government of Armenia on social sector reform issues. Under Task 1A:T1, PADCO is reviewing the existing legal framework for social insurance and proposals for reform of this legal framework.

Reform of the old age pension system is a priority concern to the Government of Armenia. In December 1999, the Government of Armenia adopted a Concept "On Confirming the Principles of the Strategy for Pension Security in the Republic of Armenia." This outlined the overall directions of future reforms of the pension system. In August 2000, the Government of Armenia adopted the overall framework for a new draft law on reform of the mandatory pension system. According to the concept law adopted earlier, the state pension benefit will have two components: the first component is a type of notional defined contribution plan – offering a benefit based on past contributions paid to the Social Insurance Plan made on behalf of the insured person, and converted, at retirement into a type of annuity based on life expectancy at retirement. The second component of the benefit would be based on money accumulated in a personal account by the SIF.

To assist the GOA in refining and developing its concept for pension reform, the PADCO Armenia Social Transition Program has prepared this report. This is one of series of reports on issues related to pension reform prepared at the request of the Pension Department of the Ministry of Social Security. It was drafted by Anna Nechai, legal consultant to the AST Program.

CONTENTS

PREFACE **2**

CONTENTS **3**

1. COMMENTS AND SUGGESTED CHANGES IN THE "CONCEPT FOR A PENSION STRATEGY FOR THE REPUBLIC OF ARMENIA" **4**

1.1. INTRODUCTION 4
1.2. PROPOSED CHANGES IN THE PENSION BENEFIT CALCULATION FORMULA 4
1.2.1. "Basic Pension" *4*
1.2.2. "Insurance pension" and creation of personified recording system *4*
1.3. CHANGES IN METHODS OF FINANCING SOLIDARITY SYSTEM BENEFITS 6
1.4. ESTABLISHING THE MANDATORY FUNDED PENSION SYSTEM – 'SECOND PILLAR' 6
1.5. ESTABLISHING VOLUNTARY PRIVATE PENSION FUNDS – THE 'THIRD PILLAR' OF THE PENSION SYSTEM 7

2. COMMENTS AND SUGGESTED CHANGES IN "THE CONCEPT PAPER ON THE LAW ON MANDATORY PENSION INSURANCE" **8**

2.1. COMPONENTS OF THE FUTURE MANDATORY PENSION INSURANCE SYSTEM 8
2.2. DEFINING 'NOTIONAL ACCOUNTS' 9

3. CONCLUSION **9**

1. COMMENTS AND SUGGESTED CHANGES IN THE "CONCEPT FOR A PENSION STRATEGY FOR THE REPUBLIC OF ARMENIA"

1.1. INTRODUCTION

On December 2, 1999, the GOA adopted Decree #734, "Concept for a Pension System Strategy for the Republic of Armenia" (hereinafter referred to as "concept strategy"). This concept strategy was issued to define the main directions for reforms of the current state pension system. The major proposed reforms are:

1. To convert the current "solidarity" pension system into the pension insurance system by:
   - Changing the formula for calculating pension benefits;
   - Creating personal account for each insured person by creating a personified reporting system; and
   - Changing the way social pensions, privileged pensions, and work experience based pensions are financed.
2. To create a "second pillar" mandatory system based on notional accounts;[1] and
3. To create third pillar of voluntary private pension insurance.

These elements are discussed in the following sections.

1.2. PROPOSED CHANGES IN THE PENSION BENEFIT CALCULATION FORMULA

Section 4.2 of the concept strategy proposes to create three types of pensions financed from the mandatory system: 1) a basic benefit; 2) an additional benefit based on years of work; and 3) an "insurance pension" based on amount individuals have accumulated in their individual notional accounts. However, there are some issues that need to be resolved in drafting a law on mandatory pension insurance.

1.2.1. "Basic Pension"

According to the concept strategy, a basic pension will be guaranteed for all people with the required minimum of years of work – 20 years for women and 25 years for men. Does this mean that someone who alls just short of the minimum years of work will receive no "basic pension" at all? During a meeting with PADCO, Mr. Artem Asatryan, head of the pension department of the Ministry of Social Security, stated that it was the intention of MOSS that persons not having required number of insured years will receive a "basic pension" pro-rated to the number of working years.

This proportional decrease in the "basic pension" benefit is fair and widely used in state pension systems. But any draft law must provide a clear, concise legal definition of those who are not eligible for a proportional basic pension including setting a minimum number of years for receiving a basic pension. That is, it is necessary to define a "minimum number of insured years" which entitle the person to get a proportional amount of basic pension. In this case, persons not meeting this minimum will receive social pensions from the state budget – and no basic pension from the SIF. Estimating the fiscal impacts of this will require additional actuary calculations to ensure the financial stability of the social insurance fund.

1.2.2. "Insurance pension" and creation of personified recording system

It is proposed to replace the benefit supplement -- currently the second component of the "solidarity" benefit – with "insurance pension". This reflects the intention outlined in the concept strategy to create a new funded second pillar (paragraphs 1,2,3 of the 3rd clause of section 4.2). This insurance pension will be made up of two components:

- **The first component** will be paid based on the creation of notional accounts reflecting the accumulation of past contributions paid by or on behalf of an individual to the mandatory state pension system; and

[1] The issue of notional accounts as proposed in the concept strategy is discussed in another AST report: "Should State Pension Benefits in Armenia be Based on Notional Accumulation Accounts?" PADCO AST Program, October 30, 2000.

- **The second component** will reflect real balances accumulated in real bank accounts. This part is a fully-funded, mandatory pension program (usually referred to as a "second pillar").

The benefit from the first component of "insurance pension" will be calculated based on: 1) the amount accumulated in "notional accounts" at the time of retirement and 2) the average life expectancy at retirement. Such calculations are not necessary in the traditional "first pillar" solidarity system. Pension benefits paid under 'pure solidarity' pension systems (i.e. those not using 'notional accounts') are often calculated through a formula that may include a replacement rate (relating pension to wages at retirement) and years of experience. Such formula re usually supported by actuarial calculations showing that the formula yields expected benefit payments that are financially feasible relative to projected revenues of the solidarity system.[2] Pension benefits calculated in this way make it possible to maintain the financial stability of the pension fund.

The benefits paid from the first component would threaten the financial stability of the social insurance fund in two ways. First, the way that notional accounts will be managed outlined in the concept strategy is that account balances would be "notionally" indexed based on prevailing rates of economic growth during the current year (paragraphs 2 and 3 of the 3rd clause of section 4.2). This means that the social insurance fund commits to pay future pension benefits in excess of the actual contributions made by insured persons. Yet demographic trends in Armenia (with a high rate of out-migration and declining birth rates) means that the future revenues collected from working Armenians may not be sufficient to cover future pension benefit obligations as calculated under the first component. Thus, the financial feasibility of introducing notional accounts should be carefully assessed through an actuarial analysis of the pension system under various economic and demographic scenarios. From a financial point of view, it is safer and more equitable to index pension benefits hen they are paid rather than to index notional accounts.

Second, the formula for calculating benefits paid under the first component proposes to use the life expectancy of the beneficiary at retirement to convert the accumulated balance in the notional accounts into an annuity – that is, an annual payment then pensioner receives until death. If, on the other hand, benefits are based on "notionally indexed" notional accounts, pensioners may receive benefits that cannot be supported by current revenues. Furthermore, using life expectancy in benefit calculations to convert the notional account balance into annual pension payments in the 'solidarity' system is likely to create an extra risk for the fund of social insurance that this or that individual will live over the average life expectancy. In this case the fund faces an unanticipated expense that it may not be able to finance without increasing contribution rates. Private insurance and investment companies cover such contingent liabilities from risks associated with converting a fund into an annuity from their revenues raised from investment activities. But notional accounts do not represent funds that can be invested. Thus, the solidarity system can only cover unanticipated liabilities by either raising contributions or reallocating benefits among beneficiaries – usually by reducing benefits of future retirees. This piecemeal and ad ho approach t benefit calculations, which has characterized Armenia's approach to the financial difficulties of the Social Insurance has resulted in the almost complete elimination in the difference between minimum and maximum benefits in Armenia.

Estonia is an example of a country that has adopted pension reforms that provide benefits from three components that is similar to the approach being considered by the GOA. But Estonia does not use a life expectancy factor when calculating solidarity system benefits. Pension benefits in Estonia is based on the following three components:

$P = B + E + I$, where

B is the basic pension and its amount is established by the Parliament for each fiscal year.

[2] Actuarial calculations are based on a number of economic and demographic factors, such as number of pensioners in the country and expected changes under demographic forecasts; number of employees making contributions to the 'solidarity' pension fund; contributions (as percent of average wages), forecast of changes in average wages; forecast of birth rate in the country (as it is an indicator of future labor force in the country), etc. In addition, any actuarial model of he Armenian social insurance fund will have to consider migration and the composition of the migrants (today, for instance prevailing number of immigrants are people at working age, and emigrants are pensioners or close to pension age).

E is the component reflecting years of work entitling the person to receive a benefit calculated by multiplying the number of years of work multiplied by the annual accrual rate.[3]

I is the 'insurance' component, calculated as the sum of annual pension insurance coefficients multiplied by the annual accrual rate.

The rules for calculating these ratios should be thoroughly studied by the official representatives of the Ministry of Social Security.

1.3. Changes in Methods of Financing Solidarity System Benefits

The strategy concept establishes the principle of financing insured and non-insurance benefits separately. But it fails specify any methods for financing early retirement pension and privileged benefits. Section 4.3 says that early retirement and privileged pensions will be gradually abolished. Further, point 4 of 4.3 of the Concept says that, until they are abolished, privileged pensions will be paid using SIF funds.

During a meeting in the Ministry of Social Security, Mr. Artem Asatryan explained that, currently, early retirement and privileged pensions are paid by the SIF but subject to reimbursement by employers of those entitled to privileged pension benefits or early retirement. But as the SIF is unable to (or does not) collect the funds from the employers, it pays these benefits from its own resources. In view of the severe shortage of funds in the SIF, the GOA should consider transferring the payment for these privileges until they are abolished to the State Budget and using state procedures to enforce their repayment from employers.

1.4. Establishing the Mandatory Funded Pension System – 'Second Pillar'

In section 4.2, point 3 paragraph 3, the strategy concept establishes the principles for creating the mandatory accumulative component. The second pillar will be a constituent part of overall pension and it will be paid <u>in addition to</u> the benefit from the 'solidarity' fund (i.e. in addition to the basic pension and notional accounts benefit). The second pillar will be implemented through special sub-accounts held in the form of deposit accounts in commercial banks. If the latter were actually carried out, Armenia would be the only country to create a second pillar in this manner. Holding pension account in bank accounts is a bad idea for several reasons:

1. Accumulation pension system should not only accumulate individual contributions but also invest those funds in the interest of the fund beneficiaries. Separate bank accounts prevent the proper diversification of investments and impose very high administrative costs for investment management. From this point of view, bank deposits are not the most profitable form of investment.
2. Pension funds should be made in a manner that is protected as much as possible from risks. This requires obeying the basic rules of prudent investment:
   - Assets should be diversified among assets of different risk. Avoiding risk requires investing in various types of assets – including a small share in "high-risk/high return assets, and most in lower risk securities.
   - Assets should be diversified among different sectors of the economy. If one sector of the economy suffers recession, then assets held in other sectors will protect the fund owner from experiencing the full impact of that recession. Risk is reduced by 'not putting all eggs in one basket' of the economy.
   - Assets should be diversified among regions (local and international). History shows that economic development does not proceed at the same speed in all countries or even in all regions of the same country.

Separating pension funds in separate bank accounts means that the fund owner is entirely dependent on the loan policy of the bank in which his fund is held. If the bank lends unwisely, he may lose his entire pension fund.

The Strategy Concept has not established any principles or rules on:

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[3] The accrual rate is a percentage by which each year of work is multiplied in order to determine what share of the basic pension the beneficiary is entitled to receive. An accrual rate of 5%, for example, would mean that the beneficiary receives the full pension after 20 years.

1. Conversion of the accumulated funds into an annuity;
2. Who and in what way will be paying the annuity from the real accumulated funds;
3. What is the legal background of real pension accumulations – are they the property of future pensioner and can they can be inherited if the owner dies before pension age or after pension; and
4. Many other issues that must be addressed in creating a viable pension system come up and require a legal solution when introducing the system of mandatory pension insurance.

"The Concept of the Law on Mandatory Pension Insurance" – discussed in detail in the second part of this paper – also fails to answer these questions nor to many questions relevant to the creation of the mandatory accumulation part of pension insurance (component 2 of the proposed pension benefits). That's why, the issues of establishing the system of accumulation pension insurance, inclusion of it in the draft of the future law on Mandatory Pension Insurance still require a detailed discussion and will be addressed in a separate report.

1.5. Establishing Voluntary Private Pension Funds – the 'Third Pillar' of the Pension System4

Section 6 of the strategy concept establishes principles for creating and implementing voluntary private pension funds. Following are the basic requirements for pension funds:

1. mandatory capital requirements for the foundation of the fund;
2. requirements for capital from founders of the funds, for investors, and for non-governmental funds involved in management of pension assets; and
3. mandatory re-insurance of the accumulated funds.

The way that these issues are addressed in the concept strategy is cause for serious concern. The strict regulation of founders of private pension funds, by the persons involved in the administration of the pension funds, those involved in safe-keeping of the accumulated funds (known as "custodians"), those involved in asset management and investment advice is necessary to guard against risks of:

1. assets of beneficiaries being stolen by founders, by custodians, or fund managers;
2. assets being misused by founders, by custodians, or fund managers;
3. assets being lost as result of unwise investments (in risky investment that has resulted in loss).

Large capital requirements for the founders of companies involved in private pension funds should NOT be the basis of risk protection. International practice shows that most successful companies involved in management of pension assets (as distinct from the founders of the funds) need to invest only small amounts of their own capital. Their basis for selection as asset managers or investment advisors or custodians is based on an established track record of successful performance that demonstrates their professional qualifications.

Capital requirements make little sense for those founding pension funds. International practice shows that most companies creating private pension funds are either trust companies or non-commercial companies (i.e. companies that do not aim at profit to be shared among FOUNDERS). So it makes little sense to put forward a statutory capital requirement for a pension fund (as founders do not receive any distribution of profits – all profits are distributed among fund beneficiaries).

There is another reason why minimum statutory capital requirements for pension funds make little sense. The fundamental principle for protecting pension fund assets from the risks described above is to separate completely pension assets from the assets of any other legal entities -- even within inside the pension fund. That's why the legal form of the pension fund is:

1. either a trust, which has no assets other than those from the pension fund beneficiaries; or
2. a legal entity – a non-profit company – that has no statutory capital because its assets are only those of the pension fund beneficiaries.

The concept strategy also fails to clarify the status of pension fund beneficiaries. Contributors to the pension fund are not only employers making contributions on behalf of their employees, but also individuals who are

[4] The basic requirements for the creation of a safe and viable system of voluntary non-state pension funds are described in detail in a report by the AST: "Guidelines for Creating a Viable Non-State Pension System."

willing to pay into pension funds. The proposed capital requirements in the concept strategy would preclude individuals from paying into pension funds because they would not meet the "minimum own capital requirements" either at home or in their bank accounts.

The re-insurance requirements in the concept strategy are also doubtful. Initially, re-insurance was the idea of insurance companies for the purpose of diversifying risks through the creation of 'insurance pools'. Usually, these insurance pools were created by insurance companies facing large potential losses through large single commitments to provide insurance. An illustration of a single large risk is that carried by an insurance company covering a nuclear power plant against damages from an explosion. Potential damages from a catastrophe could be billions of dollars in compensation to those harmed by such an event.

In CIS countries, re-insurance has become very important in a way unknown to the western world: legislation of almost all CIS countries limits or even prohibits financial institutions – including insurance companies from investing internationally. Thus, insurance companies in the CIS are precluded from the most obvious and safest way to diversify risks. Instead, they are using re-insurance as a way to circumvent the law and investing internationally. In the case of pension funds, the costs of re-insurance are born by beneficiaries whose assets are being re-insured. Thus, the proposed requirement that pension funds engage in re-insurance increases administrative expenses, lowering the rate of return earned by beneficiaries on their fund balances.

Reinsurance is not a good way to reduce risk for pension funds. The best ways to protect assets is the principle of separation of assets and the rule of investment diversification. Adhering to these two principles is administratively cheaper than re-insurance and yields a higher rate of return on fund investments while reducing exposure to risk.

2. Comments and Suggested Changes in "The Concept Paper on the Law on Mandatory Pension Insurance"

The "Concept Paper on the Law on Mandatory Pension Insurance" (hereinafter the Law Concept) was adopted by the GOA in August 2000. Its purpose is to outline the main provisions of the future law and to clarify the provisions related to the law in the concept strategy discussed in the preceding section. The law concept has reconsidered a few provisions of mandatory pension insurance as outlined in the concept strategy. The following subsection gives an overview of the principle differences.

2.1. Components of the Future Mandatory Pension Insurance System

The main difference is in the structure of the components of mandatory pension insurance. The concept strategy proposed two levels: reformed 'solidarity' pension system (with notional accounts) and newly established 'accumulation' pension system. In this case the future retirement pension after the transition period was to be comprised of:

- Basic 'solidarity' pension
- Insurance pension in the form of additional benefit calculated on the basis of 'notional accounts' and
- Insurance pension from a real mandatory pension accumulation.

According to the Law Concept future pension benefits are to be comprised of:

1. During the transition period – the following three components:
   - basic 'solidarity' pension
   - insurance pension – in form of additional payment calculated on the basis of employment history before the introduction of personified records in the country;
   - insurance pension – defined by rate of notional accumulated contributions after introduction of personified records and life expectancy (in months) after retirement;
2. After the transition period – the following two components:
   - basic 'solidarity' pension;
   - insurance pension defined by rate of notional accumulated contributions after introduction of personified records and life expectancy (in months) after retirement.

Thus, the law concept abandons the proposal to create a mandatory accumulation system (the second pillar). During a meeting in the Ministry of Social Security, Mr. Artem Asatryan confirmed that the Ministry is not planning to include articles establishing mandatory accumulation system in the new "Law on Mandatory Pension Insurance." Dropping this proposal was based on several considerations.

Introducing a mandatory accumulation system would require extensive work in laying the institutional and legal infrastructure (regulatory oversight agencies, investment guidelines, etc). This was viewed as impossible for at least three years. Nevertheless, the GOA views an accumulation system as an appropriate complement to the solidarity system – especially in view of demographic forecasts that indicate growing problems for the solidarity system. Therefore, the GOA is intending to introduce the mandatory accumulation system under a separate law. If this approach is to be followed, the title of the new law should be changed to make it clear that it will be regulating only those aspects of the mandatory system that are related to 'solidarity' pension insurance with the accumulation system to be introduced by another law.

Introducing reforms in the mandatory pension system in two parts will create some problems. It is dangerous to carry out reforms of the existing 'solidarity' system without a clear-cut view of what role the future accumulation system will play or, even of whether or not there will be one. Absence or presence of accumulative level as a compliment to the 'solidarity' system must shape the design of solidarity system benefits. If there were to be an accumulation system, for example, the role of the solidarity system would be, essentially, to provide basic benefits. Any serious discussions of the future law should be initiated only after a final decision on introduction of accumulative component. We think that introduction of accumulative component of the mandatory pension insurance is a necessary requirement. But this decision, in turn, can be made only after the economic preconditions for the introduction of an accumulation system are analyzed, and after a decision on what governmental and non-governmental bodies would be involved in functioning and administration of the accumulative component, etc.

Taking into consideration the importance of this issue, experts of the Ministry of Social Security must develop specific recommendations to be submitted top GOA policymakers to clarify the strategy of the Government for introducing the accumulation system.

2.2. DEFINING 'NOTIONAL ACCOUNTS'

The Law Concept and the concept strategy differ in their approach to 'notional accounts'. The strategy concept stated that it is a database of personified accounts reflecting the accumulated total of pension contributions with indexed earnings added to the sum of past contributions – section 4.2, point 3 paragraph 3. But the Law Concept does not mention anything about indexing.

During meetings with the AST team, experts from the Ministry of Social Security stated that there would be no indexing of the balances of 'notional accounts' and that those account balances would only reflect the pension contributions made. In this case it is merely a personified record of pension contributions and not a notional account system as is usually defined in international practice. Of course, the Republic of Armenia has the right to use of its own terminology in its legislation, however this differs from international practice. But it will be under increasing pressure in the future to harmonize its legal terminology with that used internationally. That's why accepted international terms are recommended in drafting future laws.

3. CONCLUSION

In conclusion, the adoption of the two concepts discussed in this paper is evidence of positive moves for reforms of the Pension Benefit System and a good start for further detailed constructive discussions. But much work remains to be done to convert these concepts into an effective and sustainable legal framework for pension reform in Armenia. In view of the implications for the state budget as ell as for the administration of the Social Insurance Fund, the AST team recommends the creation of a task force to prepare a new drat law. The task force should include representatives from the Ministry of Social Insurance, the Social Insurance Fund, the Ministry of Finance and Economy, the Ministry of State Revenues, the Securities Regulatory Commission, and the State Insurance fund.