Developing Comprehensive Social Security and Social Insurance for the Republic of Armenia

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This document contains a proposed outline of a concept paper and three thematic areas for the concept paper, on disability, investments and payments. It begins with a discussion of institutional considerations, namely what are the institutional requirements for a second pillar program and how this will affect what institution should be responsible.

Outline

1.The Inadequacy of Current Social Insurance in Armenia

This section introduces the need for launching the reform and the GOAM's commitment to enhancing both social security and social insurance. It also will contain a brief summary of current social insurance programs administered by the SIF.

1.1. Demographic Situation in Armenia

Aging of the population, small formal labor force

1.2. Benefits generally inadequate

This will contain poverty data, calculations of replacement rates for different segments of the population, gender analysis.

1.3Fiscal Issues

1.4 Labor market issues

Incentives for evasion and the problem of migration

2. Options for Reform

2.1.General reform directions

This will contain a general description of the proposed reform architecture for a multi pillar pension system.

2.2 Minimal Social Pension Benefit (zero pillar)

2.2.1.Eligibility requirements – several options

This will discuss the option of a demogrant vs. a means tested pension
Specific demogrant requirements will be proposed: age, citizenship, and years of residency

2.2.2. Benefit adequacy for Social Pensions

This will present several possible methodologies for determining adequate social pensions: poverty level, food basket, etc.

2.2.3. Financing Social Pensions

2.2.4. Indexation of Social Pensions

2.2.5. Social Pensions for Disability and Survivors
Definition of disability to be revised to apply only to total disability
Survivors' pensions for spouses may not be necessary, depending upon eligibility criteria for social pensions. If the social pensions are a true demogrant, then spouse survivors will receive them at pension age. Similarly survivors pensions for children may not be required if there is a comprehensive social safety net for children and vulnerable families generally.

2.3. Basic Pensions (first pillar)

Discussion of options, social insurance vs. social security

2.2.1. Eligibility requirements – several options

2.2.2. Benefit calculations – several options – linked to service only, or to wages and contributions

2.2.3. Financing of Basic Pensions

2.2.4. Indexation of Social Pensions

2.2.5. Basic Pensions for Disability and Survivors

2.2.6. Improvement in collection of contributions

2.2.7. SIF Governance Improvement

2.3. Mandatory Accumulative Pensions (second pillar)

Institutional Considerations

2.3.1. Eligibility requirements

2.3.2.Contribution rates – several options demonstrating different replacement rates and transition costs

2.3.3. Collection of contributions and information on participants

2.3.4. Recordkeeping – options
Centralized vs. decentralized
Maintenance of individual accounts critical
Use existing SIF systems or build a new system - advantages and disadvantages

2.3.5. Reporting to participants

Providing regular information on amounts on individual accounts

2.4.6.Administrative Costs

2.4.7.Disability and Survivors – options

One option is to provide survivors and disability benefits only in the amount standing to the individual account.

2.4.8. Privileged groups - Options

Additional contributions to finance early retirement are required. These can be accommodated within the second pillar or within the third pillar. The essential task is to certify the necessity of early retirement for particular professions, and to have appropriate contributions paid by the industry benefiting from this labor. As the Labor Inspectorate develops improved labor standards and enforcement this should become a decreasing number of occupations.

3. Investment - options

3.1.Introduction
ISSA Governance structure and process guidelines

3.2.Investment Requirements – international best practices for pension assets
ISSA OECD guidelines

3.2. Asset Manager Selection Options

This section will describe architecture options with advantages and disadvantages of each, taking into account the number of participants and total amount of assets, and the need for good governance and for avoidance of conflicts of interest.

Single state asset manager
Single private asset manager
Single state (possibly statutory) institution offering portfolio choice
Single private institution offering portfolio choice
Multiple private asset managers and choice by participants

3.3. Asset Custody – best practices

3.4. Avoidance of Conflict of Interest

4.Payment of Benefits – Options

4.1.Annuities – several different forms of annuity; spousal benefit essential in a mandatory system.
Phased withdrawals, Lump Sum, Terminal Illness

4.2. Provider of Benefits – Options
Centralized vs. decentralized
Domestic vs. international

5. Supervision over Mandatory Accumulative Pensions

6. Transitional Issues

6.1. Determining who transfers to the new system – options – choice

6.2. Payment of benefits to participants in previous system

6.3. Fiscal burden of transition

7. Voluntary Pensions

7.1. Occupational Pensions

7.2. Individual Pensions

8. Economic impact
8.1. Labor market

8.2. Financial system
8.2.1. Capital market
8.2.2. Insurance market
8.2.3. Financial institutions

8.3. Savings and consumption

8.4. Poverty reduction

9. Implementation

9.1. Political Issues of Implementation

9.2. Public Consultation prior to introduction of reform

9.3. Public Information during the reform process
Assuring informed choice is critical.

9.4. Schedule

2.3 Institutional Considerations for the Second pillar

A second pillar system must be extensive, detailed, and appropriately governed. These criteria pertain to all aspects of the system: collection of contributions, collection of information, storage of information, custody of assets, asset investment, asset choice if applicable, regular information to participants, reporting to regulators, and payment of benefits. Whether these functions are to be performed by new or existing institutions depends on the current function and actual condition of the institutions and on the feasibility of using their resources for a new task. In this section some considerations governing these choices are discussed.

2.3.1.Collection of Contributions and Information

In some countries collection of contributions is not centralized; however, given economies of scale and certain preferences already mention by the Pension Working Group, we assume that collection of second pillar contributions will be centralized. It is often thought that collection of contributions for pensions through the same system that collects income taxes is optimal for cost-effectiveness. That is indeed the case in many countries. However, this is not always the case. Factors to consider are:

- Does the tax administration devote considerable resources to collecting income taxes attributable to individuals from employers' payrolls and keeping records by individual taxpayer? If the tax administration is NOT currently devoting extensive resources to income tax collection from employers' payrolls, and if individual income tax records are not already being stored, then this is not necessarily a cost effective option.
- What is the tax administration's record of performance and absence of conflicts of interest and corruption in collecting income taxes?
- Do most people pay income taxes? If most people do not pay income taxes, there may not be a significant overlap of records between the second pillar and the tax system.

2.3.2. Storage of Information and Reporting to Participants

Likewise, either the existing first pillar pension system or the tax system is sometimes considered to be the best place for storing information on individual accounts in the second pillar and for issuing annual statements to participants. This is an important function that will have to be performed for decades to come. However, whether existing institutions can best meet this need depends on a number of factors:

- Does the existing state pension system (or the state tax system) store the records of individual (first pillar) pension contributions? If such information is not already kept, it will not necessarily be easier to provide this in an existing structure than in a new one.

- Is there another institution where such records are kept, such as an institution establishing individual social security cards?
- If there is an existing record keeper for the first pillar pension system, how good is its governance? How good is its technological capacity? What is its capacity in issuing annual reports? Has it ever issued reports to participants? How accurate were the reports that it issued?
- How many people who are in the existing (fist pillar) pension system will ALSO be in the new second pillar system? If only some cohorts of young people will be in the new system, they may be better served by a new institution.

2.3.3. Custody of Assets

Asset custody refers to a number of very important financial functions, including keeping records of all assets, as well as of all asset purchases and sales. It is usually accomplished by a reputable financial institution. In some countries this will be a bank, in some countries a specialized depository, and yet in other countries it may be the Central Bank. In some cases this is a centralized function, and in other cases it is decentralized. Usually, if collection and record storage is not centralized (like in some countries of Latin America) there will be a custodian for each asset manager. In more centralized second pillar systems, there will be a single custodian. It does not appear that there is an existing financial institution currently serving such needs in Armenia and that this will likely have to be a new body. It will have to have extensive financial controls, appropriate independent governance, protection against conflicts of interest, and regulatory supervision. A private institution chosen transparently may be the best option.

2.3.4. Asset Investment and Asset Choice

Likewise, no existing institutions in Armenia perform the functions of investing assets for people, choosing appropriate asset managers, or providing asset manager choice. However, some have argued, and indeed the GOAM 2006 program provided, that the SSIF should serve this function. Whether this is appropriate, instead of the creation of a new body for these functions, depends on whether the SSIF can meet at least the following criteria, which are listed here and are more fully described in Section 3 below:

- Governing body that is responsible for drafting an investment strategy for the second pillar and for identifying appropriate asset managers is clearly indicated
- The governing body, in drafting investment strategy and choosing asset managers, is free from political influence and will reliably resist pressure from the GOAM to make particular decisions as to either asset managers or asset classes
- Governing body has the responsibility of applying the prudent person standard and has strict fiduciary duty
- Governing body is comprised of professionals expert in the financial sector who are appropriately compensated

- Structures for addressing conflicts of interest in the governing body, such as requirements for disclosing all assets and income sources, prohibitions against transactions involving governing body members are in place

It must be noted that the typical ILO-style tripartite state pension body that represents employers and employees is NOT appropriately constituted to accomplish these tasks.

2.3.5. Payment

The types of payments to be made are described in Section 4 below. Whether the existing state pension system is the right body to make second pillar pension payments depends on many factors. Particularly important is the question of where second pillar records will be stored. If the records are stored in some other newly created institution, it is potentially more administratively complex to have the second pillar pensions be paid by the existing first pillar institution.

Second pillar payments will not be made for many years on a large scale; it is likely that they can be made through the banking system. It is therefore not very important to have a nationwide network of offices.

2.4.7.Defining Disability and Compensating for Disability within the Second Pillar

This section addresses how disability might be defined in a reformed pension system, and also presents options for the disposition of second pillar individual accounts upon disability.

Disability in a pension system ought to be only for persons who are of working age, that is to say 16 and over. Disabled children under the age of 16 are not workers and it is not reasonable to use a payroll based tax to meet their needs. The needs of disabled children should be met comprehensively within a social assistance system that is means-tested and focused on education and inclusion, rather than on life-time income. Not all disabled children will require means-tested assistance.

1.Definition

Defining disability is complex. The traditional definition emphasized a specific medical condition, limiting the concept to the lack of ability to function normally. It is now understood that disability is not only medical but is a complex function of personal, environmental and social factors that can affect the ability of an individual to perform daily tasks. The most commonly used definition is the one proposed by the WHO in the 1980 International Classification of Impairment, Disability and Handicap (ICIDH-1):

> A disability is any restriction or lack of ability (resulting from an impairment) to perform an activity in the manner or within the range considered normal for a human being.

The main components of this definition are impairment, disability and handicap. This definition incorporates social factors as well as medical diagnosis. This interaction is critical as it suggests that rehabilitation and social inclusion are feasible and important. In 2001, searching for a more positive and integral definition, WHO adopted another version, the ICIDH-2. It has been used increasingly in the last few years. Disablement is a comprehensive term, covering three dimensions: 1) biological; 2) personal and 3) social. These dimensions relate to an individual's health condition and are referred to as "body functions and structure" at the biological level, at the personal level as "activities," and at the social level as "participation." Within this framework, "impairment" is a loss of a body structure or function. "Activity" refers to tasks. And finally "participation" is the extent a person is involved in a life situation. Activity limitations and participation restrictions are influenced by the context, which can be environmental (social attitudes, architecture) or personal (coping styles, education, profession). ICDH-2 separates impairment into body functions and structures and incorporates the contextual element. One can have impairment without activity limitations, or have activity limitations without an evident impairment. Participation can be limited with or without impairment.

Another method is used by U.S. Social Security. Social Security pays benefits to people who cannot work because they have a medical condition expected to last at least one year or result in death. The law requires this very strict definition of disability. While some

programs give money to people with partial disability or short-term disability, U.S. Social Security does not. Disability is measured by the Activities of Daily Living (ADL) index. Physical functioning is measured based on an individual's self-ratings of ability to engage in specific activities, and is not based on general assessment of illness symptoms. It works as follows. For certain activities, (walk a distance, carry a load, kneel, bathe, feed self, etc.) the respondent answers if he or she can perform them easily, with difficulty, or not at all, and a value is given in each case. A level of disability is measured by the sum of these variables. Doctors and disability specialists in the state agency where the applicant lives asks the treating doctor for information about the condition and consider all the facts in the case. Information requested includes: the medical condition; when it began; how the medical condition limits activities; what the medical tests have shown; and the treatment received. The doctors also give information about the ability to do work-related activities, such as walking, sitting, lifting, carrying and remembering instructions. Doctors do not decide if the person is disabled.

Social Security uses a five step process:

1) Is the person working? If a person is working, then the person is not disabled.

2) Is the medical condition severe? Does it severely limit abilities?

3) Is the medical condition on the "List of Impairments"?
There is a List of Impairments that describes medical conditions that are considered so severe that they automatically mean that a person is disabled as defined by law. If the condition (or combination of medical conditions) is not on this list, the agency looks to see if the condition is as severe as a condition that is on the list. If the severity of the medical condition meets or equals that of a listed impairment, the agency will decide that the person is disabled. If it does not, the agency goes on to step four.

4) Can the person do the work he or she did before? At this step the agency decides if the medical condition the person from being able to do the work he or she did before. If it does not, the agency will decide that there is no disability. If it does, the agency goes on to step five.

5) Can the person do any other type of work? The agency looks to see if the person would be able to do other work. It evaluates the medical condition, your age, education, past work experience and any skills that could be used to do other work. If the person cannot do other work, the agency will decide that he or she is disabled. If the person can do other work, the agency will decide that he or she is not disabled.

In addition, there are special rules pertaining to blind people.

2. Proposed Standard for Disability Assessment

Drawing upon these sources, and seeking to propose something workable, the following standard is suggested. Disability for which a pension is paid should be defined to mean total and permanent inability to work. A decision making body ruling on disability must

include both medical and vocational expertise to assess the condition of applicants for disability pensions. It is not acceptable to simply accept the diagnosis of a doctor.

Disability assessments must be made in writing and include the following factors:

(a) Medical Assessment. A specific statement of the diagnosis of the physical, sensory or mental condition, disease or disability that the applicant is suffering and the date of the condition, disease or disability onset; the diagnosis must describe the condition, disease or disability as well as the particular impact of the condition, disease or disability on employment, including a specific description of impaired functioning.

(b) Vocational Assessment (daily living tasks). An assessment of the applicant's functioning with respect to daily living tasks and tasks associated with employment; this must include reference to applicant's prior employment if any.

(c) Employability. A determination of whether or not the applicant can be employed, in any capacity, given the total circumstances of the disease or disability.

(d) Length of Disability. A determination of complete disability for a prior period of one year or longer, during which time the applicant was incapable of employment for remuneration.

(e) Permanent. Prognosis of the permanence of disability.
Persons capable of employment or actually employed in any manner, including any self-employment, shall not be eligible for disability pensions. Actual employment, including self-employment, should constitute presumptive proof of the absence of disability.

3. Addressing Rehabilitation

In order to encourage inclusion, rehabilitation and participation, the disability pension should not simply be terminated upon re-employment. Rather, there should be vocational training made available by the agency and a gradual offset of income against disability pension so as to make it financially advantageous for a disability pensioner to be rehabilitated. (This is analogous to welfare reform, where the welfare recipient is given support during initial employment so as to stimulate employment.)

4. Disability Pensions in the Mandatory Accumulative Pension System

There are two possible approaches to disability in a mandatory "second pillar" pension system. The first approach is to compensate disability primarily from the social or solidarity pension system (the "first pillar"), while allowing disabled persons to withdraw their accounts and either purchase annuities or receive lump sums or phased withdrawals, depending on the size of the amounts. In this option, there is no additional compensation for the disability from the second pillar. The other approach, chiefly used in Latin America, is to have a small portion of the contributions to the second pillar used to purchase disability insurance. This approach requires a relatively robust insurance sector as well as sufficiently high contributions to have some extra funds to spare for disability

insurance. It has not been adopted in any of the countries of Central or Eastern Europe that have adopted second pillars.

We suggest that the law provide the simplest and least expensive solution by compensating for disability from the first pillar and providing for withdrawals of the second pillar individual account only when a person is judged disabled according to the first pillar decision making process.

Disability in the first pillar can be addressed in two ways. One option is to simply have a disability pension paid to all persons regardless of the previous income, based on some standard such as the minimum consumption basket. This would essentially equate disability with a social pension. This is the simplest and less costly approach. The other option is to have disability compensated based on the previous income, to some extent, perhaps up to a maximum. It would only be appropriate to do this for income that was in the formal sector for which contributions are made to the first or second pillar. This would require accuracy in recordkeeping, would be more expensive and harder to administer.

3. Investment Options

This section addresses investment issues relevant to the second pillar. It begins with a discussion of applicable international best practices for investment governance and structural arrangements, and then describes several optional arrangements for the second pillar in Armenia. The section then addresses custody and conflicts of interest, and concludes with an annex that illustrates and appropriate and a less than optimal investment policy.

3.1.Introduction – Governance and Structures

The International Social Security Association (ISSA) Guidelines for the Investment of Social Security Funds, 2004 contain guidelines for appropriate governance structures and governance mechanisms for social security funds. While these are not designed expressly for second pillar pensions, they are appropriate benchmarks to assess the governance structure of the proposed system because they are designed to be flexible and to apply to government ministries, statutory bodies and private institutions providing pensions. Nine governance structures and four governance processes are provided. In addition, ISSA guidelines specific to investment are discussed in the next section.

3.1.1.Governance Structures

3.1.1.1.Identification of responsibilities

This refers to the need for clear identification and assignment of operational and oversight responsibility. This is true whether the system is state administered or privately administered. If a statutory body is established as an autonomous institution, the law establishing it should specify its legal status and governance and main objectives.

3.1.1.2.Governing body

The governing body must be empowered to take the actions necessary to fulfill the requirements of the law. The governing body must be subject to the least possible interference on political influence. The governing body should not be able to absolve itself of responsibility by delegation but must conduct active monitoring and oversight of all delegated functions. The governing body must address the possibility for conflicts of interest in a proactive manner.

3.1.1.3.Investing Institution and investment committee

The investing institution can be either the governing body of the pension system or an entity established expressly for the purpose of investing. In the latter case, there must be a clear statement of the legal status of the investing institution. The body responsible for the investment policy and the investment strategy must be identified.

3.1.1.4.Accountability

The governing body and the investing institution must be accountable to participants. There must be a transparent process for selecting the members of the governing body and transparency in how decisions are made.

3.1.1.5. Suitability

Those who are members of the governing body and those who invest must be suitable, that is to say professionally qualified. Absence of conflicts of interest is one element of suitability. The law should address suitability and conflicts of interest.

3.1.1.6. Expert Advice

If the members of the governing body lack expertise, they must obtain expert advice.

3.1.1.7. Auditor

An auditor independent of the institution and of the government should be appointed to carry out annual audits. The auditor must be free from political interference and given sufficient access to carry out the auditing function.

3.1.1.8. Actuary

An actuary is needed particularly in the case of defined benefit pensions.

3.1.1.9. Custodian

The statutory administrator, a government institution such as a central bank or a treasury, or an independent private custodian can provide asset custody. If an independent custodian is appointed, then the assets must be legally separated from those of the custodian. The custodian must be independent from the private asset manager or managers in order to prevent conflicts of interest.

3.1.2.Governance Mechanisms

3.1.2.1.Systems of Control

There must be systems of control to be sure that all persons with operational and oversight responsibilities acts appropriately in accordance with the law. This includes basic administrative procedures such as organizational and administrative process, performance assessment, compensation, information, risk management and review of advisers and contractual arrangements. An internal audit function is also a modern trend in such institutions. Conflicts of interest (this includes personal interest, political interference, nepotism) must be expressly prohibited and this issue should be monitored.

3.1.2.2.Internal Reporting

Reporting channels must be established between the entity administering the pension system, the governing body, then investing body, the government and all other involved persons or entities to assure effective and timely transmission of information.

3.1.2.3.Public Disclosure

Relevant information must be made public in a clear, accurate and timely fashion.

3.1.2.4.Redress

Statutory redress of grievances must be available to participants and survivors.

3.2. Investment Requirements – International Best Practices for Private Pensions

The purpose of this section is to describe best investment practices applicable to mandatory private pension asset management. These best practices are exemplified by the OECD Guidelines on Pension Fund Asset Management, 2006 and by the International Social Security Association (ISSA) Guidelines for the Investment of Social Security Funds, 2004 which are very similar. The OECD Guidelines are best practices for private funds, whether mandatory or voluntary, and the ISSA guidelines were drafted for social security institutions.

ISSA has developed twenty guidelines for the appropriate governance and investment of social security systems. These guidelines are divided into three categories: governance structures, governance mechanisms, and investments. There are seven guidelines with respect to investments. OECD has five guidelines for investments. This section will list and discuss the seven ISSA guidelines with respect to investments, while the governance guidelines are be addressed in another section.

With respect to investments, the ISSA seven guidelines are: 1) establishment of objectives, 2) integrated approach, 3) investment policy and strategy, 4) restrictions on investments, 5) prudent person principles, 6) asset valuation and 7) performance analysis. OECD offers five similar guidelines: 1) income objective and prudential principles; 2) prudent person standard; 3) investment policy: 4) portfolio limits; and 5) valuation of pension assets.

3.2.1. Objectives

According to ISSA, there are two basic objectives for investment of social security funds: security and profitability. Assets must be secure, and profits must be realized, and these objectives must be balanced. Social and economic utility if taken into account at all must be subsidiary and must not detract from profitability or security. OECD objectives are phrased somewhat differently to include three items that are prudential principles: security, profitability and liquidity using risk-management concepts such as diversification and asset-liability matching.

3.2.2. Integrated Approach

Integrated approach (ISSA) refers to taking into account the obligations of the scheme, its required cash-flow and the commitments of the scheme in the medium and long term. This could be interpreted to include liquidity, stated above as an objective by OECD.

3.2.3. Investment Policy

The adoption of an investment policy is critical for both ISSA and OECD. Investment policy should be based on prudent person principles (however these might be expressed

in the relevant legal system) and include appropriate quantitative restrictions. They should take into account risk management, diversification, matching assets and liabilities, currency matching, and performance measurement and monitoring. A statement of investment policy must be articulated and readily available. It is most common for the law to provide general guidelines and for investment policy to be a separate document, readily amended from time to time in response to changing needs and circumstances.

OECD has more details on investment policy, including the need for strategic asset allocation, overall performance objectives, and monitoring. Very critical for second pillar funds:

> The investment policy for pension programmes in which members make investment choices should ensure that an appropriate array of investment options, including a default option, are provided for members and that members have access to the information necessary to make investment decisions. In particular the investment policy should classify the investment options according to the investment risk that members bear.

Thus, second pillar pension systems with choice of investment option must provide default investment options and information on the risk entailed in other alternatives. Public information is critical to best investment practice.

Parties responsible for investment must be identified and procedures for changing the investment policy specified.

3.2.4. Restrictions on Investments

Restrictions on investments are critical, but should not be overly restrictive. There should be no minimum requirement for any category of investment, except for exceptional reasons and on a temporary basis. Maximum levels by category should be minimized and if introduced set with reference to prudential rules and include a process of transition within time limits in the event of deviation due to cost fluctuations. Quantitative restrictions are giving way to modern risk management methods. However, it may be appropriate to have two sorts of quantitative restrictions: one on the percentage of any one institution that may be purchased by a pension asset manager, so as to prevent the transformation of pension asset management into industrial policy, and on the percentage of the total assets in one institution's financial instruments, for the sake of diversification. Examples of a limited quantitative restriction and of excessive or inappropriate restrictions (from the Philippines) are provided in an annex below (these can be made into text boxes if desired).

Investments in some categories should be limited or prohibited outright. Loans without guarantees, unquoted shares, individually placed investments and illiquid assets fall into this category. Particular care must be taken to address conflicts of interest with respect to such investments.

International investments should be investment grade. Derivatives may be used to hedge risks, but risk management structures should be used to avoid an uncovered position.

Investment must be free of conflicts of interest and for that reason transactions with affiliated parties are often prohibited outright and in any case must be disclosed and monitored.

3.2.5. Prudent person

Prudent person principles should be used to impose significant fiduciary obligations on persons in charge of investment policies and investments. Fiduciary duty to participants must be clearly expressed. Assets must be valued transparently and consistently, ideally based on market costs. Reporting of all results and analysis of performance on a regular basis is critical to measure the efficiency of the entire enterprise.

In the event the legal system does not already contain an appropriate definition of fiduciary duty generally, or of prudent behavior when investing the money of others, care must be taken to express these criteria in a way that is consistent with existing legal norms and customs. One should not simply impose the concepts of trust or of fiduciary duty but rather seek to describe the process that is entailed of looking after money that is intended for someone else according to expert professional standards.

Prudent person principles if appropriately developed are more useful in some cases than quantitative restrictions.

3.2.6. Valuation

A transparent and fully disclosed basis for valuing assets is critical. Assets should be valued in accordance with generally accepted accounting principles. There should be disclosure of the methodology used and of the results that would have been obtained using an alternative methodology.

3.2.7. Performance Analysis

Periodic analysis of asset class allocation and of each asset class separately should be carried out.

3.3. Pension Asset Manager Selection Options

This section describes options for the architecture of the pension asset manager. It must be considered that Armenia is the second poorest country to ever consider introducing the second pillar (the poorest is Bolivia) and that it is also one of the smallest countries to introduce the second pillar. For both reasons, volume of assets will be low, and economies of scale difficult to achieve. Centralization is therefore an important goal.

The institutional requirements for selection options in asset management of the second pillar are part of the overall architecture of the system.

3.3.1. Single state asset manager

A single state asset manager could either be an existing institution – the SIF – or a new institution. Advantages would include centralization and opportunity for reducing costs. The lack of choice by participants would reduce costs. However the disadvantages would be significant, including low capacity and low compensation in state institutions, exposure to political interference and corruption, and difficulty in implementing best practices.

3.3.2. Single private asset manager

A single private institution managing assets could be selected by tender, either from among existing domestic institutions or through an international tender. This would have the advantages of centralization, private professional expertise and access to increased salaries. There would still be no choice by participants. However, there are significant disadvantages in creating a private monopoly. The tender would be subject to political manipulation and corruption. The institution would be subject to political pressure once it won the tender. It might be more insulated from interference if an international private entity were involved. It would also be difficult to change the asset manager.

3.3.3. Single state (possibly statutory) institution offering portfolio choice

A single state institution (such as SIF) or a newly created statutory body could offer portfolio choice to participants. There would be some advantages of centralization, although there would be the cost associated with choice. The capacity of a state institution to offer competitive market salaries would be limited. A statutory body might be able to offer more. The ability of a state institution or a statutory body to be sufficiently independent is questionable. Would the portfolio choices be chosen on the basis of investment criteria or politics?

3.3.4. Single private institution offering portfolio choice

A single private institution could also centralize the records on individual accounts and offer portfolio choice to participants. It would have the advantages of centralization and of market based compensation. If it were a domestic institution it would however be subject to political pressure. Introducing an international partner for a single private

institution would dilute the effect of political interference and would also have the advantages of providing access to best international practices and additional capital. There would also be the advantage of competition since there would be choice by participants. Disadvantages would include the complexity of the arrangements required to bring in an international institution.

3.3.5. Multiple private asset managers and choice by participants

In order to offer the greatest benefit of private markets and competition, most second pillar systems have multiple asset managers and offer participants choice. Some systems centralize collection and reporting, and some do not. Assuming that Armenia would centralize collection and contributions is reasonable. Thus, in this option, the asset managers would only invest assets and not keep individual records or issue reports to individuals. There would be the advantage of choice and market competition. The disadvantages would stem primarily from low initial volume of assets in the system. It is not clear that there is a sufficient asset flow anticipated to make this option viable.

3.3.6. Hybrid Option of 3.3.4 and 3.3.5. A Single Private Institution can offer choice among multiple private asset managers

To address issues of scale, a hybrid of the last two options can be considered to have the administrative advantages of a single institution and the market advantages of choice among multiple asset managers. An independent private-public partnership, with shareholders consisting on a public international financial institution, a private international financial institution and an account manager could have responsibility for maintaining records and directing investments. It would also conduct a tender to provide suitable investment choices to individuals. This would have the advantage of international support and transparency.

3.4. Asset Custody

Asset custody is an important aspect of asset investment. The ISSA guidelines mentioned above note, that a government institution or an independent private custodian can provide custody. If a government institution provides custody, the institution should not have any responsibility for oversight of asset investment or choice of asset managers. If a private custodian is chosen, it must be appropriately licensed and subject to a number of qualification requirements. Conflicts of interest with asset managers need to be avoided.

The functions of a Custodian would include at least the following:

- Receive and keep paper securities (if any);
- Keep records of paperless securities;
- Receive and keep copies of settlement documents on the transfer and issue of monetary funds;
- Make entries in the correspondent accounts in the register of assets deposited with the Custodian;

- Provide all necessary information to various actors in the system to comply with the obligations of applicable law;
- Ensure the acquisition and disposal of assets is in accordance with law and applicable rules and the investment policy;
- Fulfill the instructions of the applicable governing bodies, unless such instructions are in violation of this or other regulation or applicable rules or the investment principles;
- Report violations to appropriate supervisory bodies.

3.5. Avoidance of Conflict of Interest

Conflict of interest should be interpreted broadly to include self-interested financial decisions by individuals who have multiple roles, political pressure, pressure to address the genuine need in the country by investing pension assets in socially motivated projects, nepotism, and other forms of non-transparent collusion.

3.5.1. Avoiding economic conflicts of interest

The pressure to use pension assets to meet other important economic goals is what is meant by economic conflict of interest. As can be seen in many countries, governments often use pension assets for positive economic purposes that nonetheless result in lower investment returns and greater risks for pension participants. This can be seen from the example of the Philippines, where pension assets are used to give high risk unsecured loans and mortgages as a matter of policy. The best way to avoid this conflict is to establish autonomy of the investing pension institution from the government and to provide for a merit-based appointment process for the governing structure, with fixed terms. Any state institution is by it very nature more prone to abusive economic conflicts of interest than a private entity.

3.5.2. Avoiding political conflicts of interest

Political conflicts of interest arise when the governing body of the pension institution is subject to political pressure in making appointments, including appointments of institutions making investment decisions. There is no possible way to avoid all political conflicts of interest, so at best they can be contained and channeled. For example, the tender process (if one is used) or the licensing process for asset managers should be entrusted to an apolitical expert body using predetermined criteria for making the decisions. A pension institution that is private is more likely to resist political conflicts of interest.

3.5.3. Avoiding personal conflicts of interest

Personal conflicts of interest arise when individuals have discretion over investments and can use those investments to benefit themselves. Personal conflicts of interest are best avoided by having strict prohibitions against transactions between affiliated parties, using

a comprehensive definition of affiliated parties to include both individuals and legal entities. Nepotism in appointments can also be addressed.

Affiliated entities could be defined to include:

- Citizens or physical persons in those cases where they may, directly or indirectly, determine the decisions made by such entity
- A founder, officer, executive body, or affiliate business of such entity
- A shareholder (participant) or a group of shareholders (participants) if they can to determine the decisions taken by such entity
- A group of persons, who by virtue of an agreement, including an oral agreement, or another relationship, have the ability to determine decisions undertaken by such entity
- Spouses
- Parents, guardians, conservators, brothers, sisters, children, and those underage persons residing with them who are under 18 years of age

While some exemptions are possible, there should be a general rule stating that an entity providing services cannot negotiate with itself or with an affiliate to be a provider of other services or goods. This rule is designed to address abuses where entities affiliated with someone on the governing board could use that relationship to negotiate lucrative contracts that requiring pension institutions to pay more for services than market rates. In addition, agreements between affiliated parties permit concealment of fraud and other abuses.

ANNEX

Example of Appropriate Qualitative Requirements and Quantitative Restrictions:

1. Pension Assets shall only be invested in accordance with the provisions of this law and in to maximize returns on investment solely for the benefit of Participants and Beneficiaries. The goals of prudent investment for Pension Assets are:

(a)The security of Pension Assets;
(b)Diversity of investment;
(c)Maximum return consistent with security of Pension Assets; and
(d)Maintenance of adequate liquidity.

2.The Governing Board of the Pension Company shall on professional advice draw up a statement of investment principles, which shall conform to the principles set out above. The statement of investment principles shall set forth:

(a)The way in which the requirements of this law shall be satisfied;
(b)The types of assets in which the Pension Assets may be invested;
(c) The parties responsible for decisions related to making and realizing investments;
(d)The procedures for making those decisions; and
(e)The method of revising the statement.

The Governing Board of the Pension Company shall regularly review the statement of investment principles and, if necessary, amend it.

3.Pension Assets may be invested in the following classes of international assets:

(a) Monetary funds, including bank accounts and deposits with banks that are licensed by the banking regulatory authority of a member state of the OECD, and which are not under any enforcement action and are not subject to a suspension of their license;

(b) Securities issued by any member state of the OECD;

(c) Securities issued by local governments in member states of the OECD;

(d) Securities registered with the capital markets regulator of any member state of the OECD on account of having been placed through a public offering, provided that such securities have been listed on the stock exchange subject to the supervision of the applicable capital markets regulator; and

(e) Mutual and investment funds subject to approval in the state of establishment within a member state of the OECD.

4.Pension Assets may only be invested in the following domestic classes of assets:

(a) Monetary funds, including bank accounts and deposits with banks that are licensed by the Central Bank but which are not under enforcement action and are not subject to a suspension of their license;

(b) Securities issued by the Government, to the extent guaranteed;

(c) Securities of enterprises (including but not limited to stocks and bonds) registered with the capital markets regulator and placed through a public offering, provided that such securities have been listed on a licensed domestic securities exchange or in another jurisdiction of the of a member state of the OECD, subject to the supervision of the applicable capital markets regulator; and

(d) Mutual and investment funds subject to regulatory approval of the capital markets regulator.

5.The maximum proportion of the securities of any single issuer, including its Affiliated Entities, which may be held by the Pension Company, is five percent (5%) for stocks and thirty percent (30%) for bonds. This restriction shall not be applicable to mutual and investment funds whose investment policies otherwise meet these requirements.

6.The maximum proportion of total Pension Assets that may be invested in the assets of any single issuer, including in this calculation assets of Affiliated Entities, is five percent (5%). This restriction shall not be applicable to mutual and investment funds whose investment policies otherwise meet these requirements.

7.Rules of the Pensions Regulator may from time to time specify minimal acceptable ratings for any class of asset enumerated herein.

8.Pension Assets may not be invested in:

(a)Securities that are either unlisted or not publicly traded;

(b)Assets that are not capable of alienation by law;

(c) Derivative securities, options, futures, forward and other agreements with respect to securities and other financial assets;

(d) Real estate or physical assets not listed on organized markets and for which valuation is uncertain, including, for the sake of example, antiques, works of art, coins, and motor vehicles;

(d) Any property of the Asset Manager or Custodian or member of the Governing Board of the Pension Company or any Affiliated Entity of the Asset Manager or Custodian or member of the Governing Board of the Pension Company;

(e) Securities issued by:

(i) A member of the Governing Board of the Pension Company;
(ii) The Asset Manager;
(iii) The Custodian;
(iv) Any person who is an Affiliated Entity in relation to the entities listed in (i) to (iii) above; and

(f) Such other assets as are specified by the Pension Regulator.

9. If the provisions of this section are breached as a result of:

(a) Changes in market prices constituting a basis for valuation of the assets;
(b) Changes in foreign currency rates;
(c) Changes in organizational or economic relations between entities in which assets are invested; or
(d) Any other circumstances beyond the immediate control of the Asset Manager;

Then the Asset Manager shall be obliged to take measures to adjust investment activities to the requirements specified in this regulation, while meeting the other requirements of this Section to maximize returns and preserve Pension Assets.

The adjustment of investments to the requirements specified in this law shall be completed no later than six (6) months after the date when the breach occurred or the date when a valuation of assets indicates that there had been such a breach, whichever is later.

10. Pension Assets may not be sold to:

(a) The Custodian holding its assets;
(b) An Asset Manager;
(c) A member of the Governing Board of the Pension Company; or
(d) Any person who is an Affiliated Entity in relation to the Asset Manager or Custodian or member of the Governing Board of the Pension Company.

11. The Asset Manager may not issue loans and guarantees of any kind to any of the entities listed in section 10.

12. The Asset Manager shall exercise all of the voting rights attaching to the relevant stock shares it holds on behalf of the Pension Company solely and exclusively in the interests of Participants and Beneficiaries.

Example of Excessive Quantitative Restrictions, and other inappropriate investment guidelines for pension investment, from the Philippines:

The Social Security Act of the Philippines, last amended in 1997, does not require the professional adoption of an investment policy and strategy. Instead, the Act itself is the policy and lists permissible asset classes, with limitations on investment as a percentage of the total.

(a) Bonds, securities, promissory notes of the Government of the Philippines or to which the full faith and unconditional guarantee of the Government of the Philippines is given;

(b) Bonds, securities, promissory notes of the Government of the Philippines or any of its agencies to finance domestic infrastructure projects such as roads, bridges, ports, telecommunications, provided such instruments are guaranteed by the Government and that the SSS shall have priority;

(c) Bonds, securities, promissory notes of government financial institutions or government corporations with "acceptable credit or guarantee;" up to 30%;

(d) Bonds, securities, deposits, promissory notes of any bank in the Philippines in good standing with the BSP to finance loans to private corporations in the Philippines including schools, hospitals, small-and-medium scale industries, cooperatives and NGOs, with collateral or securities assigned to SSS; bank deposits shall not exceed unimpaired capital and surplus or total private deposits of the bank, and the bank is designated as depository by the Monetary Board; up to 40%;

(e) Bonds, securities, promissory notes of shelter agencies of the National Government or financial intermediaries to finance housing loans for members and in long-term direct individual or group housing loans giving priority to low-income groups, up to 90% of the appraised value of the properties to be mortgaged; and in short and medium term loans to members such as salary, educational, livelihood, marital, calamity and emergency loans; up to 35% may be used for housing purposes and up to 10% for short and medium term loans;

(f) Bonds, securities, promissory notes of educational or medical institutions to finance construction and improvement of schools and hospitals; up to 10%;

(g) Real estate property, including shares of stock involving real estate, and investments secured by first mortgages for the benefit of SSS members as well as the general public; investment in real estate including shares of stocks up to 5% and investments secured by first mortgages; up to 25%;

(h) Bonds, debentures, securities, promissory notes of a prime corporation or multilateral institution to finance domestic projects; there must not have been defaults and during each of any three years including the last two of the preceding five, the net earnings must be not less than one and one-quarter times the total of fixed charges; up to 30%;

(i) Preferred or common shares of stocks listed in the stock exchange, subject to prior approval of the BSP (probably now this would be the SEC), and other risk management instruments of a corporation or financial institution, with track record of profitability over the last 3 years; not to exceed 30%;

(j) Domestic or foreign mutual funds in existence for at least three years; not to exceed 20%; foreign mutual funds are not to exceed 1% in the first year to be increased by 1% each year but in no case more than 7.5%;

(k) Foreign currency deposits or AAA foreign currency denominated debts, prime and non-speculative equities, and other BSP approved instruments issued in accordance with laws of the countries where issued, and listed on bourses, and if that the issuing company has a track record of profitability over the last three years and record of dividend payment; not to exceed 1% in the first year to be increased by 1% each year but no more than 7.5%;

(l) Loans secured by collaterals such as cash, government securities or guarantees of multilateral institutions; up to 30%;

(m) Other instruments approved by BSP.

In addition, the following limitations are imposed as cumulative ceilings:

- 40% in private securities
- 35% in housing
- 30% in real estate investments
- 10% in short and medium term member loans
- 30% in government financial institutions and corporations
- 30% in infrastructure projects
- 15% in any particular industry
- 7.5% in foreign-currency denominated investments

As can be seen from the foregoing, there are many classes that do not meet best international practices for building a liquid, diversified and secure portfolio. Instead, housing needs of poor people, and of SSS members, as well as the health care, educational and general development are served. Member loans have been provided, in order to support low-income members, and many of these have not been repaid. Indeed, the SSS has sold some of this portfolio of bad loans for approximately 20% or original value to a collection agency.

Another example, also from the Philippines, the Government Service Insurance System Act of 1997, provides the following limitations on investment:

(a) Bonds or securities of the Government of the Philippines;

(b) Interest bearing deposits or securities in any domestic bank in the Philippines, provided these do not exceed "unimpaired capital" and the bank is designated as depository by the Monetary Board;

(c) Direct housing loans to members and group housing projects secured by first mortgage, giving priority to low income groups and in short and medium-term loans to members such as salary, policy, educational, emergency, stock purchase plans and other similar loans, PROVIDED that no less than 40% of the GSIS Social Insurance Fund be invested for this purpose;

(d) Bonds, securities, deposits, promissory notes of educational or medical institutions to finance construction and improvement of schools and hospitals;

(e) Real estate property, including shares of stock involving real estate, and investments secured by first mortgages for the benefit of GSIS members as well as the general public;

(f) Debt instruments and other securities traded in the secondary markets;

(g) Loans to or bonds, debentures, promissory notes or other indebtedness of any solvent corporation in the Philippines;

(h) Preferred or common shares of stocks of any solvent corporation under the laws of the Philippines listed in the stock exchange with, with track record of profitability over the last 3 years and payment of dividends at least once;

(i) Domestic or foreign mutual funds including investments related to the operations of mutual funds;

(j) Foreign mutual funds and foreign currency deposits or foreign currency denominated debts, non-speculative equities, and other financial instruments or other assets issued in accordance with laws of the countries where issued, and listed on bourses, and showing a track record of profitability over the last three years and payment of dividends at least once.

These investment requirements of the 1977 Act do not meet best international practices for building a liquid, diversified and secure portfolio. They provide an example of a particularly inappropriate requirement, namely the imposition of a MINIMUM percentage of an illiquid and often non-performing asset, loans to members.

In addition, the foregoing investment guidelines, as interpreted, allowed the GSIS to make illiquid investments in art and establish an art museum at headquarters. The GSIS

bought the painting of a major Filipino painter and historical figure at an auction for 46 million pesos (US $884,615). The GSIS said its purchase of the painting by Juan Luna, also a key figure in the struggle against Spanish colonization, was meant to “save a piece of Philippine history.” But politicians and other critics said the government agency had wasted the badly needed resources by buying it.

“We are very happy that we are able to bring home this famous painting to its permanent residence,” GSIS chief Winston Garcia said at the unveiling of the painting at the GSIS Museum. But “you can’t eat a Luna,” remarked a congressman who said the money used to buy the painting should have been used to feed the hungry in this country of 80 million people, 40 percent of whom live below the poverty line.

Critics, while not necessarily opposed to the preservation of artistic heritage, asked if it was right for the GSIS to use funds coming from contributions of government employees to acquire the Luna painting. The GSIS has argued that the money had come from its investment funds stemming from a healthy net income, and that it did not eat into funds for members in order to buy the Luna. Its officials also said the agency wanted to buy the painting rather than see it go into the hands of foreigners.

4. Payment of Mandatory Accumulative (or Savings, or Funded) Pensions

This section discusses how payments will be made in the second pillar pension system. Issues related to annuities are discussed first. Then other payment options are discussed. Finally regulatory concerns are noted.

4.1. Issues concerning Annuities

Annuities are the best form of benefit payment for pensions because they result in a lifetime stream of income to the pensioner. There were concerns expressed in the pension working group about this form of payment in Armenia, due to the limited availability of insurance and due to the preference of many people not to use that vehicle since it is unknown and can result, for example, in a person who dies very early on not benefiting from his savings or leaving it to his heirs. On the other hand of course, those who live longer will obtain more.

It should be noted that for a second pillar pension system there are many important policy reasons to require all persons to take an annuity who can. One reason is adverse selection. If an annuity is a choice, the persons who are likely to die early (i.e. know they are very ill) will tend not to purchase an annuity. This will mean that annuities are more costly for those who do choose them. A second reason is human myopia in considering finances: persons tend to prefer spending now rather than saving, and individuals who receive lump sums or phased payments early in their retirement years are likely to run out of resources before they die and will become a burden to society. A third reason is economy of scale. The system will be less expensive to operate if there is uniform treatment.

However, for purposes of facilitating discussion, a long phased program is also proposed in this section. It should be noted that this should be considered only if the Basic Pension in the solidarity pension is preserved for all participants in the second pillar, so that there is at the very least a basic benefit until the end of life.

4.1.1. Forms of Annuities

When a worker reaches pension age (63) he or she should ideally use the amount on his or her individual account to purchase one of the forms of annuities that will be specified in the law. If the amount is insufficient to purchase an annuity, there will be two other alternatives—withdrawal, and phased payouts--discussed later. In addition phased payouts may be chosen by some persons even with larger amounts, as discussed below.

The CBA (or FSA) should license insurance companies to provide annuities for mandatory accumulative pensions and supervise their activities. The CBA should maintain a list of licensed insurance companies that can provide such annuities in Armenia. A worker should be free to choose from which licensed insurance company he or she purchases an Annuity.

The recordkeeping entity of the pension system should notify a worker in writing of his or her impending pension age approximately six (6) to twelve (12) months prior to

pension age and shall also provide her or him with the standard forms necessary to apply for an annuity as well as information about insurance companies licensed to provide annuities in accordance with applicable law. These standard forms relate to releasing the pension funds— applications for annuities are to be made on each company's forms.

A transfer payment should be made to the licensed insurance company chosen by the worker approximately thirty (30) days before the worker reaches pension age, provided that the worker gives notice of the date of reaching pension age and the details of the licensed company from which he or she will purchase an annuity according to instructions. Payment of the annuity should begin approximately thirty (30) days after the transfer of the balance to the insurance company selected. Appropriate timeframes should be specified in the law. This presupposes monthly payments—one of the means of reducing the administrative costs and maximizing pension return is to pay on a less-frequent basis— and this possibility should be discussed and addressed.

Each licensed insurance company should offer several types of annuity, including a single life, options for married persons and options with a guarantee period. The basic types can be described as follows:

(a)**Single Life.** A single life annuity payable until the death of the pensioner It should be noted that these types of annuities are no longer offered in most developed countries—although they are actuarially justifiable [i.e. those dying early are balanced by those living longer than predicted], because it is generally seen to be unfair on an individual basis [if a pensioner dies shortly after purchasing an annuity, the insurance company gets to keep the entire accumulation]. Even though this form of insurance exists, it may be better not to allow it.

(b)**Single Life with Guarantee.** A single life annuity guaranteed for a period of at least five (5) years whereby if the pensioner dies during the guarantee period, the outstanding payments which would have been paid to the pensioner for that period shall be paid to beneficiaries designated by the pensioner; the guarantee could extend for a longer period, such as ten or twenty years, but this will make the annuity more costly;

(c)**Survivor.** A survivor's annuity payable for the life of the pensioner and then to his or her spouse for the remainder of his or her life in a fixed percentage (usually ranges from 50 to 100%). In drafting the law, we will need to discuss what constitutes a "spouse" [i.e. legally-married, living together for defined period of time, same-sex benefits, etc.]. Another issue is whether we want to consider survivor benefits for children under a certain age, either in lieu of or together with spousal survivor benefits. ;

(d)**Survivor with Guarantee.** A survivor's annuity payable for the life of the pensioner and then to his or her spouse for the remainder of his or her life with a guarantee period of at least five (5) years whereby if the pensioner and his or her spouse both die within a five (5) year period (or such longer guarantee period) the outstanding payments which would have been paid to the spouse from the date of his or her death until the end of the guarantee period shall be paid to beneficiaries designated by the

pensioner; the guarantee could extend for a longer period, such as ten or twenty years, but this will make the annuity more costly. For instance, TIAA-CREF, the largest private defined contribution pension system int eh US, offers a twenty year option.

It is desirable to allow market development and for the law to provide that other types of annuity as are specified in rules to be issued by the CBA from time to time can also be offered.

If a worker has a spouse at the date of reaching pension age, he or she should be obliged to purchase an annuity of the type specified in section (c) or (d) above. Many pension systems have a one year marriage requirement or exclude spouses after receipt of the pension. The exclusion of spouses when a marriage takes place after receipt of pensions is because the life expectancy of the spouse was not factored in at the time the annuity was taken. Exclusion of short term marriages (less than a year) is common in pension systems where there is a concern to protect the person about to retire from a fortune hunter.

The CBA needs to be empowered to issue rules specifying the manner of making and revoking beneficiary designations.

4.1.2.Uniform Rates

In order to prevent adverse selection and discrimination, some second pillar laws also provide that an insurance company providing annuities pursuant to the mandatory pension system must establish uniform annuity rates by which the annuity purchased may vary only on the basis of the age of the annuitant, the age of his or her spouse (if a survivor annuity is purchased), and the amount paid to the annuity provider. Annuity rates vary from company to company (within a range of 15-20%), depending upon actuarial projections, business efficiencies, business plans, etc. Rates must be allowed to vary from time to time, to reflect changes in actuarial assumptions, future projections, actual experience, etc. while being uniform for all customers at any one time.

Companies providing annuities within the mandatory pension system should be required to publish their annuity rates and make these available to anyone who requests them and also provide them to the CBA. The uniform rates provided by a particular company should only vary over time.

It should be discussed whether any rules to be issued by the CBA should apply to setting of rates. One perspective is that rates should be based on market realities and that the CBA should not second guessing the companies' actuaries. Another perspective might be that the CBA should set some parameters on considerations used by the actuaries.

Likewise, a licensed insurance company providing annuities pursuant to the law regulating the mandatory pension system could be prohibited from refusing an application to purchase an annuity so long as the applicant satisfies such requirements set out in the law or in rules to be issued by the CBA.

A number of second pillar laws require that a company providing annuities within a mandatory system may not impose any special terms or rates on the grounds of health, gender, race, religion, nationality or any other similar criteria. Annuities are the reverse of life insurance. Life insurers will naturally want to discriminate against those who are in poor health, and in favor of those in good health. It is in the interest of an annuity-issuer to take as many annuitants in poor health as possible, knowing that the annuity payments will cease or decline to survivor levels before the average age of disability/death. Life insurers are able to determine [through medical examinations] who is unhealthy and likely to die or become ill earlier than the average. Companies issuing annuities may similarly be able to guess who will live longer than the average from medical examinations of from occupations. The draft law will need to take a policy position to either allow differential pricing or not, for example for smokers, miners, etc.

4.1.3. Technical Reserves as required by regulator

A company providing annuities should satisfy such requirements for the maintenance of technical reserves as shall be specified in rules to be issued by the CBA.

4.1.4. Collateral Benefits as Inducements to Sales

In order to prevent overly aggressive sales, it is desirable to prohibit insurance companies and their salespeople from offering any collateral benefit to a person for the purpose of persuading that person to purchase an annuity (this refers to various consumer products offered as part of an aggressive selling campaign). Also offering any collateral benefits to an employer or affiliated persons of the employer for the purpose of inducing or rewarding that employer to persuade or require its employees to purchase an annuity from a particular provider should be prohibited. This should not apply to “benefits” in the sense of better rates from the outset.

4.2. Phased Payments

Phased payments may have to be required for smaller individual accounts that are too small for an annuity purchase, as discussed below. In addition, there is a possibility of arranging for phased payments over a longer period of time instead of annuities. This might be an attractive option to people who are unwilling to commit all of their resources to an annuity company, or who have other family or financial considerations. The following long term phased payments might be considered:

- Phased payment for a long time, perhaps twenty years, that ends several years after the life expectancy of the individual. Any balance remaining at the time the participant dies would be paid to heirs. There is a risk that the participant will outlive his resources.
- Phased payment of investment return only, while allowing the amount standing to the account to be inherited.

4.3. Death Prior to Retirement

There needs to be provision for workers who die prior to pension age and have not purchased an annuity. The balance on such accounts should be paid to (or transferred to pension accounts of) beneficiaries in accordance with the law within approximately thirty days after written notice of the death (precise time to be specified in the law). Persons claiming to be beneficiaries should have a fixed time (maybe up to six months) after the death of the worker to submit claims. It should be made feasible to determine that a beneficiary who is a legal spouse is entitled to the entire individual account and to pay this amount immediately upon such determination. There is also a need to make provision for ascertaining the reconciled amount standing to the individual account at the time of payment and to send any amount determined to be due after the payment is made based on a subsequent reconciliation within a reasonable time (perhaps ninety (90)) days of any subsequent reporting date when it is determined that a reconciled balance is due. There has to be provision fro making determinations as to eligibility of the applying beneficiaries and the appropriate disposition of the individual account, perhaps by rules issued by the CBA. Any disputes as to such decisions with respect to beneficiary payments should be resolved according to general dispute resolution procedures adopted in the law. It should also be possible to reclaim any amount erroneously attributed to beneficiaries.

4.4. Small Accounts

It is also necessary to address the contingency of small accounts, too small to purchase annuities. The law might specify that if the value of the individual account at pension age is less than a certain sum (adjusted for inflation), at pension age the worker shall receive the amount in a lump sum payment upon providing notice as required. There should also be provision for phased withdrawals in case the amount is too small for annuity purchase but could be paid over a series of years. The mechanics of phased withdrawals [i.e. for what term? expected life? expected life plus a fixed number of years? reducing payments? increasing payments to reflect increased need for healthcare?] could be discussed in the law but details could be left to regulations.

4.5. Disability or Terminal Illness

If a worker is determined to be totally disabled and incapable of work prior to reaching pension age pursuant to the applicable law, the worker should be able to purchase an annuity or receive a lump sum or phased withdrawal distribution of the individual account balance, as appropriate. (The options for disability insurance generally were addressed separately above.)

Most terminal illnesses will also involve a disability determination. However, in case that does not occur for some unusual reason, the same provision ought to apply to a person with a terminal illness: the second pillar account should be available for distribution.

4.6. Transfers for those moving to another country

If a worker ceases to be a resident of Armenia, the balance on the individual account may be transferred to another pension account licensed and regulated within a member state of the OECD or possibly with a country with a bilateral agreement, provided it is payable to the worker only at pension age or disability, and provided that applicable legislation permits such transfer. Workers could request such transfers after terminating their employment in Armenia for which contributions were made. Transfers would have to be requested in a manner and on a form designated as approved by the CBA. Transfer payments should be made no later than some reasonable time (perhaps thirty (30) days) after the transfer request is completed and filed.

4.7. No Transfers for Short term Emergencies or large Purchases

Some mandatory second pillar systems, primarily the Asian provident funds, allow for withdrawals from the second pillar for major purchases (such as a house) or expenses (a wedding). This is not a good practice as it completely undercuts the purpose of second pillar, which is retirement security. We recommend that this not be permitted.

4.8. Regulatory Authority

In addition to rules specified elsewhere in the insurance law, it might be necessary to authorize the CBA to issue additional rules. If the annuity issuers are only going to be insurance companies, many of these rules will be contained in the insurance law and regulations. If they are, they should not be separately addressed in the pension law and regulations. According to the new law companies will not be able to write life- and non-life insurance. Current insurance law provides for employment of actuaries, but whether or not there are any qualified actuaries to employ remains doubtful.

Areas of possible rules might be:

(a) Selling and marketing of annuities;

(b) Accounts of annuity providers;

(c) Dissolution, merger and acquisition of annuity providers;

(d) Reporting obligations of annuity providers;

(e) Procedures to be followed if an annuity provider is unable to satisfy its obligations under the law;

(f) Method and timing of payments for all annuitants, including those living abroad; and

(g) Such other matters, as the CBA deems appropriate.