



Pillar II Pension System Development **CONCEPT**

National Securities and Stock Market Commission

DRAFT FOR DISCUSSION

This concept is consistent with the globally
accepted IOPS (International Organization of Pension Supervisors) principles

Prerequisites for Pillar II Implementation in Ukraine

To ensure the enhancement of current pension provision for citizens, Verkhovna Rada of Ukraine by the Law #2148-VIII set requirements of necessity for cumulative pension provisions. Starting from January, 1 , 2019, such contributions will be obliged simultaneously with the payments to the pay-as-you-go system.

The following changes to financial market legislation must be made before Pillar 2 is launched

01

#DraftLaw2413a

Consolidating the Pillar 2 entities supervision and control functions under NSSMC

Currently, such functions are divided between two regulators: the National Securities and Stock Market Commission (NSSMC) and the National Commission for State Regulation of Financial Services Markets (FSR).

02

#DraftLaw6303

Strengthening the institutional capacity of NSSMC as a market regulator

To supervise Pillar 2 entities and ensure effective protection of pension system participants, as well as to prevent capital market abuse, an institutionally capable regulator is needed.

The Ukrainian Parliament must consider and pass these bills before Pillar 2 is launched

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1

**International Experience of
Pillar 2 Implementation**

Prerequisites for Pillar II Implementation in Ukraine

The following changes to financial market legislation must be made before Pillar 2 is launched



Objective

National laws must set a clear and unambiguous objective for pension supervisors and determine their specific responsibilities.



Independence

Pension supervisors should be independent in their activities, including financially independent.



Adequate Resources

Pension supervisors require sufficient financial, human and technical resources to perform their functions effectively and independently.



Adequate Powers

To perform their functions and accomplish their tasks, pension supervisors should be given necessary authority for conducting investigations and enforcing compliance of market participants.



Attitude towards Markets

Pension supervisors should strive to minimize major potential risks to the pension system and take a pro-active approach, addressing problems before they arise



Proportionality and Consistence

Pension supervisors must strive for the proportionality of actions taken by them in relation to markets and be consistent in their actions.



Interaction and Information Exchange

Pension supervisors must interact with supervised entities and exchange information with other supervisors, both domestic and foreign.



Confidentiality

Pension supervisors must establish a proper confidentiality regime and information protection framework to prevent unlawful disclosures.



Transparency

Pension supervisors must carry out their activities in a transparent manner, report regularly about their activities and be open to an external audit.



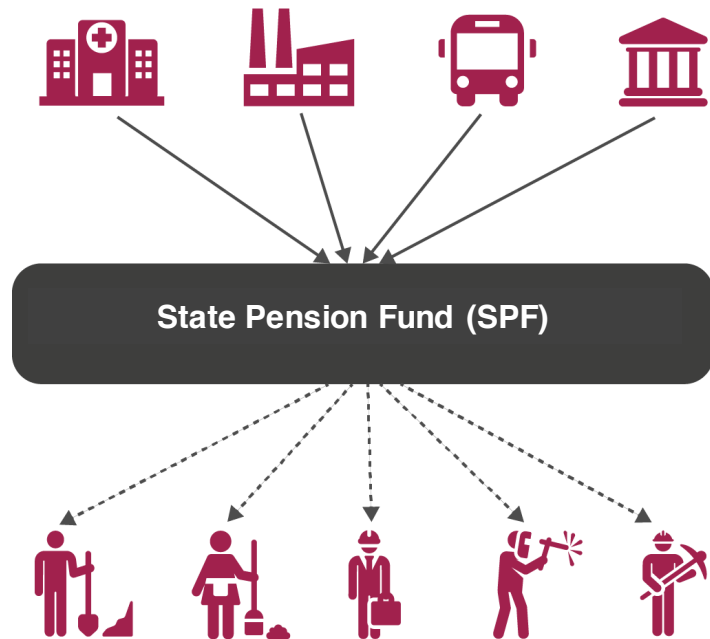
Management and Accountability

A supervisor must abide by its own governance rules and be accountable to the President, the Parliament and other stakeholders

International Experience. Key Pillar 2 Models

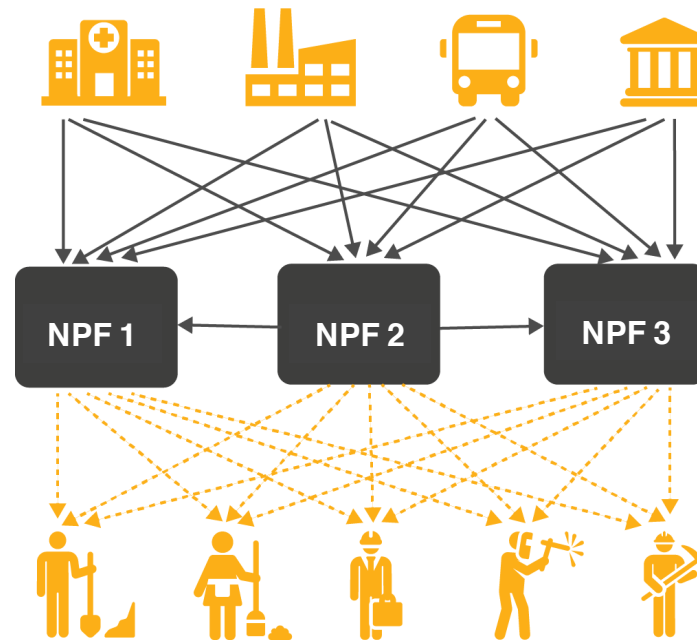
Key pillar 2 models can be divided into four types: from fully centralized to decentralized models

Full centralization (Kazakhstan after reform)



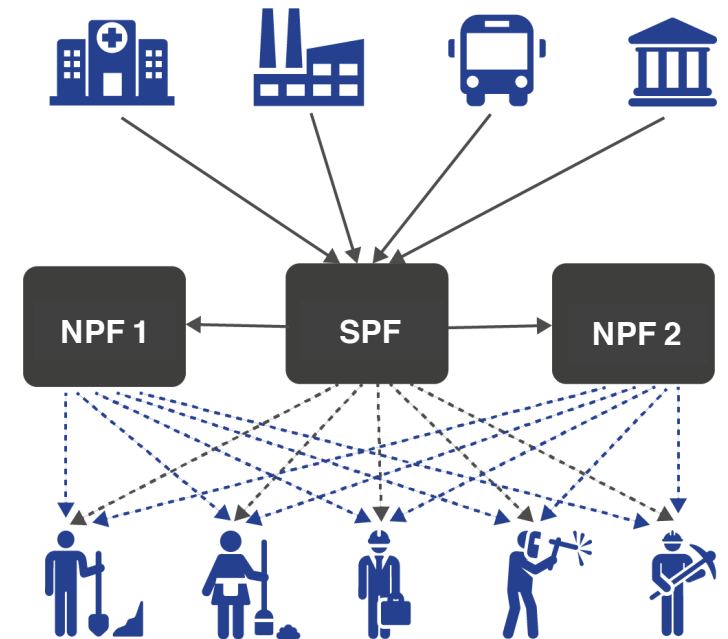
The State is fully responsible for creating infrastructure and providing services. Pillar 2 costs are lowest. However, there are significant fiduciary and political risks.

Full decentralization (Chile, Hungary)



The State has practically no responsibility for creating infrastructure or providing services. However, Pillar 2 administrative costs (explicit and implicit) are highest and a burden for system participants

Mixed Model A (Poland, RF)

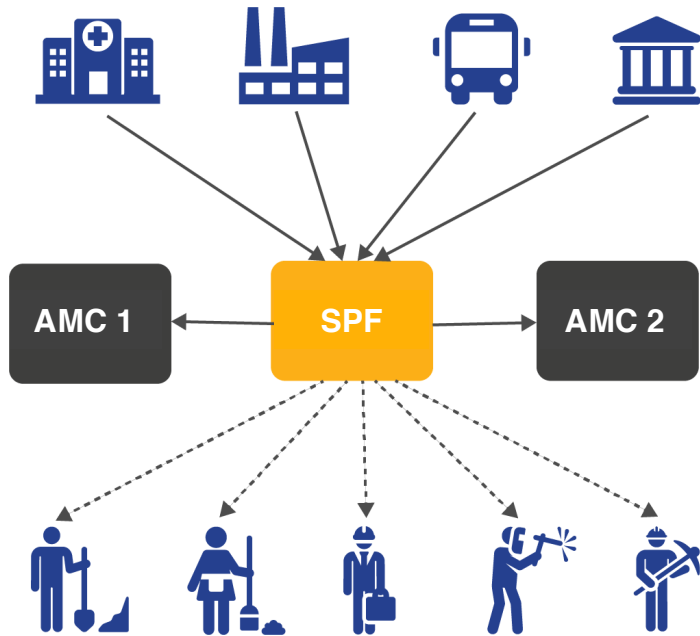


The State plays a leading role in Pillar 2, including the distribution of contributions to private (non-state) funds (NPFs) and administration of the default option, but do not keep personalized records of those who have chosen NPFs

International Experience. Key Pillar 2 Models

Mixed Pillar 2 models allow for using the existing elements of the solidarity system and minimizing administrative costs

Mixed Model B (Sweden, Croatia)



The State plays a leading role in Pillar 2, including the centralized keeping of personalized records, which results in significantly lower administrative costs. Assets are managed by asset management companies (AMCs) rather than by the State

Swedish experience

Collecting contributions

Tax Authority

Collecting personalized data

Tax Authority (tax returns)

Clearing transactions

Swedish Pension Agency

Storing information on individual accounts

Шведське пенсійне агентство

Managing pension assets

"Blind" fund managers (do not keep individual records)

Communicating with clients (choosing funds, changing funds, annual individual accounts, etc.)

Swedish Pension Agency

The accumulation pension system is created, first and foremost, to provide supplementary pension benefits to its participants and operates for this purpose

Decent pension benefits from the accumulation pension system are possible provided that:

Key points

The accumulation pension system produces positive results under conditions of macroeconomic stability

- Administrative, political and investment risks are minimized
- Sufficient contributions are paid
- Administrative costs are low
- There are effective investment returns

02

Principles of Pillar 2 Development in Ukraine

Pillar 2 Development Principles



- Minimize administrative costs of market participants by achieving economy of scale
- Minimize government costs on supervision
- Ensure that the State controls the payment of contributions
- Ensure that the system is transparent and clear for participants
- Mitigate risks of losing pension assets
- Ensure that there is competition in asset management

Pillar 2 Development Principles

In designing of Pillar 2 in Ukraine, a mixed model is proposed as a basis



The Accumulation Fund (AF) will be established as a separate legal entity with the organization-legal form – social business. AF tax status: a non-profit.

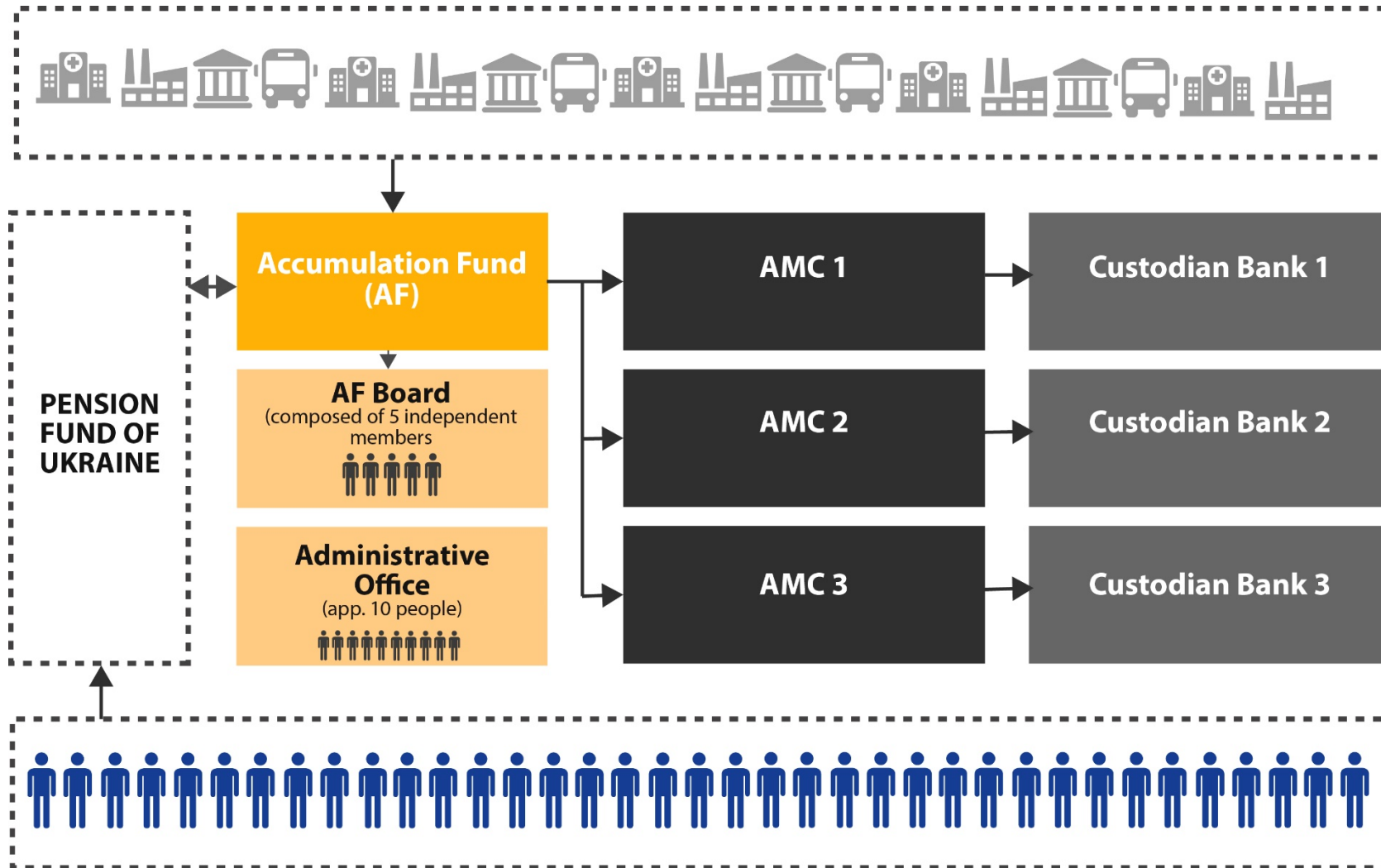


The overall operating supervision of the system will be exercised by the AF Board, operating functions will be performed by the Administrative Office. The Pension Fund will provide personalized record keeping services to AF.



AF assets will be managed by asset management companies (AMCs) licensed for Pillar 2. The function of storing pension assets will rest with custodian banks licensed for Pillar 2.

Pillar 2 Model Proposed for Ukraine



All elements of the pillar 2 system that are profitable provide the competition and participation for only commercial service providers!

Benefits of the proposed model:

- A centralized cost part that does not generate profits;
- The development of the system based on the existing software complex of PFU, which will avoid significant costs for the development of new software ;
- System service costs are passed on from participants to PFU

Functions of the State and Bodies of the Accumulation Fund

REGULATOR (NSSMC)

- License Pillar 2 asset management companies and custodian banks;
- Supervise Pillar 2 entities;
- Determine requirements for accounting policies of asset management companies;
- Determine diversification requirements for investments of pension assets (for the portfolio);
- Register the AMC investment declaration (AMC portfolio);
- After custodian banks are determined by AMCs, verify and monitor them for conflicts of interests.

ACCUMULATION FUND BOARD

- Choose auditors on a competitive basis;
- Approve AF accounting policies;
- Consider quarterly and annual reports of asset management companies, custodian banks, PFU;
- Analyze the performance of asset management companies, develop benchmarks to adjust ratios in the default distribution system for passive participants;
- Approve the budget for AF operations and the Administrative Office of the AF Board;
- Determine a custodian bank for each asset management company if there are more than one bank;
- Appoint the Director of the Administrative Office.

ADMINISTRATIVE OFFICE

- Handle AF paperwork;
- Keep accounting records and perform audits of AF;
- Manage and monitor cash flow in participants' accounts.

Functions of Pillar 2 Entities

It is advisable to provide for centralized performance of administration functions in Pillar 2

PENSION FUND OF UKRAINE

- Communicate with participants (enter into contracts, administer the personal choice, etc.);
- Keep personalized records and provide services to system participants;
- Manage pension benefits, make lump-sum payments and pay defined period benefits;
- Coordinate planning of pension benefits with the Administrative Office;
- Clearing under pension obligations.

PILLAR 2 ASSET MANAGEMENT COMPANY

- Manage Pillar 2 pension assets;
- Calculation of net asset value.

PILLAR 2 CUSTODIAN BANKS

- Keep Pillar 2 pension assets;
- Monitor investment transactions of AMCs;
- Daily confirmation of the net asset value (NAV);
- Daily calculation of a pension unit;
- The provision of information to PFU on net asset value and unit value on a daily basis for distribution to participant' accounts.

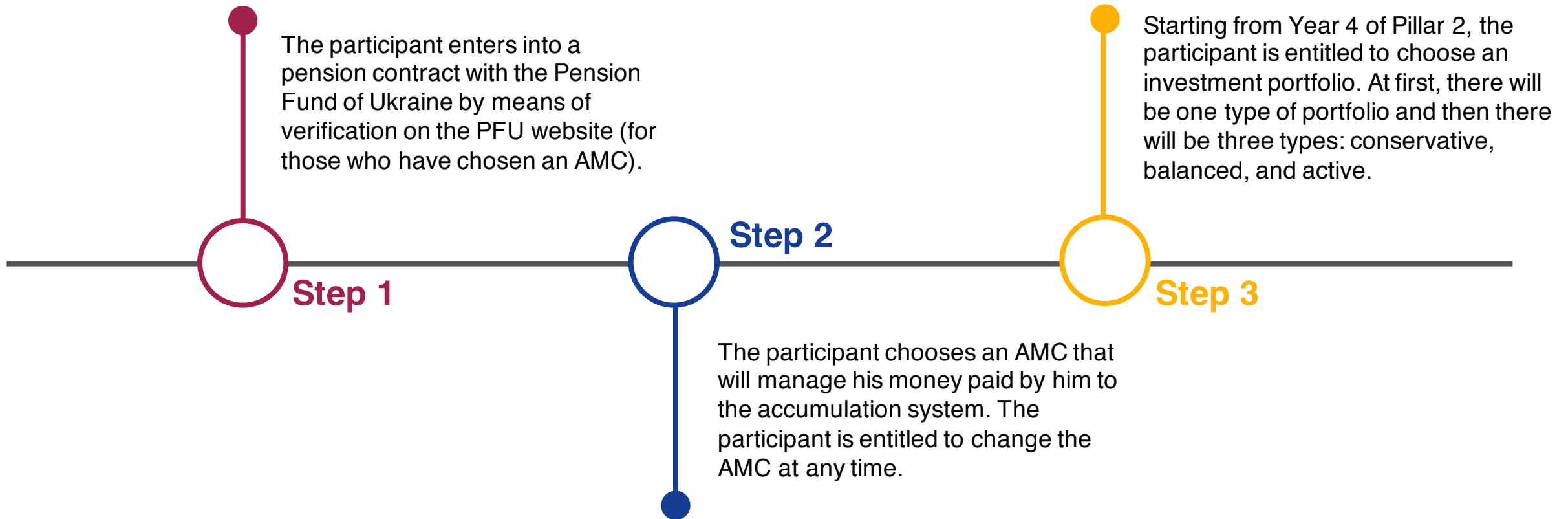
Requirements for Pillar 2 Elements

Requirements for asset management companies and custodian banks will be established by the following elements

- 01** Company capital requirements
- 02** Company staff requirements, including experience and business reputation
- 03** Transparent ownership structure
- 04** Fee calculation and disclosure requirement
- 05** IT system requirements
- 06** Internal audit and internal control requirements
- 07** Risk management requirements
- 08** Compliance function requirements
- 09** Conflict of interest control requirements
- 10** Lack of fundamental or systemic violations of legislation over the past 5 years

Algorithm for Pillar 2 Participant

Participation in the system is mandatory for all categories of employed people until they reach a legal retirement age



The Default Distribution System for Passive Participants

Distribution of pension assets and passive participants will be carried out proportionally between asset management companies
The distribution procedure will be established by NSSMC, and the distribution itself will be carried out by PFU

01 At first, all Pillar 2 participants are entitled to make their own choice of AMC

02 Pillar 2 participants who will not make their own choice will be distributed by default among AMCs admitted to Pillar 2

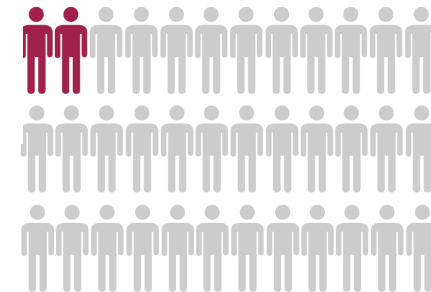
03 Starting from Year 2 of the system operation, AMCs' performance will influence the results of the default distribution

According to preliminary estimates of NSSMC:

Their own choice of AMCs will be made by no more than

2%

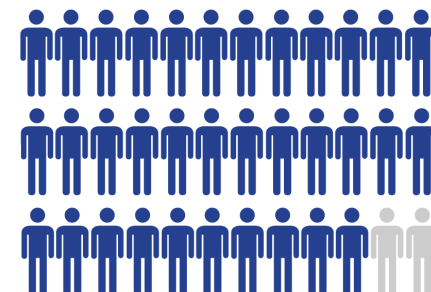
of participants



about 0.25 mln. people

98%

of participants will be in the default distribution system



about 12.75 mln. people

Distribution of Informational and Financial Flows

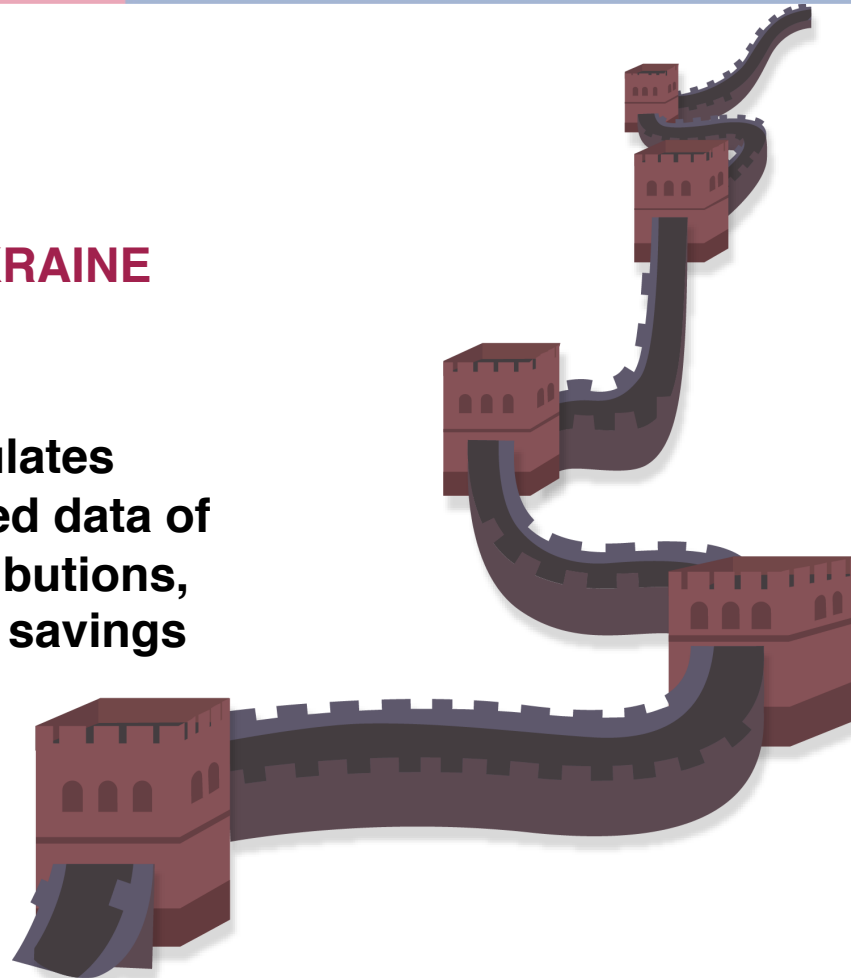
The AF Board and the Administrative Office will not have access to personalized data, and PFU will not be able to manage participants' contributions

PENSION FUND OF UKRAINE

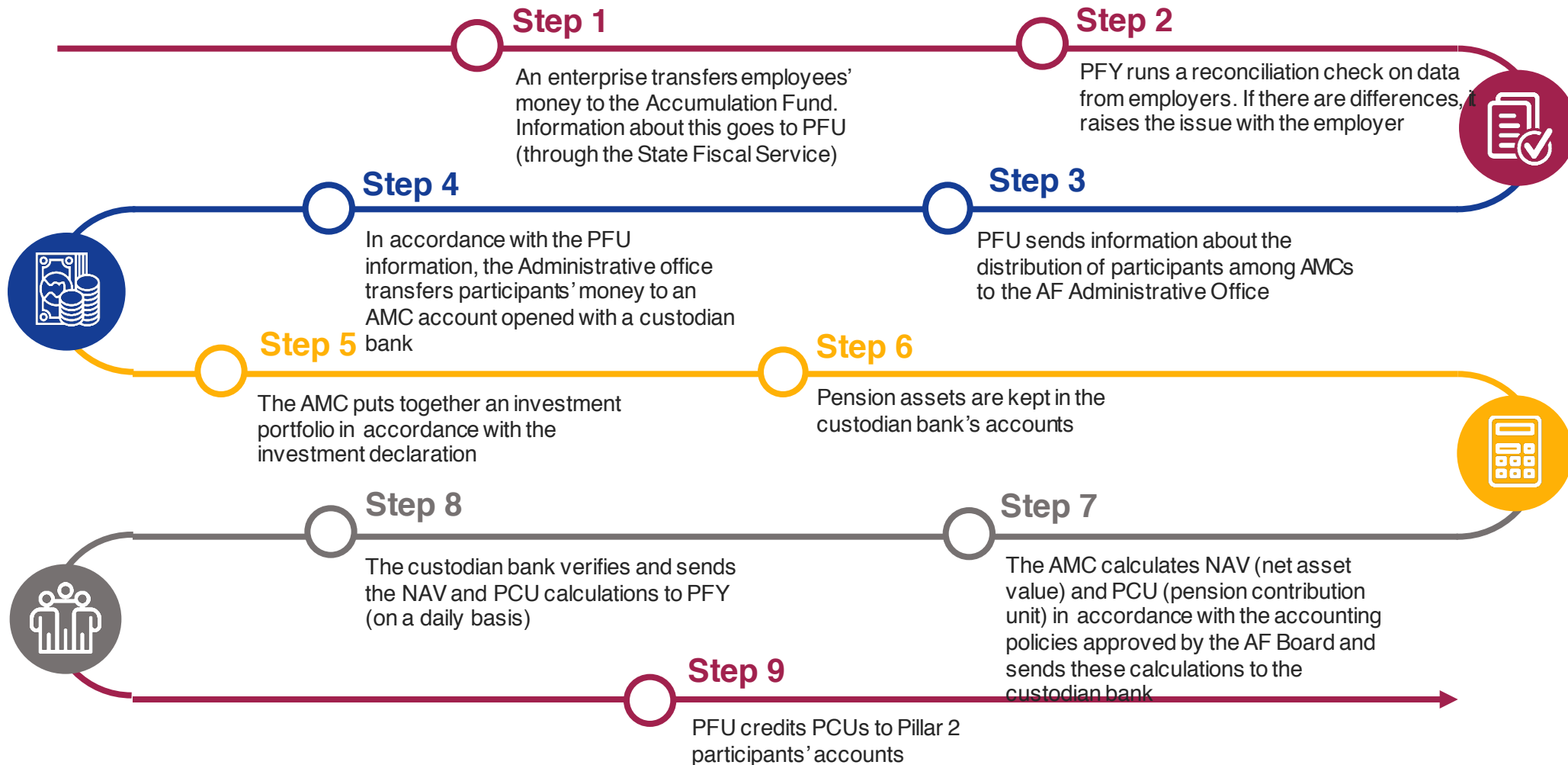
Collects and accumulates information – personalized data of participants, their contributions, amount of accumulated savings

ADMINISTRATIVE OFFICE OF THE ACCUMULATION FUND

Manages the AF's current account for participants' contributions

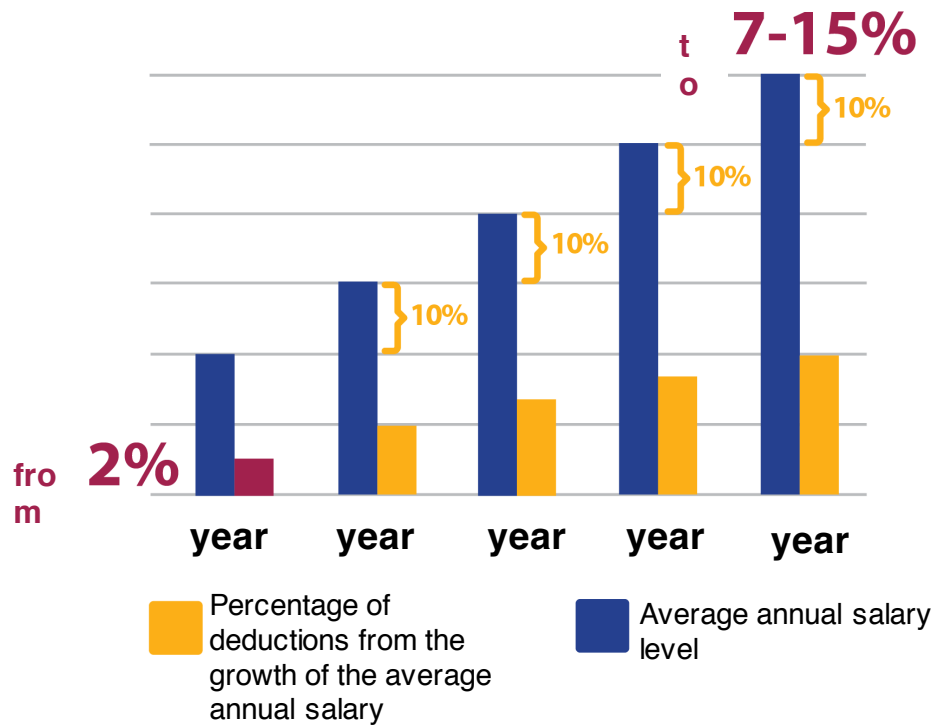


Pillar 2 Contributions Flow Chart



Pillar 2 Contribution Rates

Contributions to the Accumulation Fund are paid by employees



In Year 1 of the system operation, the contribution rate is expected at 2% of an employee's salary.

Each successive year, the contribution rate will increase by 10% of the growth rate of the average annual nominal salary.

The contribution rate will increase only if the average annual salary grows, i.e. if the wellbeing of citizens improves.

For self-employed persons, there will be a fixed contribution rate that depends on the turnover and category and is linked to the minimum wage.

It will take 6 years for Ukraine to reach a contribution rate of 7%, 10 years - 10%, 17 years - 15%.

The Replacement Rate As a Result of Pillar 2

Pillar 2 participants who will pay contributions for 30 years can increase their replacement rate in addition to the solidarity system

The replacement rate is one of key performance indicators of the pension system

HIGH
replacement
rate

The pension system **can** preserve the same lifestyle after retirement

a deduction of 7%

men

10,2

women

7,3

LOW
replacement
rate

The pension system **cannot** preserve the same lifestyle after retirement

a deduction of 10%

14,6

10,4

a deduction of 15%

21,7

15,4

Detailed assumptions:

- 1. The retirement age after 2021 remains at 60 years for women and men
- 2. Provides planned real yield of 2% per annum until 2025, and 1.5% after 2025
- 3. Provides real GDP growth at 3.5-4% per year until 2025, and the slowdown after 2025 gradually to 1-2%

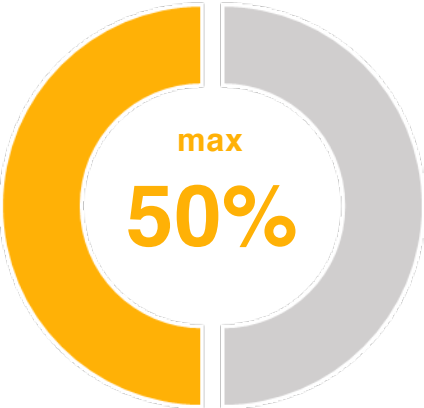
Investments of Pension Assets

NSSMC will set restrictions on investments of pension assets

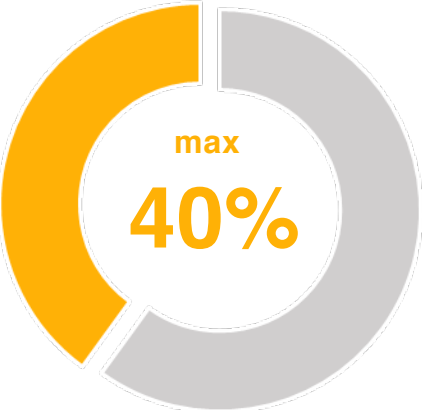
At the beginning of the system operation, it is planned to set the following restrictions on investments of pension assets:



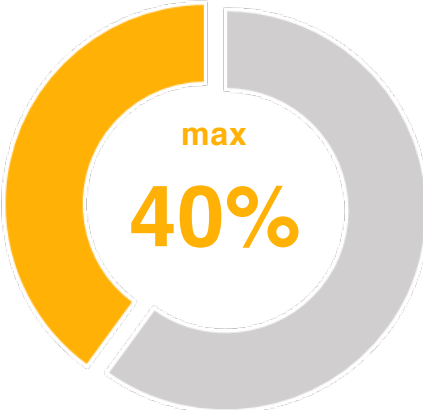
Securities with the redemption and income guaranteed by the Cabinet of Ministers (**domestic government bonds**)



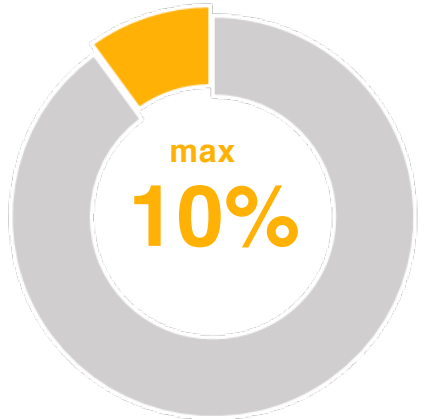
Cash in money market instruments, but no more than 10% of the total value of pension assets in the instruments of one bank



Listed stocks, but no more than 10% of the total value of pension assets in the stock of one issuer



Listed corporate bonds, but no more than 10% of the total value of pension assets in bonds of one issuer



Foreign securities, but no more than 5% of the total value of pension assets in securities of one issuer

It is expected that Pillar 2 participants will be offered three types of portfolios: conservative, balanced, and active. Each of these portfolios will have a clearly defined investment regime. At the early stages of the system operation, only a conservative portfolio will be offered.

Types of Pension Benefits

The system should provide for the possibility of the flexible use of different pension instruments

01 Lump-sum benefits

If, at the time of retirement, the amount in a person's pension account is less than 60 minimum salaries, this person will be paid a **lump-sum benefit**.

02 Defined period pension

If, at the time of retirement, the amount in a person's pension account is more than 60 minimum salaries, this person can choose one of the options – **defined period pension** (at least 10 years) or **life-time pension** (annuity).

03 Life-time pension

Life-time pension benefits will be paid on a voluntary basis under separate agreements with insurance companies.

In case of the person's death, the ownership of pensions savings should be transferred to its successors.

It is advisable to provide for the use of early (on treatment, etc.).

Guarantees of the Preservation of Pension contributions

Issue to be discussed: guarantee options for the preservation of pension contributions of Pillar 2 participants

Potential options:

direct government guarantees for the amount of contributions (e.g., for the last 1.5 or 5 years)

insurance of contributions
(regular deductions from AF)

ongoing control of benchmark compliance

Potential consequences:

This option leads to additional budget expenditures

This option leads to lower return on pension savings

This option provides no direct guarantees but aims to establish a clear indicator – benchmark – and monitor its compliance on an ongoing basis (to be done by the AF Board and the regulator)

The last option is most acceptable in terms of the burden for the system

Pillar 2 Taxation

The Accumulation Fund will be established as a social business. AF tax status: a nonprofit

Pillar 2 contributions are exempted from taxation and deducted before the collection of all taxes and charges



Minimum salary*

3720 UAH

Average salary **

8777 UAH

Investment returns which participants will get from Pillar 2 are exempted from taxation



Share of savings in income**

>2%

Replacement rate in mandatory system

33% → 20%

Benefits paid from the Accumulation Fund are not subject to taxation



Minimum pension payment *

1373 UAH

Average pension payment *

2448 UAH

Taxation of pension savings can only be introduced after stabilizing the economy and achieving a certain level of replacement rate. Taking into account the favorable tax regime, it is necessary to limit the amount of non-taxable contributions and non-taxable pension benefits (for example, the size of the minimum wage).

* according to the State Budget of Ukraine for 2018

** according to Ukrstat data for 2017

***after recalculation of pensions in October 2017

A Possibility for the Opt-out

To implement the opt-out, it is necessary to strengthen requirements for Pillar 3* entities to the requirements set for Pillar 2

Prerequisites for the opt-out must be:

- 01** A new license to be obtained by the Asset Management Company and the Administrator;
- 02** Compliance of the Administrator and NPF with requirements set for Pillar 2 entities
(capital requirements, HR and business reputation requirements, existence of independent directors, transparency of the ownership structure, remuneration disclosure, internal audit, risk management, compliance, liability, etc.);
- 03** No conflict of interest between the Administrator, NPF, and the Board (now, in most cases, AMC-Administrator-Private Fund (NPF) are related parties;
- 04** Change a custodian status for NPFs: this function can now be performed only by those who have obtained a license for Pillar 2;
- 05** NSSMC is granted the right to intervene and bar the AMC or the Administrator from professional activities by canceling their license;
- 06** Change requirements for NPF asset structure in accordance with pension investment requirements for Pillar 2;
- 07** Establish a barrier ("Chinese wall") between informational and financial flows in the Pillar 2 system, in particular between the AMC and the Administrator;
- 08** Introduce daily reporting based on results of NAV and PCU calculations.

***Due to the Law №1057-IV. on Non-Government Pension Funds from 09.07.2003 current 3rd level of Pension system - is a system of non-state pension provision according to which citizens and employers voluntarily make contributions in favor of themselves or third person party on individual pension accounts to non-state pension funds. These NPFs served by professional licensed service-providers such as Asset management companies and Administrators (provided personal pensions accounting, bookkeeping, reporting).**

Ukraine. Pillar 2 Scale Estimate



Detailed assumptions:

Pillar 2 will be launched on January 1, 2019 by introducing additional contributions, apart from USC and regardless of the state of the solidarity system.

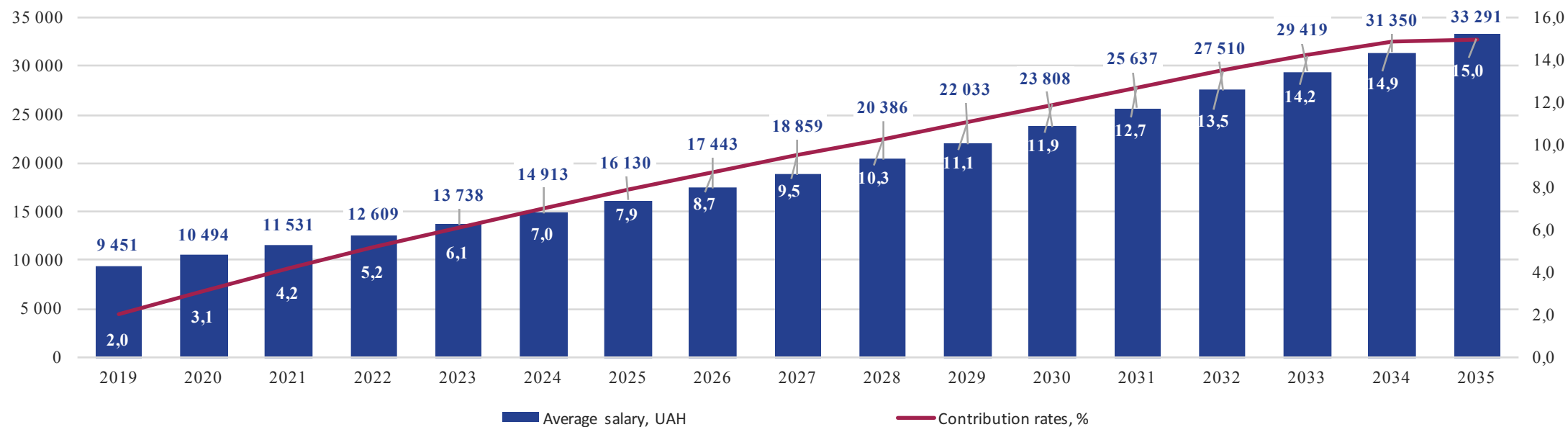
Participation in the system is mandatory for all categories of employees.

A contribution rate increases in accordance with the nominal salary growth rate, starting from 2%, with sub-options at a maximum rate of: 7%, 10%, and 15%.

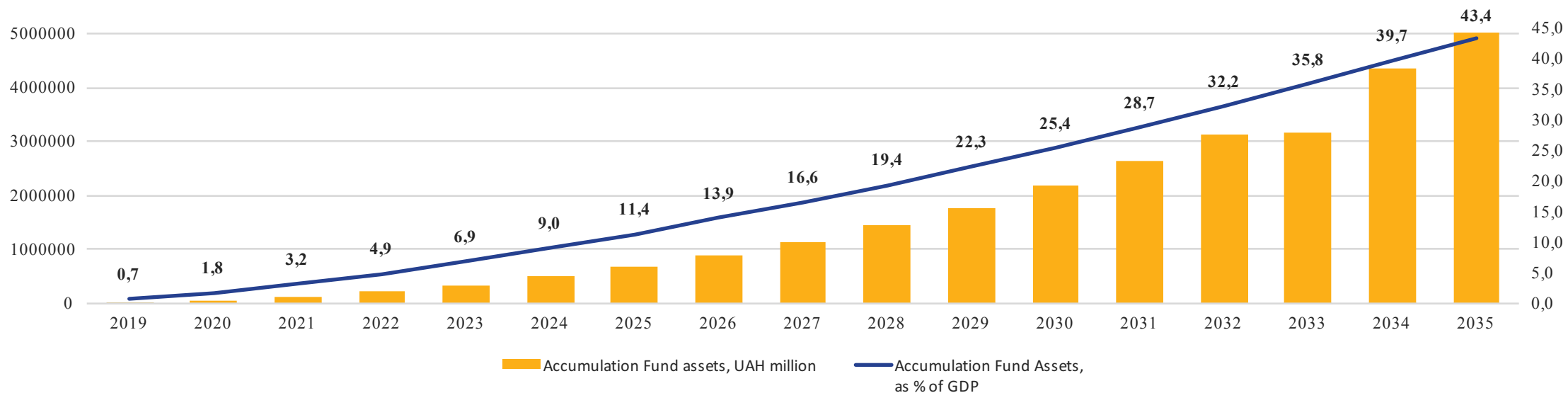
At the beginning, the retirement age in the Pillar 2 system is 60 years for men and women (the benefit is granted at the age of 60).

		2020	2030	2040	2050
Accumulation Fund Assets, UAH million	7%	69 319	1 704 367	4 799 875	7 954 217
	10%	69 319	2 085 509	6 514 032	11 159 476
	15%	69 319	2 178 748	8 614 862	15 951 310
Accumulation Fund Assets, as % of GDP	7%	1,8%	19,9%	34,0%	41,3%
	10%	1,8%	24,3%	46,2%	57,9%
	15%	1,8%	25,4%	61,1%	82,8%
Average amount in the account of one participant (at current prices), UAH 	7%	2 494	167 503	643 890	1 616 851
	10%	2 494	196 705	851 578	2 213 243
	15%	2 494	200 312	1 077 189	3 026 856
Average amount in the account of one participant (at current prices), UAH 	7%	815	88 713	418 195	1 138 930
	10%	815	94 054	545 852	1 560 679
	15%	815	94 054	663 721	2 129 249

Growth of average salary (UAH) and contribution rates (%)



Growth of the Accumulation Fund assets (UAH million), as % to GDP



03

Useful Information about Pillar 2 in Other Countries

International Experience. Pillar 2 Costs

Analysis of Administrative Costs of Pillar 2 and Pillar 3 Entities in Some OECD Countries, 2013 (as % of assets)

COUNTRY	%
Czech Republic	1,5
Estonia	1,4
Spain	1,2
Slovenia	1,2
Hungary	1,0
Slovakia	0,8
Australia	0,8
Mexico	0,7
Turkey	0,7

COUNTRY	%
Chile	0.6
New Zealand	0.6
Greece	0.5
Switzerland	0.5
Poland	0.5
Austria	0.5
Israel	0.5
Canada	0.4
Luxemburg	0.3

COUNTRY	%
Belgium	0.3
Norway	0.3
Iceland	0.2
Great Britain	0.2
Portugal	0.2
Germany	0.2
Netherlands	0.1
Denmark	0.1
Finland	0.1

The average administrative cost of Pillar 2 in the EU countries is 0.56%

International Experience. Main Features of the Pillar 2 System

Main features of mandatory Pillar 2 of some European countries

COUNTRIES	Retirement age (M/F)	Contribution rate, %	Year of introduction	Participation in the system (mandatory or voluntary) at the time of introduction
Bulgaria	from 60/55 to 63/60	from 2% to 5%	2002	Mandatory for all employees younger than 42 years old, without the right of choice for other categories
Estonia	from 60/55 to 63/63	6% (2% - person, 4% - government)	2002	Mandatory for new (young) employees, voluntary for persons aged 19 to 60 years at the time of introduction
Latvia	from 60/55 to 62/62	from 2% to 8%	2001	Mandatory for persons younger than 30 years old, voluntary for persons aged 30 to 50 years
Lithuania	from 60/55 to 62/60	from 2,5% to 5,5%	2004	Voluntary for all employees
Poland	from 60/60 to 67/67	7,3% at the beginning	1999	Mandatory for persons younger than 30 years old, voluntary for persons aged 30 to 50 years
Romania	from 62/57 to 65/60	from 2% to 6%	2008	Mandatory for persons younger than 35 years, voluntary for persons aged 36-45 years
Slovakia	from 60/57 to 62/62	9% at the beginning	2005	Mandatory for those born after 1983, voluntary for persons insured before 2005
Hungary	from 60/55 to 62/62	from 6% to 8%	1998	Mandatory for new (young) employees, voluntary for all employees at the time of introduction

Most EU countries had a small Pillar 2 contribution rate and now some of these countries began Pillar 2 reforms, because the amount of accumulated funds is not sufficient for people to maintain the same lifestyle after retirement.

International Experience. Replacement rate

Europe

COUNTRY	Replacement rate
Austria	78.4
Spain	72.3
Slovakia	72.3
Greece	67.4
Estonia	62.0
Hungary	58.7
Sweden	55.8
Latvia	47.5
Poland	31.6

World

COUNTRY	Replacement rate
China	96.0
Argentina	81.7
India	87.4
Brasilia	85.0
Australia	82.8
Canada	54.1
Russia	46.1
Chile	39.1
OECD	64.6

International Experience. Tax regulation

Analysis of tax regulation in OECD countries, 2015

EEE Bulgaria, Slovak republic	EET Canada, Chile Japan, United Kingdom, The United States, Croatia, Estonia Finland, Germany, Greece, Iceland, Ireland, Latvia, Netherlands, Norway, Poland Romania, Slovenia, Spain, Switzerland	TET Austria, Belgium, France, Israel, Korea, Malta, Portugal
ETE Cyprus		ETT Denmark, Italy, Sweden
TEE Mexico, Czech Republic, Luxembourg, Hungary, Lithuania		TTE Australia, New Zealand, Turkey

In general, OECD and EU countries are used
6 modes of taxation of pension savings

TTE	Taxed Taxed Exempt	T=taxed
TEE	Taxed Exempt Exempt	E=exempt
ETT	Exempt Taxed Taxed	
EET	Exempt Exempt Taxed	1 - pension contributions,
ETE	Exempt Taxed Exempt	2 - investment income,
EEE	Exempt Exempt Exempt	3 - retirement benefits

EET is the most common tax treatment - only pension benefits are taxed. It is used by 18 out of 35 OECD countries (51%), including 13 EU countries.

EEE - the most favorable tax treatment. He was chosen as solely a political decision to encourage pension savings in a stagnant economy, Bulgaria, the Slovak Republic, partially Lithuania, Hungary.

But in such variant, usually the amount of non-taxable contributions and non-taxable pension benefits is limited, for example, by the size of the minimum salary, etc.



04

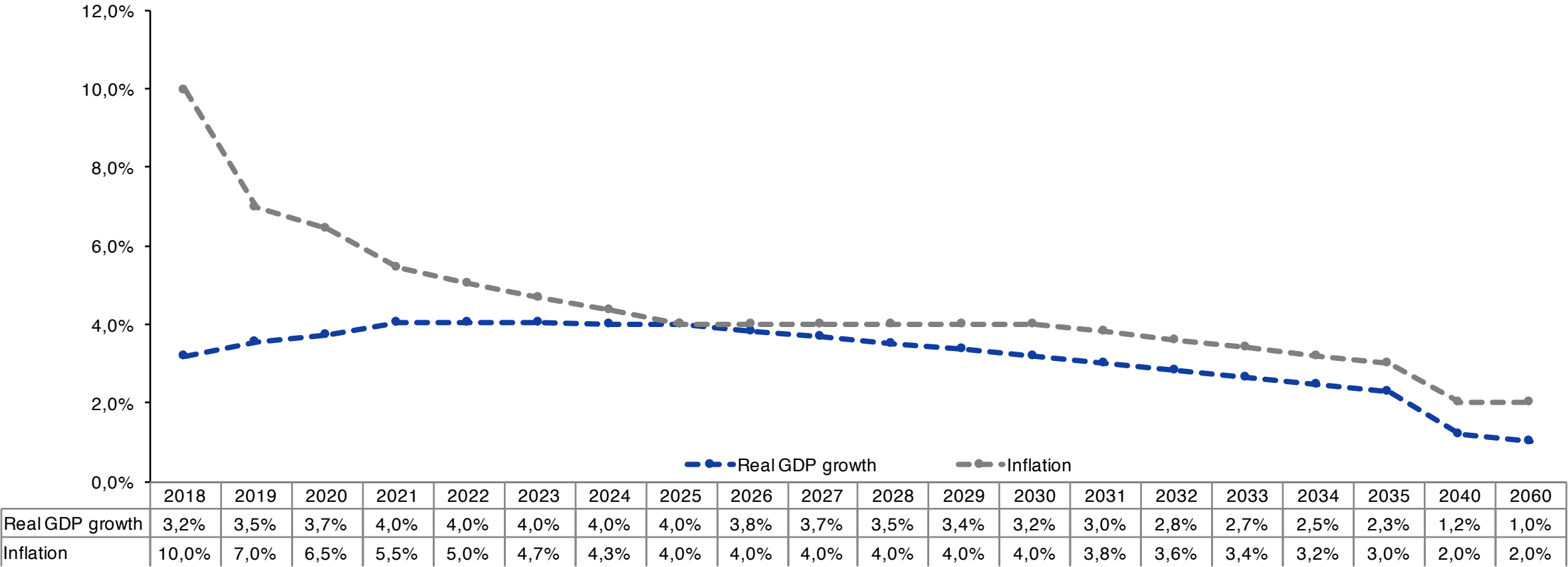
**Macroeconomic Forecasts Concerning
Ukraine and Pillar 2 Scale Estimates**

Ukraine. Demographic Assumptions

Indicator	2016	2020	2025	2030	2035	2040	2045	2050	2055	2060
Life expectancy at birth, years										
men	66,7	68,6	69,7	70,5	71,2	71,8	72,4	72,9	73,5	74,0
women	76,5	77,2	77,7	78,2	78,6	79,1	79,5	79,9	80,3	80,7
Life expectancy at 60 years of age, years										
men	15,3	16,8	17,3	17,7	18,1	18,5	18,8	19,1	19,4	19,7
women	20,6	21,2	21,5	21,9	22,2	22,5	22,8	23,1	23,4	23,7
Total fertility rate										
Children per woman	1,5	1,6	1,6	1,6	1,6	1,7	1,7	1,7	1,7	1,7

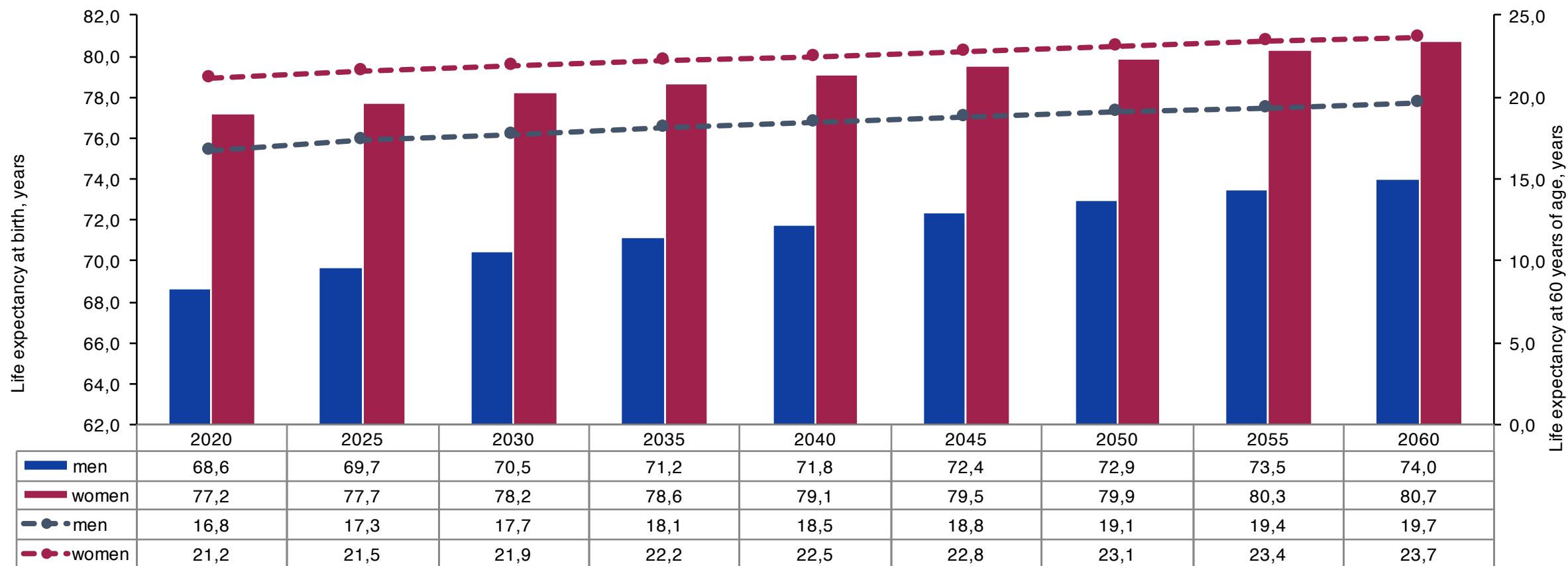
Source: State Statistics Service (actual data for 2016), Ptoukha Institute for Demography and Social Studies of the National Academy of Sciences of Ukraine
Forecast option: "average fertility rate, life expectancy, zero migration"

Ukraine. Economic Assumptions



Sources: State Statistics Service (actual data for 2016), Ptoukha Institute for Demography and Social Studies of the National Academy of Sciences of Ukraine (forecast for 2019 through 2022), World Bank experts' assumptions and internal assumptions of NSSMC

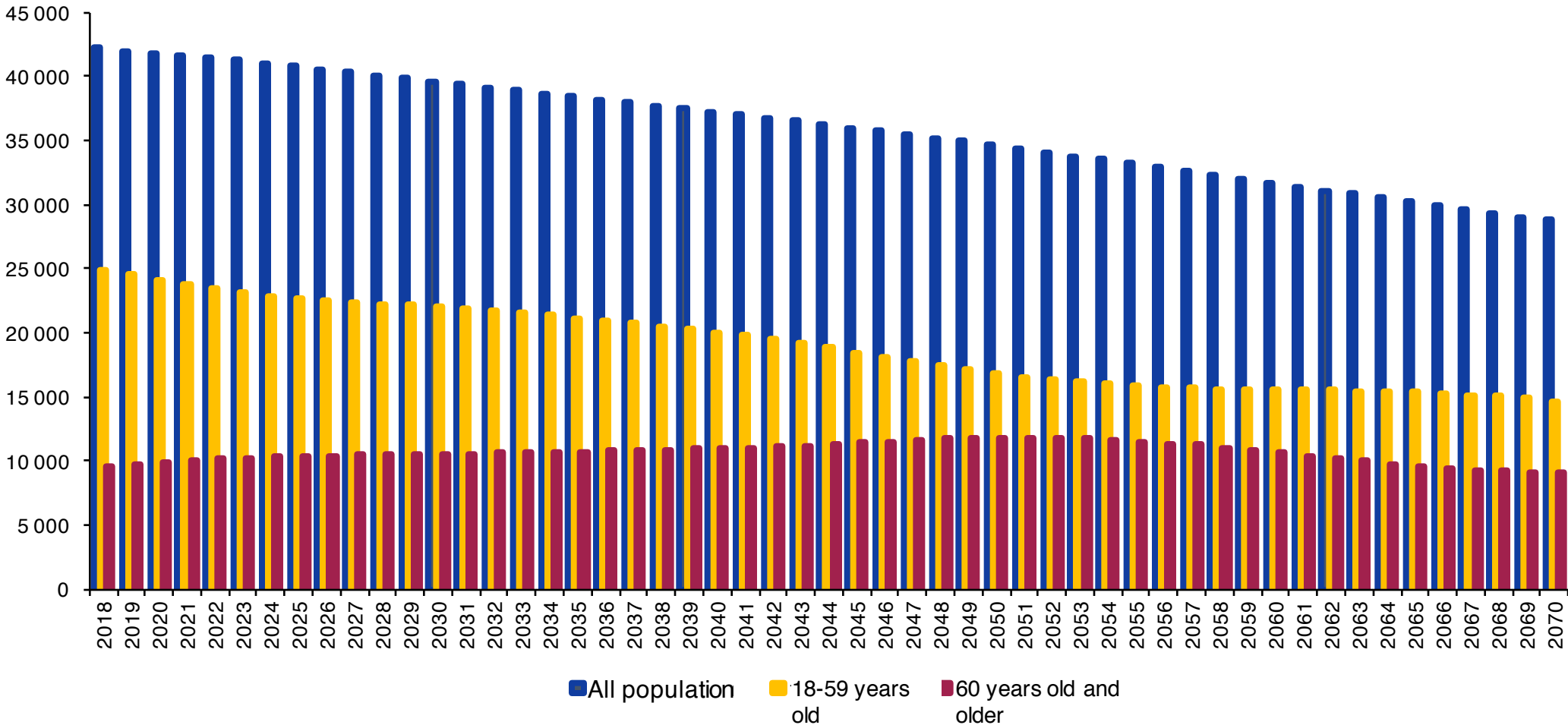
Ukraine. Economic Assumptions



Sources: State Statistics Service (actual data for 2016 and 11 months of 2017), Cabinet of Ministers Resolution 906 of Dec. 1, 2017 (forecast for 2018, scenario 1), IMF World Economic Outlook Database October 2017 Forecast option: "average fertility rate, life expectancy, zero migration"

Ukraine. Estimates of Demographic Indicators

Forecast option: "average fertility rate, average life expectancy, zero migration"



Sources: State Statistics Service (actual data for 2016 and 11 months of 2017), Cabinet of Ministers Resolution 906 of Dec. 1, 2017 (forecast for 2018, scenario 1), IMF World Economic Outlook Database October 2017 Forecast option: "average fertility rate, life expectancy, zero migration"