



Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulating their activity
Twinning Project AZ/13/ENP/SO/24



ANNEX 29

Recommendation on amendments to be introduced to secure administrative processes of funded part of labour pension at the State Social Protection Fund of Azerbaijan Republic

1. Introduction

The idea of the state funded pension scheme is to invest additional part of social insurance contributions on the voluntary basis with a goal to increase the pension capital. The implementation of the State funded pension scheme will not only affect the amount of the pension for its participants but will also facilitate a development of the national economy in general by providing availability of long-term investments and after transitional period - stimulating the financial market.

The funded component will be started from “nothing” not only in Social State Protection Fund of Azerbaijan Republic but also in Azerbaijan in general. All institutions providing the operation of the funded component should develop new IT systems, administrative procedures, train employees as well as ensure the operation of data registration and transfer systems, provide fast data transfer as well as a high level information security and protection.

Since SSPF does currently not deal with the management of funds, the implementation of the fully funded scheme would require the fund to develop and enhance its capacity to manage funds.

2. Context and Finding

According to the Law “On Labour Pensions” of the Republic of Azerbaijan old age pension capital is the amount registered in the insurance part of a personal account as well as the amount accumulated in the funded part of a personal account. Funded part of individual account is a sub-account accumulating the mandatory state social insurance contributions that are paid for the insured in accordance with the correlation established by the appropriate executive authority and that are taken into account for calculation of funded part of labour pensions, as well as the incomes generated from the turnover of these funds.

Labour pensions are administrated by the Social State Protection Fund of Azerbaijan Republic (SSPF). Similarly the SSPF work out proposals on the state policy in the area of social insurance, collect the mandatory state social insurance contributions and ensure personal accounting system.

Personal accounting system has been established in mandatory state social insurance area. The individual account with the permanent social insurance number is opened by the SSPF in the accounting period for every insured person.



Each insured person receives annual report reflecting relevant data on personal account.

Currently the establishment of the legislation on funded part is carried out. According to the project of the Law on Funded Part of the Labour pensions the SSPF is going to be the executive authority. SSPF should register contributions made to funded part, inform the person regarding to the funded part, conclude contracts with private pension funds, prepare reports on the operation of the funded part and etc.

To provide successful implementation of the funded part the personal accounting system should be upgraded establishing the flow of all necessary information and contributions among SSPF, pension funds, custodian bank and clients. Structural changes and additional processes should be implemented in the SSPF.

As one of the structural changes a default fund is required for the thorough implementation of the funded part of labour pensions. Default funds are the investment instrument for members who want to participate but do not specify their preferred asset allocation. In the context of the voluntary funded component default funds are required at three levels.

The first level is at the introductory phase: In that phase of the funded component, contributory payments are collected by SSPF, however, the funds are not invested in the financial market in a broad sense. Instead those funds are invested in a safe financial instrument e.g. bank deposits or instruments issued by the government. The rationale for such a concept is to keep financial risk and turmoil out of the pension scheme as long as portfolios are small.

The second level is after the introductory phase. A default fund is required to play the role of a “pending fund” into which funds are put while waiting instructions on how to invest them.

At the third level, the default fund to be established after the introductory phase should take into account the long-term horizon of pension saving and therefore provide for more developed portfolios. It should include two options: One is for those who want to invest only with minimum or no risk. Such a default fund would invest in real (i.e. with implicit or explicit inflation protection) government bonds.

The second option for a default fund should be designed according to life-cycle smoothing principles. This means assets are moved from riskier – and more profitable – investments at earlier ages to index bond allocations at later ages, closer to retirement. Within the spectrum of life-cycle fund designs the portfolio of a default fund should probably be towards the cautious end.

3. Recommendations are divided in following sections:

3.1. Organizational issues

3.1.1. Head sector in central office of SSPF



The introduction of funded component could be established in the Department of Individual Account as a separate sector responsible only for the implementation of funded part. The main functions of this section will be to deal with contract matters between SSPF and Fund managers; consider and draft legal amendments; instruct and negotiate with fund managers, provide all kinds of support to local offices, co-ordinate activities with other organisations, evaluate and endorse reports on reconciliation, provide training, and quality assurance to local bodies; instruct and supervise the trading in financial markets, and have continuous contact with fund managers, Central Bank, custodian bank and State Treasury.

The staff of the “funded pension sector would preferably have the following education and/or skills and interest - an economic degree (business finance or accounting) or comparable experience; a degree in mathematics or comparable experience; a law degree or comparable experience; precise; like to work in teams and to work alone; willing to co-operate with persons and organisations internal or external the SSPF; interested in the financial business; client orientated; English in speaking and writing.

3.1.2. Work at the local bodies of SSPF

To provide successful implementation of the funded part and provide a client oriented approach the staff of the local bodies of the SSPF should have a general knowledge and competence on the funded part, e.g. information regarding the funds and application forms. In some of the local bodies (in larger regions) should be some local office experts shall deal with more difficult information about funded part business, such as dividends, split and compulsory change of fund. This inspector should also provide the CDS inspectors training.

3.1.3. Interface to other departments of the SSPF:

For a successful implementation of the funded part a close cooperation between the departments of SSPF is of paramount importance. First and foremost cooperation must be ensured with the

- *Legal department* regarding the conclusion of contractual agreements with financial institutions,
- *Financial department* and the *analytical or forecasting department* for defining, negotiating and finally monitoring such agreements, as well as to ensure the transfer of money to the asset holders, organise auditing of the annual reports and accomplish the accounting of the administration expenses

In addition those activities must be reflected in the accounting and in the individual account department. Finally risk management capacities must be developed at appropriate levels.

Strong links must also be ensured with

- *Personnel department* that will provide training in case of the amendments to the legislation, changes on the operation of the IT system, also in cases when the new contracts with the fund managers are concluded as well it will accomplish the



recruitment and appointment of additional personnel to ensure a smooth operation of the funded pension scheme.

- *Public Relations department* – will participate in the information campaign and ensure the publication of report in press,
- *Information Technology Service Centre* – will provide IT/IS services for the administration of the funded pension scheme within the scope of current functions.

3.1.4. Default fund

SSPF will be entrusted the management of the “default fund” (mentioned above) during the introductory phase and the “pending fund” afterwards. These would require to strengthen the capacity of various departments to deal with market based transactions. The fund must conclude contractual agreements with a suitable third parties to invest the funds and administer the assets in line with a set of agreed rules and purposes.

After the termination of the introductory phase, most of the acquired capacities will still be required to run the “pending fund”.

In addition – as described above – the establishment of default funds with more sophisticated investment strategies should be envisaged. While SSPS may retain the tasks related to account administration, it is recommended to outsource the *financial management* of those default funds of third level to a third party financial institution.

In case that recommendation is not followed and the investment part of the default fund is managed internally, SSPF would need to acquire most of the capacities of a fully-fledged licensed pension fund.

The organizational development then should be oriented to a well tried pension fund model and tried to emulate and adjust it. Dutch pension funds would be a good starting points. The deliberation of the details of such an approach would require inputs which go far beyond the scope of the current project.

3.2. Co-operation with other organizations

A successful implementation of the State funded pension scheme is a cooperation of several institutions. Well managed information and money flow will have the crucial role in the provision of successful operation of the State funded pension scheme.

There are institutions that are involved in the administration of the funded part, with whom the SSPF did not have to co-operate before, as well as there are some new functions for the existing co-operation partners (State Treasury as a fund manager). The new co-operation partners of SSPF will be the representatives of the financial market – fund managers, custodian banks.

3.3. Administrative costs

The maximum amount of the administration (administrative) expenses of the funded pension scheme as well as procedure for payment for expenses of SSPF for



administration of the funded pension scheme are determined by the regulations of the Cabinet of Ministers.

The expenses of SSPF for administration of the funded pension scheme could consist of two main sub-groups:

- 1) start-up costs - development of IT systems, development of sector (establishment of working places), training of employees, public information campaign
- 2) maintenance costs - could be relatively divided into administration expenses and expenses that depend on the number of the participants of the scheme or number of clients (development and printing of forms, payment of postage expenses (sending of notifications regarding the affiliation to the scheme or change of the fund)

During the first year of the operation of the funded pension scheme there could be two possible financing sources of the start-up costs (investments):

- 1) loan from the basic state budget;
- 2) resources of the social insurance special budget;
- 3) subsidies from the general state budget.

Based on the estimation of SSPF the maintenance expenses for administration of the funded pensions should be estimated by SSPF

3.4. Training

The development of additional and enhanced capacity would require significant efforts in training of the staff members to be appointed to those tasks. Probably it will be also advisable to hire a more senior manager with experience in commercial fund management. That will get the fund acquainted with the business practices of financial markets at a faster pace.

The additional capacity must be tailored to put the fund in a position to monitor and ensure compliance with the agreements on a day-to-day basis.

The training is necessary for employees at all levels, so it will be necessary to identify appropriate target groups. There could be the following groups:

- Managers (head of departments, directors of local bodies) – funded part and its ideology; knowledge regarding the operation process of the funded pension scheme,
- Managers of local bodies – funded part and its ideology; general knowledge regarding the securities, investment companies and other issues related to the capital market; operation process of funded pension scheme; use of the IT system applications for funded pension scheme;
- Local bodies inspectors - funded part and its ideology; general knowledge regarding the securities, investment companies and other issues related to the capital market; operation process of funded pension scheme; use of the IT system applications for funded pension scheme;



Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulating their activity
Twinning Project AZ/13/ENP/SO/24



Some employees at larger local bodies should be trained in operational issues of funded pension schemes. Having acquired such expertise they should be appointed as multipliers and should provide general training for other employees of the local office in respect to securities, investment companies and other issues related to capital market, and the application and input of the IT system for the funded pension scheme.