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 44

Blueprint of establishment non-state pension institutions and development of legal framework in Azerbaijan

Activity 3.1.
„Development of a blueprint to facilitate and regulate the development of private, voluntary pension arrangements“

MINISTRY OF WELFARE OF THE REPUBLIC OF LATVIA

SSPF

Gesellschaft für Versicherungswissenschaft und -gestaltung e.V. GVG

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1. Introduction

Private pensions play an important and growing role in providing for old age. As one of the main types of institutional investors, it also plays a significant role in fulfilling the diverse financing needs of various sectors of an economy and thus contributes to the economic development of a country as well as to the deepening of its financial system and promoting stability. Understanding the different features of private pensions, their role in retirement income arrangements, and their performance is essential for policymakers to design better schemes.

Blueprint of establishment non-state pension institutions and development of legal framework in Azerbaijan will provide wider context for developing private pension funds and will focus on specific aspects regarding to Azerbaijan's financial and economical situation.

This Blueprint "**For establishment non-state pension institutions and development of legal framework in Azerbaijan**" describes:

- the types of Pension Management companies and their licensing rules,
- the types of pension plans provided to pension plan members,
- participation rules in pension plans – for individuals and employers
- the rights and obligations of pension plan members,
- the asset management functions,
- the custodian functions,
- State supervision of such activities.

2. Recent developments of private pension systems across the Europe

Many pension systems across the European Union need some degree of adjusting to ensure that they can deliver adequate pensions on a sustainable basis.

Private pension systems are facing pressing and broad challenges. The economic crisis led to a reduction in government revenues to finance pay-as-you-go public pensions, leaving space for a growing role for private pensions in providing for old age. However, population ageing and the current economic environment are introducing challenges to the ability of private pensions to deliver adequate retirement income.

Population ageing is leading not only to an increase in the number of people in retirement relative to the size of the working-age population, but also most importantly to an increase in the number of years that people spend in retirement, at least when the retirement age is not increased adequately. This may affect the **solvency of defined benefit** (DB) pension plans and the **adequacy of income derived from defined contribution** (DC) pension plans.

DB pension funds are exposed to the longevity risk owing to uncertainty about future improvements in mortality and life expectancy. If pension promises are calculated based on a life expectancy that is underestimated, the actual pension payments will be

larger than expected and DB pension funds may lack sufficient assets to cover their future liabilities.

For DC pension funds, higher life expectancy means that accumulated assets must fund longer retirement periods if people do not adjust their retirement age, potentially rendering the resulting pension amount inadequate to maintain the desired standard of living in retirement.

The current economic environment characterised by low returns on investments, low interest rates and low growth is compounding these problems. These factors may lead to lower resources than expected to finance retirement promises or simply to lower retirement income. Low returns on investments reduce the expected future value of benefits, as assets accumulated will grow at a lower rate than expected. Low interest rates may reduce the amount of pension income that a given amount of accumulated assets may be able to deliver, especially in DC pensions. In DB pensions, low interest rates may increase future liabilities and lead to solvency problems. Additionally, low economic growth may reduce the overall resources (employer and employee contributions) available to finance retirement.

Complementary retirement savings have to play a greater role in securing the future adequacy of pensions, so countries **will have to find ways of improving the cost-effectiveness, safety and equitable access to supplementary pension schemes. Tax and other financial incentives, as well as collective bargaining play an important role here.** These tools are being used in very different ways across the world, so there is considerable scope for mutual learning.
Addressing gender equality aspects will also be crucial in order to avoid widening the existing gender gaps, as **women currently have fewer opportunities to build up supplementary retirement savings than men**.

The crisis has highlighted the vulnerability of funded pension schemes to financial crises and economic downturns. It has also emphasised the need to review the regulatory framework and scheme design to improve the safety of private pensions. The EU has legislative competences in this area, and two instruments are already in place: the Directive on the protection of employees in the event of insolvency of their employer and the Directive on the activities and supervision of Institutions for Occupational Retirement Provision (IORP).

The Green Paper consultation has confirmed that the Single Market is a key instrument to support pension adequacy and fiscal sustainability. There is untapped potential to realise further efficiency gains through scale economies, risk diversification and innovation. The EU can strengthen its framework to support occupational retirement provision within the overall pension system of Member States and to contribute to the reduction of the cost of pensions.
This is why the IORP Directive will be reviewed with the aims of further facilitating the cross-border activity for IORPs and modernising their supervision, taking into account the different types of IORP in Member States. **In addition, there is a need to improve the quality of financial products for individual retirement savings not linked to employment, such as third pillar schemes and other financial products used to supplement the incomes of the elderly.**

Improving consumer information and protection is necessary to enhance workers' and investors' confidence in financial products for retirement savings.
Thus they can demonstrate the benefits of working longer and of making complementary retirement savings so as to maintain an adequate income after retirement.

An enhanced role of complementary private retirement savings depends first of all on better access to supplementary schemes and their cost-effectiveness. Opportunities for complementary retirement savings through occupational and third pillar arrangements are underdeveloped and lacking in cost-effectiveness and safety in many Member States. Thus there would be added value in stepping up European support for better coverage of women and men and the proliferation of good practices including in the optimal targeting of tax incentives for prefunded pension schemes. Governments or the social partners can promote these. **As people in the future will have to rely more on complementary retirement savings, the safety and performance of which will need to be optimised.** Improving hard and soft EU regulation can contribute significantly to this. **Finally, supplementary pension schemes must be compatible with the requirements of flexible labour markets and job mobility.**

Private pension systems also need to be strengthened to ensure that they contribute effectively to retirement income adequacy. Retirement savings took a hit in the initial phase of the global financial crisis but now pension funds' asset and solvency levels have largely recovered. Nevertheless, **private pensions have come under strong pressure in a climate of distrust in the financial sector and in a prolonged low interest-rate environment.**
For example, enthusiasm for funded private pillars has waned in some of the Central European countries: Hungary and Poland have abolished or significantly scaled down their mandatory private pension systems. Partly, this was a consequence of underestimating the fiscal costs associated with the introduction of mixed public-private, partially funded systems. But another reason was growing public discontent with the results of private pension funds due to high administrative fees and disappointing returns of pension funds.
Even in Germany where individual private retirement savings are strongly promoted and subsidized, questions are being asked as to whether public support for private pensions is the right way to go. Sometimes, it is suggested that public money should rather be used to bolster public pay-as-you-go systems.

At the same time, **other countries have been moving in the opposite direction, promoting low-cost, well-managed pension organizations that are better oriented to the needs of low income households.**
A good example is the recently launched National Employment Savings Trust (NEST) in the United Kingdom, which acts as the default in the new national automatic enrolment program. The UK government expects this new system to address the major benefit adequacy gap that lower and middle income households are exposed to, because of the relatively low public pension benefits and the voluntary nature of private pension provision.
This follows an earlier reform in New Zealand that also introduced auto-enrolment for new employees. **Other countries with smaller public systems, such as Ireland, are also recognizing that private pension saving on a purely voluntary basis will not**

result in high coverage rates and sufficient contributions. They are therefore considering either soft compulsion, such as auto-enrolment in private pensions, or even mandatory participation in private pensions.
Other countries that stand out for their prudent and effective management of private pension systems include Denmark and the Netherlands, where, despite the crisis, investment returns have remained positive over the last five-year period in real terms.

While unhappiness with private pensions is understandable in the current economic context, it is important to recall the reasons why countries started to diversify the sources of retirement income in the first place. Private pensions were intended to limit the burden on younger generations by pre-funding at least part of the future pension obligations in a context of often rapid population ageing. This latter demographic challenge persists and moving back to pay-as-you-go systems will not help address the looming pension crisis.
Middle-earners will be the group of people who are at highest risk of not having sufficient retirement income; indeed most countries protect low earners through minimum pensions and old-age safety nets, while most high-income people complement their public pension benefit with income from other sources, including personal savings and investments.

Encouraging private provision for retirement, both through occupational and personal pension plans, thus remains important. But the current debate does highlight the urgency of dealing with the cost issue of running private schemes. It is indeed hard to justify obliging workers to put money into retirement income arrangements in which in the end only the provider makes a profit.

Private pension arrangements have been growing in importance in recent years, as pension reforms have reduced public pension entitlements.
In 18 OECD countries from 34, private pensions are mandatory or quasi-mandatory (that is, they achieve near-universal coverage of employees through collective bargaining agreements).
In a further eight OECD countries, voluntary private pensions (occupational and personal) cover more than 40% of the working age population.

In 2011, for countries for which data are available, on average, 76% of OECD private pension markets was held by pension funds, 19% was held in pension insurance contracts run by life and pension insurance companies, 4% was held in retirement products provided by banks or investment management companies, and 1% were book reserves.

Introducing of public (mandatory or voluntary) and private funded pension provisions there are several objectives to aim:

Primary objectives:

1) poverty reduction among the aged
2) lifetime consumption smoothing

Secondary objectives:

1) increased national savings
2) capital market growth
3) labor market incentives

One of the key indicators of the scale of pension fund's activity is the market value of assets accumulated relative to the size of the economy as measured by the GDP. The higher the value of their investments, the greater will their ability to provide high benefits to individuals.

The OECD weighted average asset-to-GDP ratio for pension funds increased from 77.1% of GDP in 2012 to 84.2% of GDP in 2013, with the Netherlands achieving the highest ratio at 166.3%.
As Figure 3 shows, in 2013, only five OECD countries reached asset-to-GDP ratios higher than 100% – the Netherlands (166.3%), Iceland (148.7%), Switzerland (119.0%), Australia (103.3%) and the United Kingdom (100.7%).
Pension fund assets were of varying importance relative to GDP in the other countries. Only thirteen out of thirty-four countries had **assets-to-GDP ratios above 20%, that is considered the minimum for meeting the OECD's definition of a "mature" pension fund market.**

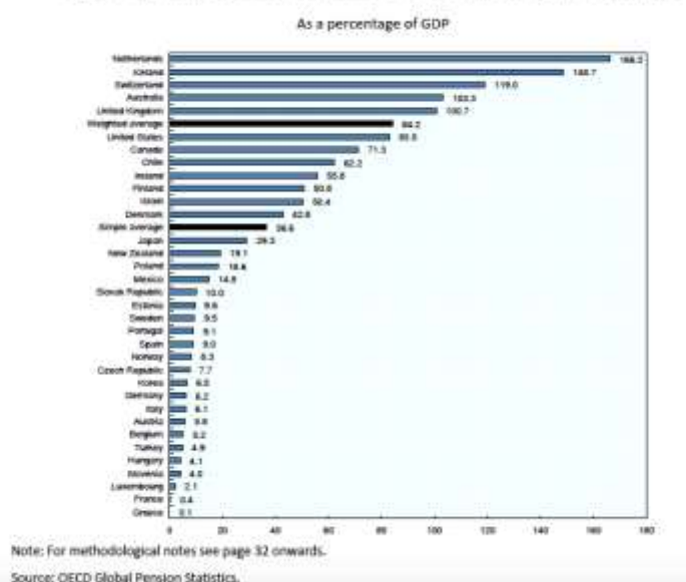
Figure 3. Importance of pension funds relative to the size of the economy in the OECD, 2013

As a percentage of GDP

Note: For methodological notes see page 32 onwards.

Source: OECD Global Pension Statistics.

3. General description, goal and principles of non-state pension savings system

Concept of private pension funds / Pensions management company
Taking into account that in Azerbaijan is on the development stage for financial and capital market infrastructure of financial instruments and intermediation of financial services there would be considered to combine pension fund administration functions with asset management functions in one legal entity - Pensions Management Company to diminish costs and make system more effective for participants of pension plans. In some countries these functions are separated in different financial institutions – private pension funds and asset management companies.
Pensions Management Company (Private pension fund) would be a financial institution for profit (usually Joint Stock Company - JSC) registered in state commercial register and State supervisory authority has been issued special license for pension fund activities.

Main functions of Pension Management Company would be:

- Accumulation of pension plan participants contributions voluntary made by themselves or on behalf by employer or other individuals;
- Investment of pension plan assets regarding to investment strategy of each pension plan;
- Organizing of participants individual accounts and providing information to pension plan participants;
- Marketing of pension plans to potential participants – employers and private persons/individuals;
- Providing of pension benefits (pay-outs) from accrued pension capital to pension plans participants or their heirs in accordance of pension plan rules.

4. Establishment of Pension Management companies (Private Pension funds)

There are 2 types of Pension Management companies would be established:

- Closed Pension Management Companies (CPMC)
- Open Pension Management Companies (OPMC)

CPMC are financial institutions where shareholders (one or several employers) make contribution on behalf of their employees.

OPMC would be created as financial institutions where shareholders would be commercial banks, life insurance companies or asset management companies.

These OPMC would be fully open for everybody – contributions could be made by individuals themselves or on behalf of other individuals (wives, children, relatives etc.) and employers on behalf of their employees can make contributions in accordance to agreement (individual or group agreement).

In financial markets such companies would operate on competitive basis as banks, insurance companies and other financial institutions by providing financial services to private persons and enterprises.
Competition should be based on pricing of products (pension plans) and financial services (advice to potential customers and participants, management of individual accounts, information and self-services provided to participants, fund management and custodian services) provided.

5. Governance of pension funds

In case of Azerbaijan OECD guidelines for pension funds governance would be applicable in setting up Private Pension Management Company, in both cases when asset management services are incorporated in Pension Fund Company or outsourced to external Asset Management Company.

OECD GUIDELINES FOR PENSION FUND GOVERNANCE[1]

I. GOVERNANCE STRUCTURE

1. Identification of responsibilities
There should be a clear identification and separation of operational and oversight responsibilities in the governance of a pension fund. To the extent that a pension entity is established that owns the pension fund on behalf of plan/fund members and beneficiaries, the legal form of this entity, its internal governance structure, and its main objectives should be clearly stated in the pension entity's statutes, by-laws, contract or trust instrument, or in documents associated with any of these. If the pension fund is established as a separate account managed by financial institutions, the pension plan or contract between plan sponsors/members and beneficiaries and the financial institution should clearly state the responsibilities of the latter with respect to the management of the pension fund. As good pension fund governance should be „risk-based", the division of responsibilities should reflect the nature and extent of the risks posed by the fund.

2. Governing body
Every pension fund should have a governing body vested with the power to administer the pension fund and who is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries. The responsibilities of the governing body should be consistent with the overriding objective of a pension fund that is to serve as a secure source of retirement income. The governing body should retain ultimate responsibility for the pension fund, even when delegating certain functions to external service providers. For instance, the governing body should retain the responsibility for monitoring and oversight of such external service providers.
Appropriate oversight mechanisms should also be established where the governing body is a commercial institution.

3. Accountability
The governing body should be accountable to the pension plan members and beneficiaries, its supervisory board (where relevant) and the competent authorities. Accountability to plan members and beneficiaries can be promoted via the appointment of members of the governing body by pension plan members and beneficiaries or their representative organisations. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibility as benefit provider. In order to guarantee the accountability of the governing body, it

[1] *OECD GUIDELINES FOR PENSION FUND GOVERNANCE*
These Guidelines were approved by the Working Party on Private Pensions on 5 June 2009.

should be legally liable for its actions that fail to be consistent with the obligations imposed on it, including prudence. In defined contribution plans, accountability calls for safe harbour rules that clarify the responsibilities and liabilities of the governing body. In a two-tier board system, involving a managing board and a supervisory board, the body that is responsible for all strategic decisions (usually the managing board) is considered the governing body.

4. Suitability

Membership in the governing body should be subject to minimum suitability (or non-suitability) standards in order to ensure a high level of integrity, competence, experience and professionalism in the governance of the pension fund. The governing body should collectively have the necessary skills and knowledge to oversee all the functions performed by a pension fund, and to monitor those delegates and advisors to whom such functions have been delegated. It should also seek to enhance its knowledge, where relevant, via appropriate training. Any criteria that may disqualify an individual from appointment to the governing body should be clearly laid out in the regulation.

5. Delegation and expert advice

The governing body may rely on the support of sub-committees and may delegate functions to internal staff of the pension entity or external service providers. Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities the governing body could be required by the regulator to seek expert advice or appoint professionals to carry out certain functions. The governing body should assess the advice received, including its quality and independence, and should verify that all its professional staff and external service providers have adequate qualifications and experience.

6. Auditor

An auditor, independent of the pension entity, the governing body, and the plan sponsor, should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement. Depending on the general supervisory framework, the auditor should report promptly to the governing body and - if the governing body does not take any appropriate remedial action - to the competent authorities and other appropriate persons wherever he or she becomes aware, while carrying out his or her tasks, of certain facts which may have a significant negative effect on the financial situation or the administrative and accounting organisation of a pension fund.

7. Actuary

The appropriate body or authority for all **defined benefit plans f**inanced via pension funds should appoint an actuary. As soon as the actuary realises, on performing his or her professional or legal duties, that the fund does not or is unlikely to comply with the appropriate statutory requirements and depending on the general supervisory framework, he or she shall inform the governing body and - if the governing body does not take any appropriate remedial action - the supervisory authority and other appropriate persons without delay.

8. Custodian

Custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.

II. GOVERNANCE MECHANISMS

9. Risk-based internal controls

There should be adequate internal controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's by-laws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law. Such controls should cover all basic organisational and administrative procedures; depending upon the scale and complexity of the plan, these controls will include performance assessment, compensation mechanisms, information systems and processes, risk management procedures and compliance. The governing body should also develop a code of conduct and a conflicts of interest policy for them and the staff of the pension entity as well as for any party with operational responsibilities.

There should also be appropriate controls to promote the independence and impartiality of the decisions taken by the governing body, to ensure the confidentiality of sensitive information pertaining to the fund and to prevent the improper use of privileged or confidential information.

10. Reporting

Reporting channels between all the persons and entities involved in the governance of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.

11. Disclosure

The governing body should disclose relevant information to all parties involved (notably pension plan members and beneficiaries, plan sponsors, supervisory authorities, auditors etc.) in a clear, accurate, and timely fashion.

ANNOTATIONS TO GUIDELINES FOR PENSION FUND GOVERNANCE

I. GOVERNANCE STRUCTURE

1. Identification of responsibilities

Good governance calls for a clear identification and separation of the operational and oversight responsibilities of a pension fund. To the extent that a pension entity is established that owns the pension fund on behalf of plan/fund members and beneficiaries, the assignment of these responsibilities needs to be clearly stated in the pension entity's statutes, by-laws, contract, or trust instrument, or in documents associated with any of these. These documents also need to state the legal form of the pension entity, its internal governance structure, and its main objectives. If the pension fund is established as a separate account managed by financial institutions,

the pension plan or contract between plan sponsors/members and beneficiaries and the financial institution should clearly state the responsibilities of the latter with respect to the management of the pension fund. In addition, there need to be a mechanism for ensuring appropriate independent oversight of the decisions taken by these third parties.

Pension entities are established in accordance to statutes, by-laws, contract (including collective agreements with trade unions), or trust instrument. These documents, sometimes together with associated material, should define the legal form of the pension entity as well as its internal governance structure and main objectives. The main objectives of the pension entity will vary depending on the type of plan that they support.

In defined contribution plans, the main objective of the pension entity may be to invest the pension assets in order to maximise risk-adjusted returns, taking into consideration any costs borne by members.

In defined benefit plans, the pension entity may have several objectives, such as ensuring an adequate match between the pension plan assets and its liabilities and paying benefits upon the death or retirement of plan members and beneficiaries.

Some of the operational functions of the pension entity that should be identified and assigned include collection of contributions, record-keeping, actuarial analysis, funding and contribution policy, asset-liability management (or equivalent concepts in defined contribution plans), investment strategies, asset management, disclosure to plan members and beneficiaries, regulatory compliance and, where appropriate, financial education. These responsibilities and their assignment should be clearly stated in the pension entity's documents, and where outsourced, monitored via service level agreements.

As good pension fund governance should be „risk-based”, the division of responsibilities should reflect the nature and extent of the risks posed by the fund. For example, where funds adopt a sophisticated investment strategy, an investment sub-committee may be appropriate.

The role of the plan sponsor and the rights of the plan/fund members and beneficiaries with respect to the governance of the fund should be also clearly documented. Appointment of the governing body should be ruled by the pension entity’s statutes and/or legal provisions. The plan sponsor may appoint some of the members of the governing body. Pension plan/ fund members and beneficiaries or their representative organisations may also play a role in appointing members of the governing body of the pension fund. If the plan is established as part of a collective agreement, the contracting trade union(s) have responsibility for the appointment of the governing body on behalf of plan/fund members and beneficiaries.

Where the pension fund is established as an independent legal entity, some of the professional staff of this entity, such as actuaries and asset managers, may also be employees of or external advisors to the plan sponsor.

However, in general, it should be the governing body's responsibility to appoint the professional staff and the external service providers of the pension entity.

When the pension fund is established as a separate account managed by financial institutions, their responsibilities should be clearly stated in the plan or contract documents. In occupational plans, plan sponsors should sign a contract with the financial institutions responsible for the management of the pension fund, where the objectives of the fund are also clearly stated. In personal plans, the contract is signed directly between the plan member and the financial institution.

2. Governing body

A governing body that is responsible for the operation and oversight of the pension fund controls pension funds. The governing body may also be responsible for other (or indeed all) aspects of the administration of a pension plan. This governing body may be a person, a committee or committees of persons (e.g. a board of trustees) or a legal entity. In a two-tier board system the managing board or body that is responsible for all strategic decisions is considered the governing body. In some countries various entities have fiduciary duties and may therefore be considered on a par with the governing body.

In general, it is appropriate to split operational and oversight responsibilities, with the governing body focusing solely on strategic decisions and oversight functions. Operational tasks should be delegated to the pension entity's executive staff or a sub-committee and, where appropriate, external service providers.

A separate supervisory board or oversight committee may be established whose main functions are the selection and oversight of the body in charge of strategic decisions. The supervisory board may have other responsibilities, and may, for example, appoint the auditor or actuary of the pension fund and control potential conflicts of interest. The supervisory board may form part of the internal governance structure of the pension entity (as in a two-tier board system) or it may be established externally. The plan sponsor and plan/fund members and beneficiaries may elect its members. In pension funds established in the corporate form, the general meeting of plan/fund members and beneficiaries also exerts some oversight functions. On-going, independent oversight by such a supervisory board is especially advisable where the governing body is also a commercial institution.

Though the governing body may delegate operational duties to the pension entity's internal staff or external service providers, it remains ultimately responsible for ensuring that pension funds fulfil their overriding objective which is to serve as the sources of funds for retirement benefits. In particular, the governing body should retain the responsibility for monitoring and oversight of those service providers, preferably via service level agreements. Core functions, such as formulating the investment policy and risk monitoring should also normally rest with the governing body taking advice from subcommittees, though external advice may of course be requested.

The governing body's main strategic and oversight responsibilities should include at least:

- setting out the pension fund's key goals or mission, identify the main risks, and lay out the main policies, such as the investment policy – including the strategic asset allocation -, the funding policy, and the risk management policy;
- monitoring the administration of the pension fund in order to ensure that the objectives set out in the fund by-laws, statutes, contract or trust instrument, or in documents associated with any of these, are attained (e.g. timely payment of pension benefits promised or targeted, adequate management of risks, including a diversified asset allocation, cost-effectiveness of administration, paying proper plan expenses from the fund, etc);
- selecting, compensating, monitoring, and, where necessary replacing internal executive staff as well as external service providers (e.g. asset managers, actuaries, custodians, auditors, etc.); in a two-tier board system the appointment of external service providers (e.g. actuaries, auditors) may be the responsibility of the supervisory board;

- ensuring the compliance of the activities of the entity with the pensions law and other applicable statutes (e.g. investment regulations, reporting and disclosure requirements, control of conflicts of interest situations, improper use of privileged information, etc.);

With DC pension funds, additional key tasks of the governing body include ensuring that:

- suitable investment choices are offered to members (including a suitable default fund),
- the performance of these funds is monitored,
- costs charged to members are optimised and disclosed in their disaggregated form, and
- members are offered guidance and where relevant projections on expected benefits. To enable the governing body to undertake its role effectively, safe-harbour rules may be appropriate.

While the governing body should best serve the interest of the pension plan members and beneficiaries, it may also be required to avoid imposing an unnecessary financial burden on the plan sponsor (i.e. where the interest of plan members and beneficiaries could be equally best served through other means, which are more beneficial for plan sponsors). The expenses of administering the pension fund should be managed efficiently, and the governing body may be required to minimise the cost to employers where these expenses are borne exclusively by the plan sponsor.

3. Accountability

Accountability over governance functions is particularly important in order to allow the supervisory authority and the plan members and beneficiaries to discipline the governing body or seek other means of redress in case of mismanagement. The governing body may also be accountable to the plan sponsor to an extent commensurate with its responsibilities as a benefit provider.

In order to guarantee the accountability of the governing body, it should be liable for its actions that are in breach of its duties. Such liability may include in some instances personal financial responsibility. In such cases, insurance of this liability can strengthen the ability of the pension fund to recover losses in case of mismanagement. In cases where the plan sponsor acts as the governing body or directs a third party provider in a DC plan, safe harbour rules may be appropriate to ensure that plan sponsors are accountable for their decisions but have a liability commensurate with the scope of those decisions. For instance, such rules can allow the plan sponsor to carry out due diligence in the choice and on-going monitoring of service providers, investment alternatives and default options, whilst limiting his liabilities.

The accountability of the governing body also requires:

- regular meetings of the governing body;
- diffusion of decision-making power in the governing body (for example, a requirement for decisions to be taken on a majority basis);
- appropriate disclosure of the decisions reached in these meetings to affected plan members and beneficiaries;
- regular reporting of important and significant information about the operation of the pension fund to the supervisory board, where relevant;

- reporting of information about the operation of the pension fund to the supervisory authorities;
- transparent selection mechanisms for the participants of the governing body (including the possibility of appointments of representatives of plan participants and beneficiaries through a fair selection system);
- appropriate succession planning processes.

Disclosure to plan participants and beneficiaries may be required for plan changes that could have a material impact on future pension benefits, such as a material change in the plan terms or their application.

In order to reduce the administrative burden on the governing body, disclosure could be made on a regular basis, for example, once a year, rather than after every meeting of the governing body.

The selection and succession planning structure should deal with the term, appointment/election and removal of members of the governing body of the pension fund. The term of appointment of the members of the governing body may vary depending on the type and context of particular plans.

Accountability to plan participants and beneficiaries can be also enhanced by requiring representation of plan participants and beneficiaries on the governing body. When the pension plan is established as part of a collective agreement, the nomination process normally involves the contracting trade unions. In some countries, law requires paritarian representation of employers and employees in the governing body, ensuring that their respective points of view are represented. In other countries, labour laws governing union-management relations may prescribe when employee representation on pension funds is necessary.

The appointment of independent professionals to the governing body is also an effective way to promote good governance.

Election through a fair voting system (e.g. majority voting) is recommended in cases where plan members and beneficiaries can elect some of the members of the governing body. Biographical information on the member of the governing body seeking election should be provided to those involved in the selection process. The information should be provided in a timely manner and should be sufficient including age, length of time he/she has been associated with the pension fund, qualifications and experience. Having said this, existing associations of employees (e.g. trade unions) already have internal electoral systems in place that may make these additional elections redundant.

4. Suitability

Members of the governing body should be subject to minimum suitability standards, such as “fit and proper” criteria. Causes of automatic disqualification could include conviction for fraud, theft or other criminal offences, and gross mismanagement of a pension or other fund that led to significant civil penalties, and, in some cases, personal bankruptcy.

Each member of the governing body should also contribute to a balanced set of skills that enables the board, acting as a collective body, to execute successfully its obligations. For this purpose, the governing body may establish a template of the skills set needed and identify any gaps. The qualifications and experience required of the members of the governing body will depend on their responsibilities. It is advisable for at least some members to possess appropriate professional qualifications and experience to assist in some key decisions such the design of the investment

strategy. In general, it is desirable that all members of the governing body have sufficient knowledge and experience to be able to understand the decisions of the professionals that operate the fund. Where the governing structure includes a general assembly of the plan participants and beneficiaries (as is sometimes the case in pension funds set up in the corporate form), these would evidently not be subject to fit and proper criteria.

The governing body should regularly review its collective skill set and consider whether it is adequate. Where relevant, it should seek to enhance its collective knowledge of pension fund matters via appropriate training, paid for by the pension entity. An annual skills inventory and training plan may be prepared for this purpose. In general, training is recommended both initially on appointment and on an ongoing basis (at least every two years). Such training could be supported by pension fund regulatory or supervisory bodies (for example via free on-line courses, other material or approval of other education providers). Alternatively, the supervisory authorities may identify or approve suitable courses. More advanced training may be needed to ensure that the governing body fully understands investment in complex financial instruments.

5. Delegation and expert advice

Where it is appropriate to do so, the governing body should seek expert advice and may delegate functions to sub-committees of the pension entity, internal executive staff, or to external service providers.

Some of the functions where the governing body may require external advice from consultants and other professional service providers include setting the investment and funding policies and asset-liability management. The governing body should have power and the ability to appoint, assess and remove such advisors. It should also take care not to rely exclusively on one source of information and ensure that the advice is independent / non-conflicted.

The governing body may also delegate operational duties, such as asset management, record keeping, and benefit payment, to internal executive staff and / or professional service providers. It may also utilise the resources of the plan sponsor, though this may not always have qualified staff to carry out specific functions, such as actuarial analysis.

The governing body should ensure that all its professional staff and, where appropriate, the external service providers have the relevant qualifications and experience required to carry out their functions in accordance with the objectives of the pension entity and the pension plan.

6. Auditor

The auditor is responsible for reviewing the financial accounts for the pension plans and/ or the pension fund with an appropriate periodicity. The extent and frequency of the audit will vary depending on the nature, complexity, and size of the pension plan/fund. The auditor may also be in charge of verifying the controls relating to risk management and conflicts of interest.

Auditors should also play also a "whistle-blowing" function. If, in the course of the exercise of their duties, they become aware of any significant threat to the financial position of a pension fund or its administrative and accounting organisation, they should promptly report to the governing body. If the governing body does not take appropriate remedial action, the auditor should report to the competent authorities and other appropriate persons. If appropriate remedial action is not taken, the auditor

should also take this into account in the issuance of any audit opinion. The authorities or relevant professional bodies should issue guidance for auditors on the significance of actions of non-compliance with the pension fund statutes and/or current legislation. In some countries, some of the functions normally carried out by auditors may be carried out by other entities, such as the custodians.

The independence of the auditor from the pension entity, the governing body, and the plan sponsor is important to ensure the impartiality of the audit. Normally, the auditor should be appointed by the governing body of the pension entity and in a manner consistent with fiduciary duties. In a two-tier board system the supervisory body may appoint the auditor. In some instances, the supervisory authority may appoint the auditor directly.

7. Actuary

The governing body should appoint an actuary for all pension funds that support plans where the plan sponsor insures the plan member against investment or/and biometric risk. In a two-tier board system the supervisory body may appoint the actuary. Even in defined contribution plans, however, an actuary with a limited role may be advisable, since investments should be made taking into account the adequacy of all retirement income assets.

The actuary may not always be an employed member of the staff of the pension entity or the financial institution managing the fund. For example, the actuary may be employed directly by the employer or plan sponsor or he/she may be an external service provider (e.g. a professional actuary or a benefits consultant firm). Members of the governing body should not normally be appointed as pension plan/fund actuaries.

Where the actuary is employed directly by the employer or plan sponsor, the possible conflict of interest should be properly managed.

The role of the actuary should include at least the evaluation of the fund's present and future pension liabilities in order to determine the financial solvency of the pension plan following recognised actuarial and accounting methods. The actuary should also identify the funding needs for the pension plan, and estimate the level of contributions taking account of the nature of the liabilities of the pension plan. The actuary should also play a "whistle-blowing" function, and report to the governing body immediately when he or she realises that the fund does not or is unlikely to comply with the appropriate statutory requirements (e.g. minimum funding requirement). If the governing body does not take appropriate remedial action (e.g. establish a recovery plan to eliminate a funding deficit), the actuary should report to the competent authorities and other appropriate persons. If appropriate remedial action is not taken, the actuary should also take this into account in the issuance of any actuarial report or opinion. The authorities or relevant professional bodies should issue guidance on the significance of actions of non-compliance with the pension fund statutes and/or current legislation.

8. Custodian

Where appropriate, it may be required that the governing body of the pension fund appoints a custodian, different from the pension entity or the financial company that manages the pension fund.

The appointment of an independent custodian is an effective way to safeguard the physical and legal integrity of the assets of a pension fund.

The custodian holds the pension fund assets and should be in a position to ensure their

safekeeping.
They may also provide additional services such as securities lending, cash management, investment accounting and reporting, and performance measurement. In some cases, the custodian may also play an external whistle blowing function similar to that of the auditor with respect to, for example, the investment of pension assets.

II. GOVERNANCE MECHANISMS

9. Risk-based internal controls

The scope and complexity of internal control measures should be „risk-based" and will vary according to the type and size of pension plan, fund and entity and the type and extent of risks faced. However, there are certain basic organisational and administrative procedures that are central to risk management and control and sound business practice:

- Regular assessment of the performance of the persons and entities involved in the operation and oversight of the pension fund, particularly where the governing body is also a commercial institution;
- Regular review of compensation mechanisms, in order to ensure that they provide the correct incentives for those responsible for the operation and oversight of the pension fund;
- Regular review of information processes, operational software systems, and accounting and financial reporting systems;
- Identification, monitoring, and, where necessary, correction of conflicts of interest situations. A policy for dealing with conflicts of interest situations should be in place;
- Mechanisms to sanction the improper use of privileged information;
- Implementation of an adequate risk measurement and management system including effective internal audit
- Regular assessment of regulatory compliance systems

Mechanisms are needed to assess regularly the performance of the pension entity's internal staff as well as the external service providers (e.g. those providing consultancy, actuarial analysis, asset management, and other services for the pension entity). It is also good practice for the governing body to undertake self-analysis and for an independent, external person/organisations (or, where it exists, the supervisory board) to undertake a review of the internal controls of the pension entity and the performance of the governing body. The governing body could also restate annually that they are aware of the governance obligations and other key documents relating to the fund, that they are in compliance or have notified any potential conflicts.
Objective performance measures should be established for all the persons and entities involved in the administration of the pension fund. For example, appropriate benchmarks should be established for external asset managers. Performance should be regularly evaluated against the performance measures and results should be reported to the relevant decision maker, and, where appropriate, to the supervisory board, the supervisory authority, and the pension fund members and beneficiaries. The benchmarks should be reviewed regularly also to ensure their consistency with the pension fund objectives (e.g. the investment strategy).
Appropriate compensation can provide the right incentives for good performance. The establishment of a compensation committee and chairperson may optimise the process of evaluating the compensation of those responsible for the operation and oversight of the pension fund, such as asset managers, custodians, actuaries, as well as the

members of the governing body.
The compensation policy of sales forces of pension plan providers may also warrant close scrutiny by the governing body, since these costs can reduce pension benefits significantly. There is a risk also that sales staff may not act in the best interest of plan members and beneficiaries, offering products that are not suitable for certain individuals. The governing body should therefore ensure that the remuneration structure for sales staff does not create distorted incentives or and lead to ill-advised decisions by consumers.
A conflict of interest policy should be in place and members of the governing body and staff should regularly report compliance with these rules. Conflicts of interest situations should be identified and dealt with in a suitable manner. Conflicts should be disclosed and recorded in the minutes of the board, as should the role of third parties in settling policy/ strategy for the fund, including trading policies, and the commission and other fees paid by the fund. In certain cases, banning the concentration of functions in a single person or entity that would otherwise lead to a conflict of interests may be the preferred solution. In other cases, disclosure of the conflict of interest to the governing body may suffice, who should be required to monitor these cases closely. It may be in the fund's best interest to adopt policies that prevent even the appearance of a conflict of interests. One effective way of doing so is for the conflicted individual to abstain from voting on any decisions related to the matter of the conflict.
Where the conflict involves a member of the governing body, the case should be reviewed and monitored by the members of it who are not conflicted. Where appropriate, the governing body may seek independent advice or guidance regarding the service or transaction. In the event of the governing body not being able to resolve a conflict of interest situation that may be judged by some of the members of the governing body as harmful to the interest of the plan members and beneficiaries, this should be reported to the supervisory board or supervisory authority, which will make a decision on whether they should be permitted, and if so under what conditions. In some cases, the supervisory authority may decide to appoint an independent professional to the governing body.
The governing body should also establish appropriate controls to promote the independence and impartiality of the decisions taken - ensuring an equal treatment of all plan members -, ensure the confidentiality of sensitive information pertaining to the fund and prevent the improper use of privileged or confidential information. Employees of the pension entity may also be required to notify to the governing body any breaches of legislation, by-laws or contracts in the operational tasks that they are responsible for.
A code of conduct should be established to implement these goals, requiring employees to observe high standards of integrity, honesty, and fair dealing. Internal review mechanisms may be put in place to verify and sanction the compliance with the code of conduct.
An adequate risk measurement/management system and an effective internal audit should be also established. The risk management system should cover the main risks that a pension fund is exposed to, such as investment, biometric and operational risks. These control mechanisms form the basis of good business conduct, enhanced transparency, consistency as to management decisions, and for the protection of all stakeholders of the pension fund. Prudent risk management practices should also consider intangible risk factors such as environmental, political and regulatory changes, as well as the pension fund's potential market impact through its investment

decisions. The risk management strategy should seek to proactively identify and explicitly balance short- and long-term, considerations.
Finally, pension entities should have mechanisms to assess the compliance with the law. A compliance officer may be assigned to carry out this activity on a regular basis. Compliance assessment should include documentation related to functions that have been delegated to external service providers.

10. Reporting
Processes need to be put in place to ensure that the members of the governing body receive appropriate, timely, accurate, complete, consistent, and easily comprehensible information so they may discharge their responsibilities effectively, in accordance with the code of conduct, and ensure that delegated responsibilities are fulfilled.
For its part, the governing body should ensure that actuaries, asset managers, consultants, custodians, and other professional service providers also receive relevant and accurate information in a timely manner in order to ensure they carry out their duties as assigned by the governing body.

11. Disclosure
The governing body should disclose relevant information to all parties involved (notably pension plan members and beneficiaries, the supervisory board- where relevant -, the plan sponsor, and supervisory authorities, etc.) in a clear, accurate, and timely fashion. The specific information that plan members and beneficiaries should receive is described in the OECD Guidelines for the Protection of the Rights of Members and Beneficiaries. In the case of pension funds that support personal pension arrangements, certain information (e.g. costs and investment returns) may also need to be disclosed to the public at large via appropriate mechanisms (e.g. websites and printed media). The governing body may also be required to disclose publicly if, and if so how, environmental, social, and governance considerations are taken into account in the investment policy. Two useful references in this regard are the OECD Guidelines for Multinational Enterprises and the OECD Principles of Corporate Governance.

6. Licensing rules for private pension funds

Private pension systems play a major role worldwide, complementing retirement income from state sources.

Supervision should possibly have a preventive effect and it is the duty of the supervisory authority to prevent the interests of the policyholders being impaired. Therefore, insurance business may not be transacted until the pension funds have received a licence from the supervisory authority.

Licensing rules are differentiated among pension systems by its restrictiveness and depth. Some systems have virtually no entry barriers while others have very complex and strict standards applied by the supervisory authority.
To support and complement the powers of continuous supervision of pension funds and pension plans by the supervisory authority and envisage that the criteria for issuing licences be consistent with and support those applied in ongoing supervision the licensing rules has to comply with. In this way, the licensing process serves also

as a regulatory tool that ensures pension funds meet ongoing minimum criteria from the point at which they are licensed.

The licensing rules promote the objective of a licensing and supervision regime to establish and maintain a robust system of pension funds management by requiring applicant pension funds to demonstrate they have in place the policies and procedures that are consistent with a system that seeks to ensure that benefits are delivered to policy holders as provided under the terms of the plan. Licensing is generally directed toward managing the risk of incompetent or unqualified pension funds entrance to the market or to insure against the results of negligent or risky behaviour by imposing capital or bonding requirements. It may, however, also have the purpose of ensuring economies of scale in pension markets or even limiting competition. The licensing rules promote effective and impartial licensing requirements and procedures, thus strengthening confidence in the pension system and its supervisory authority and promoting the development of a pension market. Especially for the Azerbaijanian country licensing rules can also be seen as a mechanism to ensure public confidence in the private pension system, by applying transparent standards and establishing security to warrantee the integrity of pension funds.

The respective licensing requirements that are mentioned in the next chapter are evident for a safe and sound ongoing supervision.

Below is illustrated the summary table of potential P2P and P3P set-up options for Azerbaijanian pension funds, **the option P2P (D) is mentioned but not relevant for regulation of Azerbaijanian pension funds:**

Key characteristics	P2P (A)	P2P (B)	P2P (C)	P2P (D)	P2P (E)	P3P
Participation	Voluntary	Voluntary	Voluntary	Mandatory	Voluntary	Voluntary
Employee contributions	4%	4%	No	No	4%	Yes
Employer contribution	No	No	No	No	No	Yes
State mandatory social insurance contribution (redistributed from 25%)	2%	0%	4%	4%	0%	No
Contribution from other government financed source (e.g. State budget, Oil fund)	0%	2%	0%	0%	0%	No
Overall contribution	6%	6%	4%	4%	4%	Sum of individual contributions

Income tax breaks	No	No	No	No	No	Yes
Eligibility	Born after 1971	Born after 1971	Born after 1971	Born after 1971	Born after 1971	All
Effective social insurance contribution rate before	25%	25%	25%	25%	25%	Sum of individual contributions
Effective social insurance contribution after	29%	29%	25%	25%	29%	Sum of individual contributions
Inheritance	Yes. Full amount, including state contribution, before retirement.	Yes. Full amount, including state contribution, before retirement.	Yes. Full amount, including state contribution, before retirement.	Yes. Full amount, including state contribution, before retirement.	Yes. Full amount, including state contribution, before retirement.	Yes
Return guarantees	No/Yes. Guarantees will refer to the loss of principal at retirement and will be provided by the state.	No/Yes. Guarantees will refer to the loss of principal at retirement and will be provided by the state.	No/Yes. Guarantees will refer to the loss of principal at retirement and will be provided by the state.	No/Yes. Guarantees will refer to the loss of principal at retirement and will be provided by the state.	Yes. Guarantees will refer to the loss of principal at retirement and will be provided by the state.	No
Pension plan change frequency	1x a year	1x a year	1x a year	1x a year	1x a year	1x a year
Types of pension plans provided	Conservative/Balanced/Active	Conservative/Balanced/Active	Conservative/Balanced/Active	Conservative/Balanced/Active	Conservative/Balanced/Active	Conservative/Balanced/Active
Transition period	Yes	Yes	Yes	Yes	Yes	No
Opt-out	No	No	No	No	No	Yes*
Pay out	Option to add to labor pension or to buy annuity	Option to add to labor pension or to buy annuity	Option to add to labor pension or to buy annuity	Option to add to labor pension or to buy annuity	Option to add to labor pension or to buy annuity	Paid out in full amount not sooner than 5 years before official retirement.

Regarding the licensing rules and assessment the compilation of pension funds/ -plans is from supervisory perspective relevant.

Licensing rules

The object of licensing depends to a large extent on the pension fund construction used in each country. Broadly speaking, there are three different types of pension funds constructions: the pension trust (mostly Anglo-Saxon countries), the pension fund with legal personality (such as the foundations, mutual associations and similar legal entities in countries such as Austria, Germany, Hungary, Italy (closed funds only) and the Netherlands), and pension funds without legal personality administered by pension fund managing companies (as in Bulgaria, Poland, Portugal, Slovakia, Spain and Turkey).

In the vast majority of countries, the law requires the pension funds that are the object of the licensing regime to submit a series of documents to the supervisory authority *prior* to the start of its operations.

The Netherlands and Canada are an exception to this. These countries presents a special case, as an assessment of the pension funds compliance with the law takes place after it has started operations. The supervisory authority can demand corrective action but cannot stop the entity from operating.

The most suitable licensing process for Azerbaijan is to submit and audit required documents before pension funds starts to operate because any failure regarding licensing rules can be avoid in advance.

In all cases an application needs to be submitted, accompanied by documents related to the financial situation and/ or organisational structure of the entity.[2] These documents must sometime prove that certain legislative requirements have been met, while others are submitted for reference purposes.

The list of documents and information to be submitted is set out in *legislation*, in the *application form*, or a combination of both and tends to include the mentioned aspects in this chapter.
In a few countries licence applications must be made by *application form* (Australia, Canada, Hungary, Italy, Slovakia, Turkey and UK). Most application forms are available on the supervisory authorities own website. The application forms vary in length. Some only request the pension funds contact details (E.g. United Kingdom), others ask for calculations related to the Pension funds financial situation (E.g. Belgium), while yet others ask details such as the management' s qualifications and the managers paid positions in other companies (E.g. Turkey).
In other countries like Germany, Latvia and the Netherlands, there is no application form, but *legislation* specifies in which format the application must be made.

In some cases the licensing procedure is followed by a registration[3] procedure with a commercial or other register.[4] Similarly, part of the application is sometimes assessed by a body other than the supervisory authority, for example the tax authorities (United States). In Ireland, informal meetings precede the initial license application.
There is a large variety in license application fees. Some countries charge no fees (e.g. Latvia, Spain) while others charge several thousands of euros/ dollars (E.g. Germany, Austria, Slovakia). In some cases, such as Canada, a basic fee is charged which is increased by a certain amount for each pension plan member or by reference to the size of the fund (in terms of members). Pension funds are expected to meet the costs for obtaining official certificates, extracts from official registers and notary declarations in all cases.[5]
Licensing requirements should be objective and promote a competitive market. Licensing procedures should also be clear and transparent. They should set out the application process, including:

- Information about the obligations of the supervisory authority and the timeframe for the submission of applications and the decision process;

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[2] Proposal to submit both to have a detailed view on the applicant pension funds. Based on international experience it is mostly required information about *both* financial situation *and* organisational structure.

[3] The inclusion of information regarding the pension funds or pension plan in a register maintained by the supervisory authority. In the broader sense an "Insurance register" that is not necessarily focussed on pension funds. The following pages focus only on licensing of pension funds, implementing a register of pension funds (insurance companies) is not necessarily inevitable for the authorisation process and lies in the decision of the supervisory authority.

[4] For example where it is the trustee that is licensed and the pension funds that is registered (Australia, Hungary, Turkey)

[5] The overview in conclusions indicates for each country whether the applicant pension funds is required to pay a license application fee.

- Procedures for the supervisory authority to seek further information from the applicant;
- The actions that the supervisory authority will take to confirm the information received as part of the license application;
- Requirements that the staff of the supervisory authority observe the appropriate standards of confidentiality with regard to the information gathered as part of the licensing application process (with the exception of information which may have to be provided to other public authorities[6]).

The licensing authority should ensure that a license clearly states its scope. It should publish information on the pension funds that are licensed[7] and the scope of their licenses.[8]

Pension funds wishing to be authorized to carry on insurance business have to meet a number of requirements.
In the case of pension fund managing companies, the company is also the object of the licensing requirements. The licensing procedures are in general similar to those of pension funds with legal personality. In some countries there is a two-step licensing procedure, whereby a company must first obtain a license for operating as a pension fund managing company and then apply for a license to manage one particular pension fund (E.g. Hungary, Spain, Turkey). In other countries (E.g. Germany, Belgium) the pension funds has to apply for a license and it has to mention any natural or legal persons with qualifying holdings (at least 10 % of the nominal capital or members funds). The persons with qualifying holdings must stand for a reliable and cautious management of the company.[9] Based on international experience it is most appropriate to apply for a license anyway, because it's the starting point for a detailed risk-based supervision of the pension funds.
The licensing rules also vary across countries. Findings seem to indicate that some countries concentrate only on the pension funds "governance structure", whereas other countries focus more on the financial aspects of the fund.[10] Often descriptions of suspicious financial transactions are part of anti-money laundering rules. Licensing requirements also vary depending on the type of pension plan that is offered. For defined benefit plans, pension funds with legal personality and pension fund managing companies are often subject to additional licensing requirements such as a funding policy statement, the appointment of an actuary and, in some cases (especially where the entity underwrites risks) additional capital or solvency requirements.

Pension funds wishing to be authorized to carry on insurance business have to meet a number of requirements:

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[6] E.g. Tax authority

[7] Based on international experience, examples for publishing pension funds starting the business are official journals or on the website of the supervisory authority. Also the supervisory authority may publish a "Pension funds-/ Insurance register" (See above). Most authorities keep registers of licensed funds on their websites. The registers contain the pension funds contact details, the sponsor´s name and the business products offered by the pension funds.

[8] Such as pension funds business in total, intermediation of insurance business, outsourced functions etc.

[9] See next chapter

[10] See conclusions

- Usually pension funds have to submit a **business plan** which describes the risks it intends to cover. In Germany, the business plan must contain evidence of sufficient funds for start-up capital as well as ongoing requirements. Submission of a business plan that takes into account the strategic and operational aims of the pension funds is required by most applicants, but not all (Canada or Ireland occupational pension schemes only). The business plan must also set out the pension funds objectives and parameters in the majority of cases, but in some countries the articles of association rather than the business plan are used to indicate the type of obligations and the pension funds objectives. In some countries the business plan must contain detailed estimates of the pension funds evolution in the coming years (in Germany for the next three years, a longer forecast will be difficult to calculate and uncertain)[11] and include estimates of setting up costs and the financial means available for the pension funds development (E.g. Turkey). In others, the business plan provides for a system of corporate governance and others, whilst in other cases these features may be the subject of separate policies or documents (E.g. Germany, because of different aspects should also be separated and treated different[12]). Where the trustee or management entity is separate from the pension fund, a distinction should be made in respect of business plans for the trustee entity itself that may be distinct from the plan for the pension fund. In Australia, pension entities are requested to submit a business plan in order to provide a context for the analysis and review of the pension funds risk management framework.

  The plan has also to comprise the articles of association and agreements with other companies or contracts spinning off certain functions.[13] Like described below in this chapter it is also possible to separate this information from the business plan.

- The pension funds may also submit the **pension plan**[14] where the plan´s parameters (such as types of contributions and benefits) are described.[15] In Germany the pension plan itself is not (directly) subject of licensing rules ("With the proviso that the authorization requirement shall not apply to pension plans; changes *and the introduction of new pension plans* shall not take effect until three months have passed, unless the supervisory authority either denies authorization or declares the application unobjectionable before that time").[16]

- Suitability **requirements should be exist for membership of boards**. In most countries like Germany, pension funds with legal personality and pension fund managing companies require a two-tier management structure of a supervisory

[11] The business plan includes a projection of balance sheet and profit and loss accounts as required for supervisory purposes over a minimum period of three years and gives information on the projected development of the business, including solvency margins.
[12] See below
[13] See also blueprint Bernd Schulte-Brinker "Outsourcing rules of responsibility"
[14] Compare summary table of potential P2P and P3P set-up options for Azerbaijanian pension funds
[15] Based on international experience
[16] German Insurance Supervision Act

board and a management board.[17] On the other hand, for trusts, a single board structure (the board of trustees) is the norm.[18] In most countries, pension funds with legal personality or management companies must establish an investment committee and in some, there is also a requirement to establish an audit committee. Annual general meetings take place in the countries where pension funds with legal personality have shareholders. In most cases the law sets minimum (and sometimes maximum) limits to the number of members that the boards may have.[19]

In some countries, the law requires that the duties of board members are described in a document as well as the procedure for selecting board members. A few countries actually set these selection procedures in the law. Where pension funds or pension plans are established pursuant to a collective agreement, both the employee and the employer are represented in the pension funds management. In some cases, employees and employers have seats on supervisory boards.[20]

The pension funds have to prove that its **management and supervisory board members** have the required **professional qualifications and experience.** In the vast majority of cases, the pension funds management must satisfy so known "fit and proper" requirements,[21] which must be proven by documents indicating academic experience and professional experience of several years.

Convictions for or pending cases relating to property and financial crime lead to ineligibility for positions in the pension funds management, as does bankruptcy. In almost all countries, the pension fund must submit judicial records for every person in a management position to show that each person is of good repute.

An exception are the United States where there is „generally no minimum suitability requirements for an individual to act as trustee", while institutions with trust powers are licensed and regulated by states and partially by the federal government.

Canada does not require information on qualifications and experience of members of the governing body but relies on a declaration of compliance and also has a conflict of interest prohibition.

Ireland, Norway and the United Kingdom are other countries where an applicant need not meet legal "fit and proper" requirements in order to obtain a license or to be registered.

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[17] See presentation Bernd Schulte-Brinker "Insurance supervision in Germany", 27.01.2015, Bonn
[18] Situation in USA
[19] For the supervisory board in Germany at least 3 members to avoid a deadlock- situation regarding taking a vote
[20] See appendix
[21] See appendix

For reasons of a sustained management it will be proposed to implement "fit and proper" rules for the board members in Azerbaijan.

- The supervisory authority should have the power to examine the proposed **ownership structures** of the pension funds and its wider group to assess the organisational parts of the pension funds. In a few countries (E.g. Germany, Belgium) the pension funds has to apply for a license has to mention any natural or legal persons with qualifying holdings (at least 10 % of the nominal capital or members funds). The persons with qualifying holdings must stand for a reliable and cautious management of the company.[22]

- Pension funds are allowed to **outsource their activities**.[23] A considerable number of countries like Germany[24] do not set limits to which the pension funds can be outsourced, while others provide that the pension funds core functions cannot be contracted out.[25] Generally the pension funds remain responsible for the activities that it contracts out. In some countries service agreements must contain certain provisions such as in relation to sub-contracting of functions by the service provider (Australia). Service providers must satisfy the standards relevant to their profession. In certain cases the licensing authority can prohibit the fund from concluding an agreement with the service provider, for example where the provider does not meet professional requirements.

- In some countries, such as Austria, a minimum **number of participants** is required before a license is granted (or in order to benefit from tax breaks, such as in the United States). In some countries, small pension funds are outside the scope of licensing requirements (such as in Australia, where most small funds with fewer than five members are outside the scope of the licensing legislation). Austria, Denmark, Finland (pension funds), Hungary, Slovakia and the United States require pension entities to have a minimum number of participants for licensing or authorization purposes.
- Depending on the **needs of the supervisory authority** pension funds have to be submitted documents related to the organizational structure of the pensions funds.
  Beside the above-mentioned functions, it may also include information about an appropriate internal control system, implementation of accounting system, investment policy and IT-infrastructure.

In this context the independent internal control system of pension funds has to coordinate and is responsible for identification of risks and monitoring limits and risks.[26] The investment policy outlines the general rules between a portfolio manager and a client. The IT systems (hardware and software components) and the related IT processes of pension funds must ensure the integrity, availability,

[22] See appendix
[23] See also blueprint Bernd Schulte-Brinker "Outsourcing rules of responsibility"
[24] But management functions can not be outsourced in Germany
[25] Depends on definition of core functions
[26] In a broader view also an adaequat risk management system

authenticity and confidentiality of data. To this end, the IT systems and the related IT processes have to be based on established standards as a general principle. Furthermore pension funds often have to describe the principles of its reinsurance policy.

Licensing assessment

Once the applicant pension funds have sent the required documents to the supervisory authority, the latter examines these and will ask for additional information if necessary. Some documents must be submitted for assessment by the authority, while others will not be assessed. There is a variation between pension systems in the aspects and documents examined by the supervisory authority.

Most supervisory authorities must decide on the application within a certain time limit, which can be extended if additional time is required by the pension funds or by the licensing authority, for example when it is necessary to receive additional information from the applicant. Where the supervisory authority is subject to specific timeframes in which to decide an application, there is usually provision for the „clock" to stop while the extra information is sought, as for example in Australia.

In all countries, the supervisory authority can oblige the applicant to make amendments if it fails to meet certain conditions.

Some licensing authorities may also carry out an on-site inspection on the premises[27] in certain cases to satisfy itself that the required infrastructure and procedures are in place (E.g. Australia, Hungary and Turkey).

There are three levels of pre-licensing assessments:

- Document review (all or some of the documents submitted in the application process): For example Germany, Latvia, Belgium, Denmark and Spain all review business plans and the pension funds/ pension plans governing documents. Not all countries review documents and information regarding internal and external governance structures and policies.

- Document review and on-site inspection: In a few countries (E.g. Australia, Hungary and Turkey) the supervisory authority has the power to carry out on-site review, for example in respect of installation and operation of electronic equipment (network structure, emergency plans, data management).

- No review: Canada does not review documents submitted with the application or conduct an onsite visit. Instead it relies on a "Declaration of Compliance" and subsequent risk assessment to determine whether an on-site visit will be made at a later time.

For a detailed view insight the pension funds there has to be at least a document review. Furthermore it supports a safe and sound supervision at a later stage. This is concordantly with the licensing assessments in most countries. Whilst Canada's approach reduces the administrative burden on the supervisory authority, it contrasts with other practices such as detailed review of all documents submitted and an on-site review and detailed review of all or particular documents submitted.

[27] See appendix

The supervisory authority should have the **power to reject an application if the criteria are not fulfilled** or if the information provided is inadequate, so that the assessment process supports the objectives in Azerbaijan. Any rejection should include identification of the specific criteria on which the rejection is based.

License termination of pension funds

The licenses can be terminate in certain circumstances in almost all countries.[28] In legislation has to be set out circumstances in which the license can be terminate. The most common reasons for license termination are:

- the licensed pension funds does not start business within a certain period after obtaining the license;
- the pension funds ceases to operate;
- an infraction of legislative requirements;
- miscellaneous: bankruptcy, insolvency or liquidation.

Often on-site inspection(s) is (are) part of the procedure for termination. Timelines are often not set out either in legislation or other regulatory documents. The supervisory authority should be responsible for the withdrawal is always the same body that granted the initial licence.

Most supervisory authorities keep registers of licensed pension funds on their websites.[29] The registers contain e.g. the pension funds contact details, the sponsor's name and the business products offered by the pension funds. A record of the authority's license termination decision must be published in the large majority of countries. The publication sometimes contains a short explanation of the reason why the license was revoked.

Conclusions

Supervision should possibly have a preventive effect and it is the duty of the supervisory authority to prevent the interests of the policy holders being impaired. Therefore, insurance business in Azerbaijan may not be transacted until the pension funds has received a licence from the supervisory authority.

The licensing rules promote the objective of a licensing and supervision regime to establish and maintain a robust system of pension funds management by requiring applicant pension funds to demonstrate they have in place the policies and procedures that are consistent with a system that seeks to ensure that benefits are delivered to policy holders as provided under the terms of the plan.

The licensing rules promote effective and impartial licensing requirements and procedures, thus strengthening confidence in the pension system and its supervisory authority and promoting the development of a pension market. Especially for Azerbaijan licensing rules can also be seen as a mechanism to ensure public confidence in the private pension system, by applying transparent standards and establishing security to warrantee the integrity of pension funds.
The licensing process serves also as a regulatory tool that ensures pension funds meet ongoing minimum criteria from the point at which they are licensed.

[28] Based on international experience
[29] See above

As described in this blueprint there have to be mentioned a few licensing rules for introducing pension funds in Azerbaijan.

All in this blueprint elaborated proposals are based on different handling of licensing rules worldwide and are results of the international experience and are the most suitable solutions for Azerbaijan.

Licensing rules are differentiated among pension systems worldwide, on the following pages are in this blueprint described aspects summarized.

Appendix

	Is there a licensing process in addition to the procedure for beneficial tax treatment?	Statement of investment policy required?	"Fit and proper" requirements for pension entity management?	Reinsurance or guarantee fund required?	Licence application fee?	On-site inspection part of application assessment process?
Australia	Yes	Yes	Yes	No	Yes	Yes
Austria	Yes	No	Yes	No	Yes	No
Belgium	Yes	No	Yes	Yes (reserve fund)	No	No
Bulgaria	Yes	Yes (pension management authorisation only)	Yes	No (pension licence and pension management authorisation)	Yes (pension licence and pension management authorisation)	No (pension licence and pension management authorisation)
Canada	No	Yes	No	No	Yes	No
Denmark	Yes	Yes	Yes	Yes (reinsurance)	No	No
Finland	Yes	Yes (pension funds only)	Yes (pension insurance companies only)	No	Yes (both pension funds and pension insurance companies)	No
Germany	Yes	Yes	Yes	Yes (intended reinsurance arrangements)	Yes	No
Greece	Yes	Yes	No information available	No	No information available	No information available
Hungary	Yes	Yes (within 180 days)	Yes	No	No	Yes

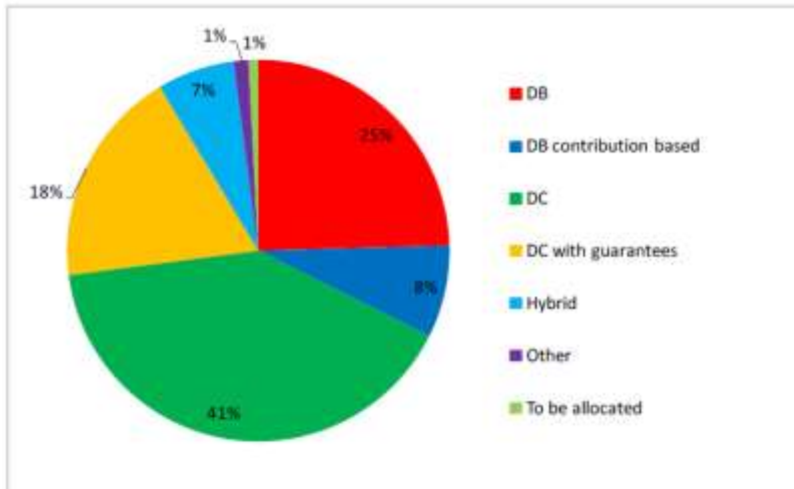
	Is there a licensing process in addition to the procedure for beneficial tax treatment?	Statement of investment policy required?	"Fit and proper" requirements for pension entity management?	Reinsurance or guarantee fund required?	Licence application fee?	On-site inspection part of application assessment process?
Ireland	Yes (PRSA); No (OPS)	Yes (PRSAs and OPS with over 100 members)	No	No	Yes (PRSA only)	No
Israel	Yes	Yes	Yes	No	No	No
Italy	Yes	Yes	Yes	No	No	No
Jamaica	Yes	Yes	Yes	Yes (investment manager)	Yes	No
Japan	Yes	No	Yes	No information available	No	No
Jordan	Yes	Yes	No	Yes (reinsurance)	Yes	No
Korea	Yes	Yes	Yes	No information available	No	Yes
Kosovo	Yes	Yes	Yes	No information available	Yes	No
Luxembourg	Yes	Yes	Yes	No	Yes	No
Mexico	Yes	Yes (AFORES)	Yes (AFORES and SIEFORES)	No information available	Yes	No
Netherlands	Yes	Yes	Yes	Yes (reinsurance), but exemption possible	No	No
New Zealand	No	Yes	No	No	No information available	No
Nigeria	Yes	Yes	No	No	Yes	Yes
Norway	Yes	No	No	Yes (reserve fund)	No	No
Pakistan	Yes	Yes	Yes	No information available	Yes	Yes
Poland	Yes	Yes	Yes	No information available	No information available	No information available

	Is there a licensing process in addition to the procedure for beneficial tax treatment?	Statement of investment policy required?	"Fit and proper" requirements for pension entity management?	Reinsurance or guarantee fund required?	Licence application fee?	On-site inspection part of application assessment process?
Portugal	Yes	Yes (open and closed pension funds)	Yes	Yes (pension fund management companies only)	No	No
Slovakia	Yes	Yes	Yes	No	Yes	No
South Africa	Yes	Yes	No	No	Yes	No, unless pension fund management company was already conducting business
Spain	Yes	Yes	Yes	No	No	No
Thailand	Yes	Yes (asset management company only)	Yes	No	Yes	Yes, if applicant consents
Turkey	Yes	Yes	Yes	No	No	Yes
United Kingdom	No	No	No	No	No	No
United States	No	No	No	No	No information available	No
Zambia	Yes	Yes	Yes	No	Yes	No, unless considered necessary

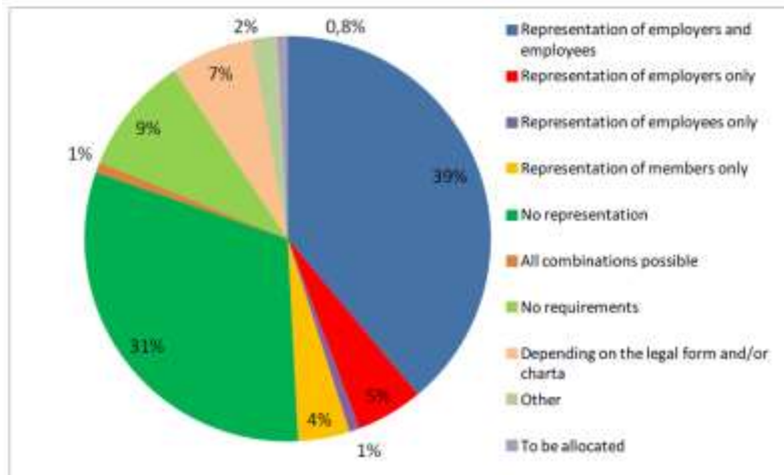
Occupational vs personal pension plans/ products - DB vs DC in EEA

	Occupational	Personal	Occupational and Personal	To be allocated	Total
DB	55	4	1		60
DC	51	45	3		99
Other	49	25	9		83
To be allocated	1			1	2
Total	156	74	13	1	244

Occupational vs personal pension plans/products – total in EEA 2014



Governance requirements in EEA - total



Governance requirements in EEA – Occupational vs Personal

	Occupational	Personal	Occupational and Personal	To be allocated	Total
Representation of employers and employees	84	2	9		95
Representation of employers only	13				13
Representation of employees only		2			2
Representation of members only	5	5			10
No representation	36	38	2		76
All combinations possible		2			2
No requirements	9	12	2		23
Depending on the legal form and/or charta	7	9			16
Other	2	3			5
To be allocated		1		1	2
Total	**156**	**74**	**13**	**1**	**244**

7. Outsourcing rules of responsibilities of pension funds

Private pension systems play a major role worldwide, complementing retirement income from state sources.
An appropriate instrument for reducing pension funds costs is outsourcing of functions. Outsourcing occurs when, through an agreement, a significant part of a pension funds is permanently transferred to another undertaking.
Outsourcing can bring significant benefits to pension funds and their customers, in organizing efficient processes or reducing costs as mentioned.

Outsourcing of functions
When an important function is performed outside an authorized firm, the pension funds may lose or have reduced control of the outsourced activity.

Against this backdrop, there has to be contracts and service level agreements. The supervisory authority expects all pension funds that enter into outsourcing arrangements to have a formal contract, and service level agreement with which to manage the relevant contract. Unless the pension funds have its own legal department with expertise in this area, it would normally be expected a pension funds to take external legal advice when drafting the contract and service level agreement and to ensure that both legal and business risks have been addressed.
Issues like management information, service penalties/ credits, escalation procedures, use of subcontractors, rights of access etc. should all be addressed.

Where outsourcing arrangements are made clear during the licensing procedure, it will be clear to all parties involved who carries out what activity. Information on the outsourcing arrangements permits the authority to assess whether the applicant does not overstep the limits to outsourcing, does not breach its duty to monitor and oversee

the external service providers and does not absolve itself of its responsibility for the outsourced activities.[30]

Where outsourcing arrangements are made clear during the licensing procedure, it will be clear to all parties involved who carries out what activity. Information on the outsourcing arrangements permits the authority to assess whether the applicant does not overstep the limits to outsourcing, does not breach its duty to monitor and oversee the external service providers and does not absolve itself of its responsibility for the outsourced activities.

In a majority of countries,[31] their legislation or supervisory authority requires pension funds to have a legally enforceable document for any outsourced activity. Outsourcing arrangements are mostly based on a contract concluded between the pension funds and a 3rd party service provider. A written form of the contract is required in most countries. Relevant national legislation provides also for the minimum content of such outsourcing contract. In a few countries the respective law or binding instrument issued by the supervisory authority prescribes requirements on exit provisions, 10 countries have minimum data protection requirements set in the law and 4 countries impose explicit or implicit costs ceilings (Based on the countries mentioned in the appendix).

There are many other issues that the national laws in the respective countries require to be included in this type of contract, such as:

- confidentiality clause,
- information duty of the 3rd party service provider, its cooperation with auditor and supervisory authority,
- possibility for supervisory authority to carry out on-site inspections at the premises of 3rd party service provider,
- requirements to safeguard continuity,
- governance rules,
- obligation to inform the pension funds in case of problems,
- necessary powers for the pension funds to issue instructions and obtain information,
- rules on remuneration/ compensation,
- limitation with respect to duration of outsourcing contract,
- the applicable law,
- jurisdiction clause.

Four countries indicated their legislation and supervisory authority do not impose any requirements in regard to the outsourcing contract.[32]

Proposal for AZ: Pension funds should have formal, written charters or documents describing the outsourcing or third party service provisions, and the rights of members and other beneficiaries.[33]

The extent of outsourcing by the pension funds is thus left at the discretion of the

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[30] See chapter "Licensing rules for private pension funds" by Bernd Schulte-Brinker
[31] See appendix
[32] See appendix
[33] E.g. confidentiality clause

supervisory authority and differs in many countries.[34] Accordingly different countries draw the line between functions considered to be ‘core activities’ of a pension funds and all other activities that may (transferable functions) or must (compulsory transferred functions) be carried out by a 3_{rd} party service provider.
All supervisory authorities consider ‘overall decision making’ and ‘bearing end responsibility (being liable)’ as a **core function** of the pension funds. In each country there are core functions that **are not allowed to be transferred to a 3_{rd} party service provider**. The majority of countries (with the exception of 4 countries) also consider the ‘setting of the overall asset management strategy’ as a core pension funds function.[35]
Pension funds are most often allowed to outsource IT services, collection of contributions from both employers as well as employees, administration of customers’ contracts, providing information (advising) to members and beneficiaries, claims administration, investment management and performance measurement. The majority of countries also indicated that their national legislation provides for the possibility to outsource valuation of assets and liabilities, preparation of financial statements for plan sponsor, auditing of processes/ reconciliations, transfer of pension rights, payment of annuities, advising plan sponsors, payment of lump sums and program withdrawals and reporting.
However, it is important to note that at the same time some of the above functions are considered as *core functions* in certain other countries, for example:[36] IT services (1), giving advice to plan sponsor (2), advising members and beneficiaries (3), investment management (3), collection of contributions from employees (4), claim administration (4), collection of contributions from employers (5), preparation of financial statements for plan sponsor (4), payment of annuities (6), valuation of assets and liabilities (6), transfer of pension rights (7), auditing of processes reconciliations (4), insurance (biometric risks) (7).

Custody of assets is a transferable function but in many cases (17) this function is required to be compulsory outsourced to a 3rd party service provider and in a lot of cases (12) the transfer of such a function to a 3rd party service provider is allowed.

Two main different approaches to outsourcing may be identified from the findings: on one hand, there is small number of countries (3) whose legislation prevents pension funds from outsourcing the majority of their activities to 3rd party service providers. On the other hand, there is quite a large number of cases (12) in which the national regulation requires only limited number of activities (3 – 5) to be carried out by pension funds themselves and all the rest can be outsourced.

Furthermore it can be concluded, that in case of DB plans, the number of core functions tends to be almost 100% lower than in case of DC plans. Results show that the same holds for compulsory transferred functions. However, one must bear in mind that in average there are only very few compulsory transferred functions in both types of plans. On the contrary, number of transferable functions tends to be almost 50%

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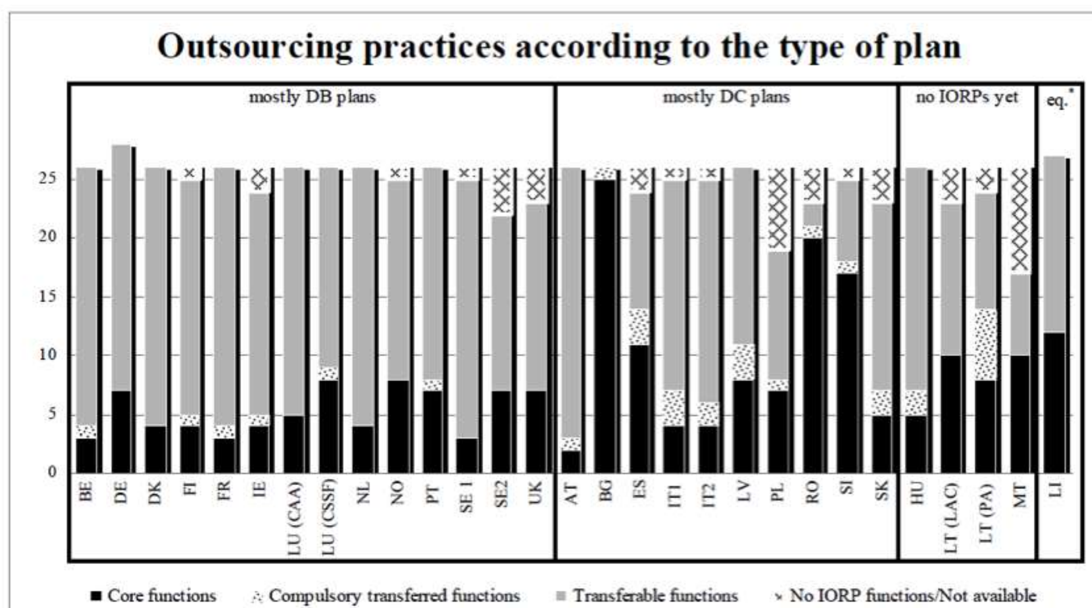
[34] See appendix
[35] See appendix
[36] The number in brackets indicates the part of all countries that were analysed, see appendix- analogue handling also regarding the following pages

higher in DB plans. One country with exceptionally high proportion of core functions has not been taken into account for the purpose of the above considerations:[37]



* eq. – in this case there is one DC and one DB plan in operation, therefore it is not possible to determine what type of plans prevails

NB: Countries are categorised as mostly DB or DC according to the different criteria (volume of assets, number of plans or members) depending on the data they supplied.

As shown above, a wide range of a pension funds functions are allowed to be outsourced. Some of the outsourced functions are required by national legislation to be exercised by entities that are subject to prudential supervision; others can be carried out by entities falling outside the category of supervised institutions. In the first case, the pension funds and the 3rd party service provider are under the prudential supervision of one *supervisory authority* (National institution in one country), which does not necessarily have to be the same for both of these institutions. In the latter case a 3rd party service provider might be unsupervised; however, the pension funds retains full responsibility for the outsourced functions and its supervisory authority is vested with some powers vis-à-vis the service provider.

Proposal for Azerbaijan: The pension funds shall determine on its own responsibility[38] what activities and processes are suitable for outsourcing from a risk point of view. This shall be the basis for a pension funds decisions on outsourcing. The relevant business units are to be involved in the preparation of the risk analysis. It is important to highlight, that this does not includes the core functions; core functions are not allowed to be transferred to a 3rd party service provider.

A large majority of countries (24) indicated that a pension funds supervisory authority in their country is able to obtain any data and/ or reports necessary to fulfil supervisory functions from the 3rd party service provider via the pension funds. This is catered for in the national legislation and/ or in the outsourcing agreements concluded

[37] See appendix

[38] Based on international experience, the decision of outsourcing special functions should be the responsibility of the pension funds to enhance their competiveness, so it's most cost effective to design individual organisational structures. *This includes not core functions.*

between pension funds and 3rd party service providers. Most of the supervisory authorities (19) also have the power to require the 3rd party service provider itself to supply data and/ or reports. Supervisory authorities in most of the cases are empowered to carry-out on-site inspections at the premises of service providers (21). If any breach of law by a service provider is discovered, supervisory authorities in several cases (7) are mostly allowed to impose the same variety of sanctions as on the pension funds.

Proposal for Azerbaijan: From the point of view of the supervisory authority, the following criteria are to be taken into account and form part of the contractual outsourcing agreement of pension funds:

a) services to be performed by the company to which the activity is outsourced must be specified and where appropriate delineated;
b) information and audit rights of the internal audit function as well as of external auditors must be determined;
c) information and audit rights as well as the controlling options of the supervisory authority must be ensured;
d) the rights to issue instructions must be clearly defined;
e) there must be rules that ensure that data protection provisions are taken into account;
f) appropriate periods of notice must be specified;
g) the outsourcing undertaking must inform the undertaking of developments that affect the proper performance of outsourced activities and processes.

Conclusions

Almost all states allow pension funds established within their jurisdiction to outsource some of their functions to 3rd party service providers.

Despite certain similarities, some states have different views to a majority of issues in the regulation of outsourcing. Thus only general observations can be made in this respect:

1. In all countries, pension funds retain final responsibility for any outsourced functions. The majority of countries consider ‘overall decision making’ and ‘bearing end responsibility (being liable)’ along with the ‘setting of the overall asset management strategy’ as a *core function* of the pension funds. However, countries differ in their consideration of what other activities are considered as core or transferable.

2. While many of the pension funds functions are considered by various countries as transferable (e.g. IT, investment management, payment of annuities etc.), there is no single common approach among states in this respect. A function considered transferable by one country can be considered “*core”* in another country. Such a different approach could be caused by the inherent differences between different pension schemes.

3. All countries considered custody of assets as a transferable function. However, approaches differ considerably as to whether such activity is compulsory outsourced to a 3rd party service provider or transfer is voluntary.

4. Divergence was also revealed as to the type of service providers to whom functions can be outsourced. Some countries require certain functions – mostly those directly related to the pension funds core activities - to be outsourced to the entities established under specific legal framework and being supervised by supervisory authorities within this framework (supervised entities) while other functions (mostly overall functions which are not directly related to the pension funds core activities) can be carried out by undertakings which do not fall under specific prudential supervision.

5. Supervisory authorities have different powers over the service provider to whom the function is outsourced. Most of them, however, have a power to carry out on-site inspections in 3rd party service providers and obtain all necessary reports directly from them. Moreover, the ultimate responsibility for outsourced functions is borne by the pension funds in all states. Consequently, pension funds have to manage all possible problems arising from outsourced functions and provide all the requested information to their supervisory authorities.

6. Almost all countries require outsourcing to be subject to a written agreement. Requirements regarding contents of this written agreement vary amongst states.

7. The majority of countries impose various obligations on the pension funds with respect to the outsourced function and the service provider that is appointed to carry out the function in question.

It can be concluded that there is a wide range of legislative and supervisory approaches among the states regarding outsourcing. The relevant proposals for Azerbaijan in this blueprint oriented on best experience and most suitable solutions.

Appendix:

Overview of the outsourcing practices in the surveyed countries

Countries: AT, BE, BG, CZ, DE, DK, ES, FI, FR, HU, IE, IT 1, IT 2, LI, LT, LT, LU, LU, LV, MT, NL, NO, PL, PT, RO, SI, SK, SE, SI 2, UK

CZ: No IORP can be set-up in the Czech republic

A) Overall decision making
B) Bearing and responsibility (being liable)
C) Asset management - including
1. investment management
2. setting the overall asset management strategy
3. custody
4. valuation of assets and liabilities
5. performance measurement
D) Administration - including
1. collection of contributions from employers
2. collection of contributions from employees
3. preparation of fin. statements for plan sponsor
4. compliance & compliance reporting
5. customers' contracts administration
6. auditing of processes / reconciliations
7. information to members and beneficiaries
8. record keeping
9. reporting
10. claim administration
11. transfer of pension rights
12. information technology
13. any other admin. activities (please specify)
E) Payment of benefits – lump sum/progr. withdr.
F) Payment of benefits - annuities
G) Insurance (biometric risks)
H) Risk management
I) Premium setting, actuarial calculations
J) Advice to plan sponsor (advisory role)
K) Advice to members/beneficiaries
L) Other (please specify):

Legend: core functions | transferable functions | compulsory transferred functions | not available / no functions of IORP

NB: Multiple answers are provided for countries where there are two or more types of IORPs each falling under different regulatory regime.

Comments:
* Malta specified the following other administrative activities (item D 13) that are core pension funds functions under their national legislation - a) monitoring and ensuring that payments due to the scheme are effected on due date and in a timely manner b) ensuring that all income and disbursements are applied and effected in accordance with the pension funds documents, c) take action in case where payments due to the pension funds are not received on due date. Furthermore, Malta identified the following other pension funds activities (item I) that are core functions under their national legislation: ensuring compliance with statutory and other obligations and in accordance with pension funds documents, ensuring documentation is in line with applicable requirements, etc.
** Italy: column 1 is related to contractual pension funds while column 2 is related to open pension funds and pre-existing pension funds.

IORP= Institutions for Occupational Retirement Provisions

8. Operational income, commissions and fee structure of private pension funds

The efficiency of private pension systems can be judged by looking at the total operating costs in relation to assets managed. The total operating costs of private pension systems include all costs of administration and investment management involved in the process of transforming pension contributions into retirement benefits. For instance, operating costs include marketing the plan to potential plan participants, collecting contributions, sending contributions to investment fund managers, keeping records of accounts, sending reports to plan participants, investing the assets, converting account balances to annuities, and paying out annuities.

Private pension systems efficiency, as measured by the total operating costs in relation to assets managed, varies considerably between countries, ranking from 0.1% of assets under management annually to 1.3%. Fees charged to plan participants to cover these costs also vary considerably in structure and level across countries.

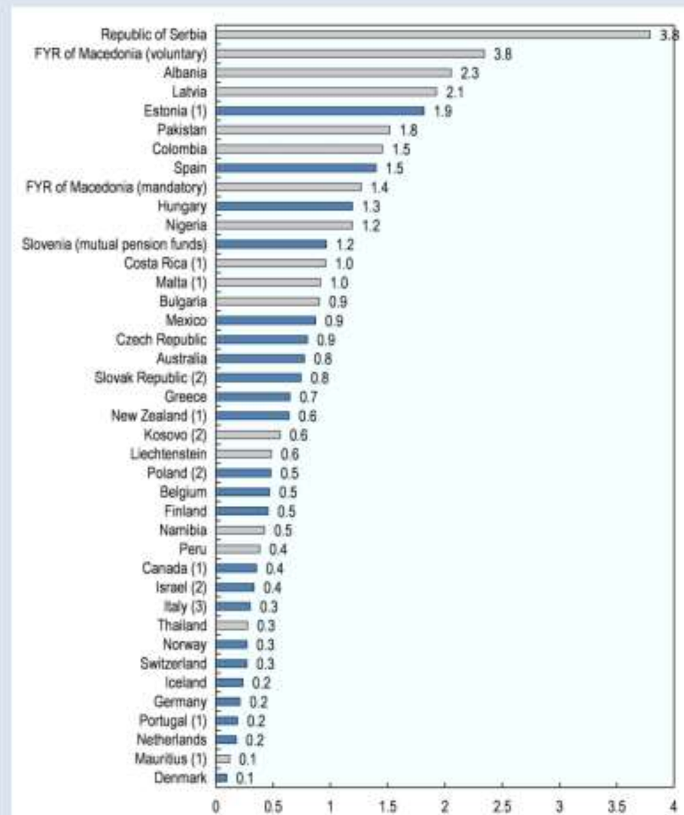
Definition and measurement of pension funds operating costs and fees
Operating costs include marketing the plan to potential participants, collecting contributions, sending contributions to investment fund managers, keeping records of accounts, sending reports to participants, investing the assets, converting account balances to annuities, and paying annuities. Some costs may not be fully reported. For example, in Chile pension funds that invest in international mutual funds deduct management costs directly from the fund. Each pension fund administrator to the Superintendence of Pensions reports these costs separately. However, they are not included in the fees charged to participants and thus not included in the operating expenses.

Fees can either be fixed or variable. Fixed fees are characterized by the fact that their levels depend neither on salaries nor on funds. A variable fee may take the form of a percentage of the inflow of contributions, of the amount of assets managed, or of the investment return on the assets under management.

In general, countries with defined contribution systems and those with large numbers of small funds appear to have higher operating costs than countries with only a few funds offering defined benefit, hybrid, or collective defined contribution pension arrangements.

Operating expenses also tend to be higher in non-OECD countries. Costs are above 1.0% of assets under management for nine non-OECD countries out of the 17 that reported such data.[39]

Pension funds' operating expenses as a share of total investments in selected OECD and non-OECD countries, 2012 (As a percentage of total investment)



In defined contribution private pension systems, providers cover their operating costs through the fees they charge to pension plan paryicipants. The structure of charges across countries is fairly complex. While there is a tendency for countries from the same region (e.g., Latin America, Central and Eastern Europe) to have similar fee structures, they can vary greatly across wider geographical regions - *Table 2 considers fees in selected DC systems only.*

Variable fees on contributions can be expressed as percentages of salaries or as percentages of contributions. Variable fees on the stock of funds can be levied either on the value of the fund or on returns. Such fees may encourage pension companies to seek higher investment returns.

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[39] Note: Countries in blue are OECD members, the others in grey are non-OECD members; 1) Data refer to administrative costs only; 2) Data refer to investment management costs only; 3) Data refer to "new" contractual funds. Source: OECD Global Pension Statistics.
Pension Market in Focus 2013, OECD. www.oecd.org/daf/pensions/pensionmarkets

Table 2. Total fees or commissions charged by pension funds or their administrators/managers to members, by type of fee, in selected OECD and non-OECD countries, 2012

As a percentage of total investment

	Fee on contributions	Fee on assets	Fee on return / performance	Other fees (e.g. exit fees, entry fees, switching fees)	Total
Selected OECD countries					
Chile	0.65	-	-	-	0.65
Estonia	-	1.73	-	0.09	1.82
Hungary	..	0.53	-	..	..
Poland	0.11	0.38	0.03	-	0.51
Slovak Republic	0.11	0.59	0.19	0.04	0.94
Slovenia (pension and insurance companies)	0.27	..	1.18	0.22	..
Slovenia (mutual pension funds)	..	0.84	-	1.07	..
Spain	-	1.08	-	-	1.08
Turkey	0.27	0.71	-	0.20	1.17
Selected non-OECD countries					
Albania	-	2.01	-	0.13	2.14
Bulgaria	0.70	0.79	0.08	0.05	1.63
Costa Rica	-	0.99	0.00	-	1.00
FYR of Macedonia (mandatory)	0.72	0.53	-	..	..
FYR of Macedonia (voluntary)	1.41	0.83	-	..	..
Pakistan	0.19	1.00	0.22	0.29	1.70
Peru	1.15	-	-	-	1.15
Romania	0.05	0.04	-	-	0.09
Republic of Serbia	0.37	1.74	-	-	2.10

Source: OECD Global Pension Statistics.

For Azerbaijan in initial stage when Private Pension Management companies would be established and pension assets accumulation would take several years to cover Pension management company costs only from fees of participants – to succeed "break-even point" in operational activities, there still remains issue about significant investment of shareholders capital to cover operational costs of Private Pension Management company.

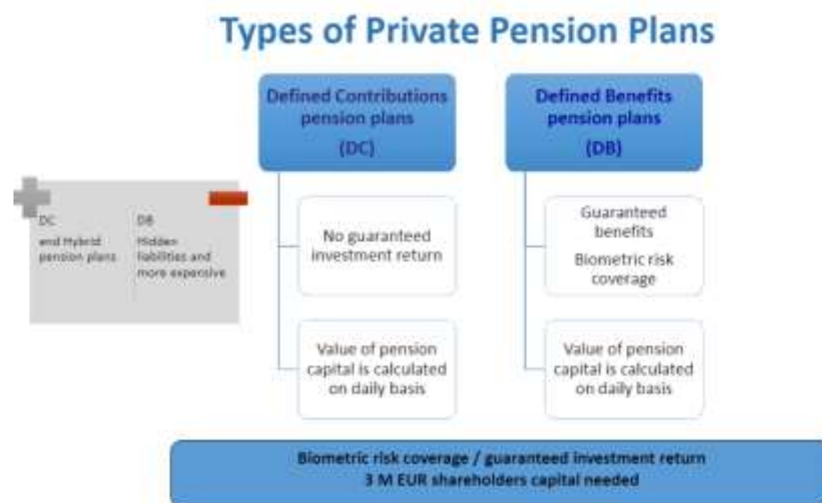
To boost private pensions asset growth it would be advisable to reconsider different types of incentives to stimulate activity of potential participants to make savings in long-term financial instruments. One of wide spread options would be tax incentives, but in Azerbaijan where savings culture is not popular and developed, tax incentives would not provide sufficient stimulus in the beginning phase to raise assets in private pension funds on voluntary basis.

Another approach when employers would have mandatory obligation to include private pension savings in employees' remuneration package would be advisable. That type of approach several European countries are applying to protect their inhabitants in old age and increase replacement rate in retirement. That would mean agreement between employer and employee should be signed not only for monthly salary, but also for private pension contributions. Private Pension Management Company would be chosen by employee or by employer regarding to agreement between these two parties. This condition should be introduced in Labour Law of Azerbaijan to set up this general principle, but minimum level of private pension contributions (for example, 20 AZN per month, or 2% from gross salary) would be set up by rules of Cabinet of Ministers. Introduction of semi-mandatory private pension savings would help to cover also younger population and would stimulate faster pension assets growth as swell as would provide higher replacement rate in the retirement.

9. Types of pension plans and participation rules in pension plans

There would be introduced several types of pension plans – financial savings instruments, and each Pension Management Company could introduced and offer to potential pension plan participants one or several pension plans regarding to it's business strategy.

In broad terms, and depending on how pension benefits are calculated and who bears the inherent risk, pension plans can either be **defined benefit (DB) or defined contribution (DC) in nature.**



Defined Benefit Plans – mostly used by employers for their employees
Under a defined benefit pension plan, an employee typically receives an annuity upon reaching a specified age.
The size of the annuity in most cases is based on length of service and employment earnings; the annuity may or may not incorporate adjustments for changes in the measured cost of living, and it may be integrated with social security.
The employer makes regular contributions to the plan to fund the participant's future benefits.
Private defined benefit plans are frequently non-contributory, that is, participants do not contribute to the plan, and generally there are not individual accounts for participants.
The risk of the investment strategy is borne by the employer. Defined benefits plans invest in a variety of tangible and financial assets, but they may not invest more than 10 percent of the fund's assets in the firm (employer) securities.

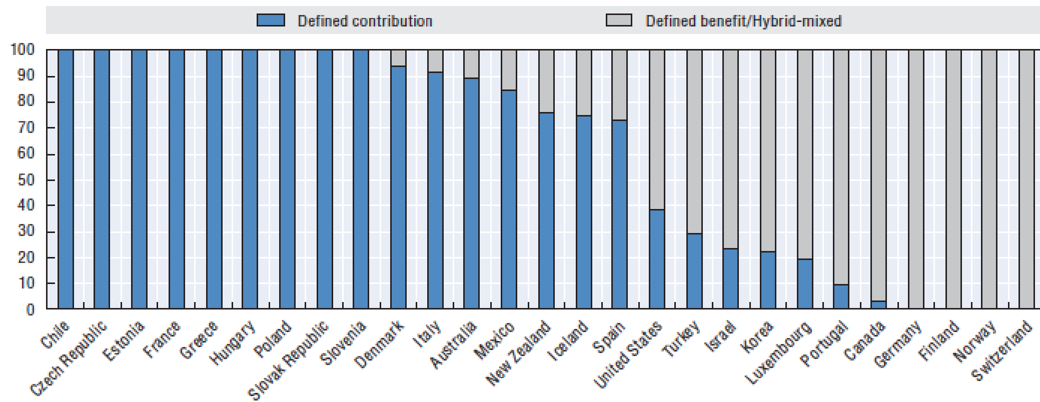
Under a **defined contribution plan**, the employer or the employee, or both, contribute to the employee account. The employee bears the investment risk, and the value to the employee at retirement depends on the accumulated contributions, investment earnings, and asset appreciation.

In DC plans, participants bear the brunt of risk, while in traditional DB plans sponsoring employers assume most of the risks.
Employers in some countries have introduced **hybrid and mixed DB plans**, which come in different forms, but effectively involve some degree of risk sharing between employers and employees.
In the conditional indexation plans in countries such as Canada and the Netherlands, benefit levels (either fully or partially) are conditional on the fund's solvency status. Cash balance plans (another type of hybrid DB plan) provide benefits based on a fixed contribution rate and a guaranteed rate of return (the guarantee is provided by the sponsoring employer, hence these plans are classified as DB). Such plans are increasingly popular in Belgium (where by law, employers must provide a minimum return guarantee), Germany, Japan and the United States. Mixed plans are those where the plan has two separate DB and DC components, which are treated as part of the same plan. For instance, the plan may calculate benefits under a DC formula up to a certain age before retirement and apply a DB formula thereafter.
There are also DC plans such as those in Denmark and Iceland, which offer guaranteed benefits or returns and in which risks are borne collectively by plan members. They are classified as DC as whenever there is no recourse to the sponsoring employer in case of underfunding. Such plans, however, provide a degree of predictability over future benefits similar to that of DB plans.

Within pension funds, DC plans are playing an increasing role, even if DB plans still dominate pension fund assets in some countries, largely due to their historical prominence as the favoured arrangement for occupational (workplace) pensions in many countries.

Occupational pension plans in OECD countries have traditionally been DB. However, in recent years, occupational pension plan sponsors have in many countries shown a growing interest in DC plans, as demonstrated by the number of employers that have closed DB plans to new entrants and encouraged employees to join DC plans (and in some cases also frozen benefit accruals for existing employees).
DB plans, however, still play an important role, largely due to their historical prominence as the favoured arrangement for occupational (workplace) pensions in many countries. In 2011, DB assets accounted for most of pension funds' assets in countries like Canada, Finland, Germany, Korea, Israel, Luxembourg, Norway,
Portugal, Switzerland, Turkey and the United States, where public sector pension funds remain overwhelmingly DB.
At the other extreme, all pension funds are classified as DC in Chile, the Czech Republic, Estonia, France, Greece, Hungary, Poland, the Slovak Republic and Slovenia. In other OECD countries, the DB-DC split varies.

8.3. Relative shares of DB, DC and hybrid pension fund assets in selected OECD countries, 2011
As a percentage of total assets



Source: OECD, Global Pension Statistics.

StatLink http://dx.doi.org/10.1787/888932908079

Taking into account that defined contributions pension plans are becoming more and more popular worldwide for pension savings, that approach would applicable also in Azerbaijan when Private Pension Management companies would be established. These schemes would be also cheaper for private sector to establish such kind of private pension business due to guaranties no needed from shareholders capital and capital market risks partly or fully would be bear by pension plan participants.

It would be recommendable for Azerbaijan not to regulate in law what kind of pension plans would be offered by private pension funds. Law should give flexibility for private pension funds choose themselves what kind of financial instruments (pension plans) to introduce for offer to customers – individuals and employers.
Each of pension plans needs to be regulated in law separately regarding to it's type – pure DC, DC with biometric risk coverage, DC with guaranteed interest return and guaranteed principle contributions, DB pension plans.

Any guaranties like investment return or biometric risk coverage would need higher shareholders capital or guaranty mechanism to protect customers. Usually for shareholders (as well as for customers or pension plan participants) it is more expensive option to provide or receive any kind of guaranties. As a minimum shareholders capital requirement in Europe to provide any guaranties to pension plan participants is at least 3 million Euros. And this approach would be recommendable also for Azerbaijan to be in line with international practice.

To cover death (survivors) and invalidity as well would very likely mean a kind of conversion to an insurance approach. The system envisaged in the first place has a savings approach rather than an insurance approach. To cover invalidity and survivors may make it risk insurance and in that case would mean and require insurance calculations. It may be decided to simply make invalidity and death also cases for paying out the achieved amount. Depending on when this will happen the amount available might be small.
According to international experiences protection in case of disability or death (survivors) usually means that there will be taken into account also those years the individual would have spent with the system if invalidity or death would not have happened. So the systems usually calculate the final benefit on the basis of not only

the years the person actually has worked but also the years he would have been otherwise able to work until retirement. This then usually is expressed in a specific benefit formula. So if disability and death should also be covered this would in the end mean that this would be a way following the insurance principle since in this case a risk is covered like in any insurance. This would also mean that in such a case inheritance is not possible since the contribution is also the equivalence for a risk.
In case of the private pension funds this might be up to the decision of the participants. The contribution to the system has to be higher in case of coverage also of death and invalidity – due to the risk element. The alternative there is that the benefit amount is lower if staying with the same contribution.
The decision should be made when joining the program since it has to be part of the contract. If the decision is made later a recalculation might be necessary.

To promote and develop decent DC pension plans OECD Working Party on Private Pensions has identified elements of good design of DC pension plans in ***The OECD Roadmap for the good design of Defined Contribution Pension plans***[40]

The OECD Roadmap for the good design of Defined Contribution Pension plans
Defined contribution, private pension plans are increasingly an integral part of most countries' overall pension system; while for some countries they are the main component of their pension system. Therefore, overall retirement income adequacy depends importantly on the pension benefits stemming from these plans.

In seeking to assist countries to strengthen retirement income adequacy in a defined contribution environment, the OECD Working Party on Private Pensions has identified elements of good design and public policy. This roadmap for the good design of defined contribution plans consists of the following recommendations:

1. Ensure the design of DC pension plans is internally coherent between the accumulation and payout phases and with the overall pension system.
Consequently, the target retirement income in DC plans should be determined consistently with the benefits provided by the other components of the pension system. To define and achieve this target, all possible risks (i.e., labour, financial and demographic risks) affecting retirement income of DC pension plans should be monitored.
2. Encourage people to enrol, to contribute and contribute for long periods.
Where mandatory enrolment is not considered opportune, mechanisms such as automatic enrolment, with the possibility for individuals to opt out, are particularly useful, together with setting adequate default contribution rates. Making sure people contribute for long periods with sufficiently high contribution rates is the most effective way to improve their chances of obtaining an adequate replacement rate from DC pension plans. This goal needs to be complemented with "work longer" policies.
3. Improve the design of incentives to save for retirement, particularly where participation and contributions to DC pension plans are voluntary.

[40] *THE OECD ROADMAP FOR THE GOOD DESIGN OF DEFINED CONTRIBUTION PENSION PLANS. This roadmap has been approved and endorsed by the OECD Working Party on Private Pensions in June 2012*

An appropriate structure of tax incentives (including financial subsidies for those who pay low or no income taxes) and/or matching contributions can both be efficient mechanisms to encourage participation and increase contributions.

4. Promote low-cost retirement savings instruments. *Policymakers need to ensure that there are incentives in place to improve efficiency and reduce costs in the pensions industry. Disclosure-based initiatives should be promoted, but may need to be complemented with more effective solutions such as appropriate tender mechanisms or default allocation to low-cost providers, especially in compulsory or auto enrolment systems. In certain pension's structures, cost issues can be addressed by establishing large pension schemes, run on a non-profit base.*

5. Establish appropriate default investment strategies, while also providing choice between investment options with different risk profile and investment horizon. *As many members may be unwilling or unable to choose investments, default options need to be carefully designed following the lessons learnt from behavioural economics. But if they wish, people should be allowed to choose the investment strategy best suited for them according to their risk profile and their level of risk tolerance, as well as their different overall pension arrangements.*

6. Consider establishing default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes. *Life-cycle investment strategies reduce the impact of market risk on the account balance as the member ages. Such a design is consistent with economic rationale and risk attitudes and is therefore well suited for default strategies.*

7. For the payout phase, encourage annuitization as a protection against longevity risk. *A certain level of annuitization of balances accumulated in DC pension plans should be set as the default mechanism for the payout phase, unless pay-as-you-go public pensions or the old-age safety net already provide for sufficient regular pension payments. A combination of programmed withdrawals with a deferred life annuity (e.g. starting payments at the age of 85) that offers protection against inflation could be seen as an appropriate default. The demand for annuities could be also promoted by financial education initiatives stressing that they are insurance products designed to protect people from outliving their resources. Lump-sum payments may have to be discouraged as a form of benefit pay-out, except for small DC account balances.*

8. ***Promote the supply of annuities and cost-efficient competition in the annuity market.*** *Different providers, such as public schemes, non-profit occupational plans, and insurance undertakings may provide different arrangements of risk-sharing in the payout phase that may help strengthen benefit adequacy and diversify risks in retirement income. Competition among different providers in the market for individual and group annuities should be promoted to ensure cost-efficient provision for plan members and to help develop the annuity sector as a whole.*

9. Develop appropriate information and risk-hedging instruments to facilitate dealing with longevity risk.

The market for annuities would benefit from certain actions aimed to making the management of longevity risk easier. Firstly, reliable life tables should be made available by public statistical agencies; they should be regularly updated and incorporate stochastic forecasts of future improvements in mortality and life expectancy. Secondly, capital market solutions to longevity risk management could be promoted by producing standardized, publicly and readily available longevity indices. While there has been no successful example of longevity bonds thus far, governments could additionally consider in certain contexts issuing longevity indexed bonds and

issuing very long-term bonds in enough quantities.
10. Ensure effective communication and address financial illiteracy and lack of awareness. *Effective communication includes providing regular individualized benefit statements. In addition, clear benefit projections under prudent assumptions, informing members about the possible impact of higher contributions or later retirement on their benefits could also be made available. Plan members should also have free and ready access to comparative information about costs and performance of different providers, and they should readily understand the language used in disclosed materials.*

Participation rules in pension plans
There are several options how individuals could become as participants (members) of pension plans of Pension Management Company:
1) **Directly**. Individual participation on individual agreement basis between private person and Pension Management Company. Individual for his account and other individual person's pension account can make contributions in accordance to pension plan rules.
2) **Indirectly**. Participation on group agreement basis between employer and Pension Management Company, where employer making contributions on behalf of their employees.

Retirement age for private pension savings in Private Pension Funds
Taking into account that Azerbaijan is on developing stage for long-term savings in financial market, there would be needed more enough attractive retirement age for private pension savings comparing with official state retirement age, for example 55 years or 5 years before official retirement age.
That would be additional advantage and stimulus for persons to start pension savings.
As well as life insurance contracts minimum policy term is 3 years to receive tax advantages for savings. Even if popularity of such savings product is growing between a population which pays official personal income taxes, there is issue if private pension savings would enough attractive comparing with life insurance savings with such a short time perspective.
There should be also options for earlier draw downing pension capital before retirement age – e.g., in case of disability or/and specific professions where working life is shorter than average possible.

Pay – out issues, products and rules
Due to rising life expectancy, many households may be faced with the prospect of insufficient pension savings to finance their desired level of consumption and lifestyle. In addition, their retirement income options are often constrained by a requirement to purchase an annuity to maintain an appropriate income level until the end of their life.

The report on Rethinking Retirement Income Strategies: How Can We Secure Better Outcomes for Future Retirees,[41], shows that this requirement does not give individuals the level of flexibility needed to choose the best solution for managing their accumulated pension savings. By holding a proportion of pension assets in equity early on in retirement, and switching to bond holdings and annuities progressively over time, individuals can expect to achieve significantly higher retirement income, at a comparatively low risk.

The explanation for this result is simple: in an environment where individuals are living longer, the benefits of investment diversification extend well beyond normal retirement age, as diversification creates the kind of upside income potential not found in conventional annuities, while providing downside protection against the higher risks associated with a portfolio that is concentrated on equity holdings.

Particularly significant is the position that requiring individuals enrolled in defined-contribution schemes to purchase an annuity at retirement is questionable. The report shows that introducing more flexibility in this area would produce potentially large welfare gains, for four key reasons:

- Firstly, as explained above, individuals can expect to enjoy a substantially higher consumption level if they keep a balanced asset allocation of their pension savings, at least for an extended period after retirement.
- Secondly, permitting more flexible choice among investment solutions for the payout phase allows to take into account people's preferences, level of risk tolerance, and other sources of wealth to tap into retirement. This last factor is particularly relevant in countries guaranteeing a significant replacement rate in the form of first-pillar pensions. In this situation, individuals should be allowed to choose an asset allocation tailored to their personal situations.
- Thirdly, it is widely recognised that households wish to provide their surviving relatives with an inheritance and build a financial buffer to cope with the risk associated with critical illness. The key finding of the report – that people are better off not purchasing conventional annuities – is not dependent upon the assumption that bequest motives and contingency planning play a role in individual savings behaviour. Once these considerations are factored in, the disadvantage from enforced annuitisation becomes substantially bigger.
- Finally, a more balanced approach to payout solutions and a supportive tax and regulatory environment would also create incentives for the financial services industry to develop innovative alternatives to annuities. Although such alternatives have emerged in a number of countries, their market uptake remains modest and restrictions often make them unappealing. Greater innovation would also lead to greater competition between solution providers.

[41] *Rethinking Retirement Income Strategies: How Can We Secure Better Outcomes for Future Retirees? is published by the European Fund and Asset Management Association (EFAMA). The authors of this report are Raimond Maurer and Barbara Somova., February 2009*

Challenges for pension payout phase – The trend towards funded individual pension schemes calls for appropriate payout products

There is a trend internationally towards greater use of individual funded pension schemes. Faced with rising life expectancy of population and financial strains on pay-as-you-go pension systems, several countries have engaged in reforms of their pension systems to expand existing and/or create new private funded pension schemes. This development has coincided with an increasing number of occupational pension schemes being restructured from the defined benefit to the defined contribution type.

While attention is often focused on the savings or accumulation phase, it is crucial to recognise the importance of adequate solutions and regulation for the payout phase. For many people, their pension saving pot may well be their most significant financial asset, and deciding on **how to convert it into retirement income is one of the most important financial decisions they will ever make**.

Retirement solutions should mitigate and strike a balance between the main potential financial risks faced by individuals: **inflation risk** (risk that prices rise at a rate that erodes the value of the future retirement payments), **investment risk** (fluctuations in the value of the underlying assets of the funded pension), and **longevity risk** (threat of exhausting one's accumulated pension assets during retirement).

Integrated payout products combine certain characteristics of annuities and drawdown plans. These hybrid solutions provide both guaranteed retirement payments as well as the flexibility, bequest potential and upside investment potential of non-pooled solutions. They come in various forms. Investment-linked or variable payout annuities on the one side, typically offered by insurance companies, and asset management solutions with investment and/or income guarantees on the other, are both examples of solutions that allow participation in the capital market in combination with the longevity pooling component. They facilitate an efficient transformation of retirees' accumulated wealth into income streams, often by offering standardised solutions.

The continuous increase in the survival probabilities used by annuity providers for pricing purposes (and the discrepancy compared to the general population life expectancy) has enhanced the attractiveness of non-pooled solutions compared to the traditional life annuity. Further, thanks to the increase in life expectancy and the ensuring long investment horizon of pension assets, investments diversified across different asset classes might form a substantial part of a well-structured payout program. It is possible to design drawdown plans or hybrid solutions that mitigate the major financial retirement risks (i.e. investment, longevity, and inflation risk) at relatively low costs.

Regulatory environment for payout solutions – Existing regulation and rules favour annuitisation

In several countries tax advantages and regulation favour annuities in the majority of pension programs. This has led to a vast dominance of annuities over phased drawdown and integrated products, with annuities with fixed payouts being the most frequently used solutions. The situation is markedly different in the United States where most funded pension schemes allow for some forms of drawdown plans, and where the majority of retiring workers choose this option.

In Europe, regulation tends to favour annuities in order to protect retirees from old age poverty by mitigating investment and longevity risk. A second regulatory

objective is to prevent retirees from spending their accumulated funds too rapidly, thereafter reverting to living off social security benefits.

Public pay-as-you-go pensions, social security benefits and employment-linked defined benefit plans already prevent, to a reasonable degree, retirees from falling under the poverty line in most European countries. Moreover, available empirical evidence does not support the notion that retirees deliberately spend too much and too quickly.

Finally, it is possible to design non-pooled payout solutions like drawdown plans or integrated solutions that minimise longevity and investment risk at relatively low cost. Hence, the bias of existing regulation towards substantial annuitisation early in retirement is not justified.

Economic modelling of payout solutions – Full annuitisation is costly

According to the modelling presented in this report[42], the best investment strategy for payout solutions is to hold a significant proportion of pension assets in well diversified equity portfolios early in retirement, and to switch to annuities and bond holdings progressively over time, taking into account individuals' specific circumstances. This strategy results in significantly higher consumption possibilities, at a relatively low risk compared to immediate full annuitisation at retirement.

The risk of being worse off in terms of retirement income in case of adverse stock market developments is limited for individuals adjusting their pension asset portfolio over the entire retirement period. The simulations of consumption levels under different financial market conditions show that the majority of individuals (70%) can expect to enjoy up to a third of higher lifetime consumption level if they hold equity at the beginning of retirement and gradually switch to annuity over time, instead of annuitising all their wealth at the age of 65. Moreover, the consumption level of individuals ending up in the worst financial market scenarios would be less than 10% lower than under full annuitisation.

As a consequence, compulsory full annuitisation of retirement wealth at the age of 65 results in significant costs in terms of foregone consumption. Taking into account the desire of individuals to leave money to their surviving relatives and/or build a financial buffer to cope with large and sudden expenses, the disadvantage from enforced annuitisation becomes substantially aggravated.

The report also demonstrates that retirees can enjoy a smooth consumption pattern during retirement if they keep their retirement wealth invested in pension products featuring a switching mechanism to increase the proportion of annuities and bonds as time goes by. This result reflects the fact that short-term fluctuations in equity markets become less important over long investment horizons when the gradual reduction in equity exposure limits the exposure of pension assets to market volatility.

Policy recommendations – Regulatory reform can balance the goals of policymakers and the needs of retirees

The regulatory framework in Europe should find a reasonable balance between satisfying the concerns of policymakers and addressing the needs of retirees. Enforcing compulsory conversion of pension savings into annuities does not give individuals the level of flexibility needed to choose the best approach to suit their

[42] Rethinking Retirement Income Strategies: How Can We Secure Better Outcomes for Future Retirees? is published by the European Fund and Asset Management Association (EFAMA). The authors of this report are Raimond Maurer and Barbara Somova.

circumstances and risk tolerance. This is particularly the case given the very different range of retirement income likely to be available, ranging from a very strong support from state and/or salary-related pension schemes through to greater reliance on a defined-contributions savings pot.
Ideally, regulatory frameworks across Europe should support, on equal terms, both annuities and other payout solutions. Restrictions on non-annuity products should be relaxed and pooled, non-pooled and hybrid solutions should enjoy equal tax treatment.
A more balanced regulatory framework for the payout phase of funded pension schemes would spark innovation in the European financial market and stimulate the creation of payout products tailored to meet individuals' retirement needs. Competition between providers of payout products would also increase, thereby lowering the cost of products. The evidence from countries where drawdown plans and other non-pooled solutions are not hindered by legislative or tax rules highlights the benefits of innovation and competition.

Less restrictive rules and regulation towards non-pooled solutions would also create incentives for the financial services industry to create a variety of standardised pooled; non- pooled and integrated payout products, designed especially for retirement. As such pre-packaged solutions are likely to include a range of choices with respect to risk attitude and preferences regarding the structure of periodic payments, improved information requirements, advice and financial education should assist individuals in deciding how to invest their accumulated pension savings. In addition, appropriate default options should be in place to help individuals who cannot or do not want to chose between the available payout products.
If nonetheless compulsion is still favoured, then the upper age limit for compulsory annuitisation should be pushed towards 85 in order to achieve a right balance between the objectives of securing a sufficient level of retirement income and protecting retirees from longevity risk at very old ages. Using some part of the accumulated assets to buy a deferred annuity starting payments at age 85 or requiring a switching of assets into annuities at that age can achieve this.

One possible compromise between compulsion and a more liberalised market would be only to make pooled solutions mandatory if a basic standard of living is not available from other annuity-like sources, such as state pension, defined benefit schemes etc. Above that minimum level, individuals should be allowed to make a free decision for themselves, given both that individual circumstances will vary considerably and that it is difficult to set regulatory restrictions that do not end up becoming burdensome for individuals.
In summary, there are several financial risks during payout phase should be covered:

1) Liquidity – flexibility to meet unforeseen expenditures, e.g., medical treatment, long-term care etc.;
2) Adequate income – alleviate poverty, provide adequate replacement of earnings;
3) Life-long income – longevity risk;
4) Common risk – inflation
5) Other risks like reinvestment risk of capital, bequests.

There are several types of products for the payout phase possible by providing specific needs in retirement:

1) Liquidity and bequest needs would be covered by lump-sum (single) payment;
2) Adequate income would be covered by programmed withdrawals: series with fixed or variable instalments;
3) Life-long income would be covered by periodic fixed or variable payment until the end of the annuitants live: annuity or life pension;
4) Combined arrangements of above mentioned would be covered by programmed withdrawals combined with a differed annuity starting at very old age, e.g. at age 80 or higher.

But at the same time there is clear conclusion that no every single product serves all needs of retirees.

Risks associated with funded pension schemes:

- ***Investment risk*** describes the threat that pension assets fluctuate over time and decline in value. The fundamental law of efficient capital markets implies that higher return prospects come with higher risks.
- ***Inflation risk*** describes the threat of general price increases over time reducing the purchasing power of pension benefits or pension assets.
- ***Longevity risk*** describes the threat of reaching an age where all savings are already exhausted during the lifetime of the retiree (risk of capital exhaustion).

In following table there is summary of risk features of several optional retirement products that differs by price, value of pension capital and risks covered during retirement.

	Risk Protection			Other Benefits	
	Longevity	Investment	Inflation	Flexibility	Bequest
Lump-sum payment	No	No	No	Yes	Yes
Term annuity	No	Possible	Possible	No	Yes
Life long withdrawal plan	No	No	No	No / Yes	Yes
Variable life annuity + minimum payment guarantee + bonus	Possible / shared	Shared	Shared	No	No
Variable life annuity, unit linked	Shared	No	No	No	No
Fixed nominal annuity	Yes	Yes	No	No	No
Escalating nominal annuity	Yes	Yes	Partial	No	No
Fixed real life time annuity	Yes	Yes	Yes	No	No

The basic retirement payout options

Regarding the range of payout products within a DC-orientated retirement landscape, there are two basic alternatives to manage the payout phase, both of which can be combined with each other:

(1) Purchase of a Payout Life Annuity
(2) Following an Systematic Income Drawdown Plan
(3) Building a Portfolio of Life Annuities and Income Drawdown Plans (hybrid solutions)

There is a wide range of types and shapes of annuity and income drawdown products in the private market, and in part two we provide a detailed taxonomy of products offered in the market.

The basic features of these payout options are following:

Life Annuity:

In its basic form, a life annuity is a financial contract that entitles the investor (annuitant) to a series of regular payments contingent on survival of one or two individuals.

The annuitant is in the position of a creditor to the provider of the annuity.

In the private market these life-contingent assets are typically offered by life insurance companies or in the case of occupational retirement schemes also by pension funds.

It should be mentioned that life annuities are also offered by the public sector, since the benefits of mandatory state pensions can also be characterised as annuities from a financial perspective. The key difference, however, is that state pension annuities are in most countries financed on a pay-as- you-go basis, while annuities in the private market offered by insurance companies or pension funds are funded by setting aside financial assets.

In turn, the insurer collects non-refundable premiums from the annuitants and invests them in financial assets backing the life contingent payment promise. If the number of annuitants is sufficiently high and mortality risks are independent, the insurer can hedge its liabilities by pooling longevity risk across a group of annuity purchasers. Surviving annuitants receive the reserved funds of other pool members who die. In this way, the life annuity is a collective (or pooled) product and the redistribution of funds among surviving members can generate an extra return higher than the capital market return of assets with similar risk profile. This extra return is often referred to as the survival credit (sometimes also named mortality drag). The insurance company anticipates the extent of the survival credit with respect to an ex ante specified mortality table and guarantees (with a high probability) the annuitants to paid it out in a pre-specified manner.

Since the annuity contract entitles the retiree to a regular income stream over the remainder of his life, the retired annuitant can transfer the longevity risk to the insurance company and earn the survival credit. In the special case where annuity payments are constant in real terms (inflation linked annuity) the retiree can also transfer the investment and inflation risk to the insurance company. However, this longevity insurance in conjunction with a survival credit comes at the expense of foregone liquidity, low flexibility, lost of control over retirement assets and no possibility for bequest.

In addition, a life annuity “doesn’t completely eliminate risk for the annuitant. The annuitant has, in effect swapped longevity risk and investment risk for credit risk – the possibility that the insurance company will default on its obligations”. While the key goal of insurance regulation is to ensure the enforceability of long-term commitments of the companies towards the policyholders, and while in most countries regulators are very successful with respect to that ask, empirical experience shows that within the insurance sector insolvencies are not only a matter of theory.

Income Drawdown:

Should the retiree choose an income drawdown strategy in retirement, this will result in **periodic withdrawals or lump sum payments**.

In such case, the retiree has the freedom to decide on how to invest his wealth among the various asset categories (stocks, fixed income, cash, real estate). The assets will earn more or less uncertain rates of return, and the retiree may withdraw periodically

a specific amount or a certain number of fund units of the invested funds to generate an income stream in retirement.
Here, the retiree must select both an investment and a spending tactic, stipulating how much of his balance to spend per year. The retiree is in the position of an owner of assets, and there is no risk pooling with other retirees. Typically the assets are represented by mutual fund units, offered by investment management companies. Besides provision of professional asset management skills to select and manage well diversified portfolios of securities or properties, the investment management company can offer additional services to retirees. This could be special spending rules, special asset allocation patterns for retirees, or also some income or return guarantees. This individual method of generating retirement income allows for bequest, provides liquidity, control over assets, and may lead to a higher consumption, as compared to the purchase of an annuity. However, the retiree cannot earn an extra return in form of the survival credit and is exposed to the risk of running out of money, as he might outlive his assets before his uncertain time of death.

Building Retirement Portfolios using Life Annuities and Income Drawdown Plans:
A retirement financial strategy need not involve a simple choice between annuitising all one's pension money versus selecting a specific income drawdown plan. Rather the retiree may optimise his retirement portfolios by simultaneously selecting combined portfolios that include both annuities and mutual fund investments, i.e. pooled and non-pooled products. To do so, the retiree has several options about when and to what extent to include a life annuity in his financial retirement strategy:

1. Purchase of an life annuity with immediate payments starting at retirement (immediate annuity);
2. Purchase of a life annuity with benefit payments starting at a certain point in the future (deferred annuity);
3. Purchase of only one life annuity, with all or with a part of retirement savings (full / partial annuitisation);
4. Gradual purchase of life annuities as retirement progresses (gradual annuitisation)

For Azerbaijan where individual decision flexibility and guaranties are playing crucial role for private pension savings development lump sum pay out option would be more appropriate and attractive by participants in the period when voluntary private pension savings just starts building up in economy, but on later stage some kind of annuities could be introduced to provide longer period regular income on retirement.
The amount to be paid out in consequence may be inherited or even more, participant could indicate beneficiary (concrete persons whom private pension capital would be paid out in case of participants death) in participation agreement with Pension Management Company. That approach with beneficiary indications would be additional incentive to use private pension savings as instrument for inheritance needs.
The individual at a certain stage may opt for annuity that can be done by the fund managing the contributions paid in or by an additional institution.

If an individual decides in favor of an annuity the issue arises who should be in charge of administering the annuity. In the case of a voluntary pension savings – in general totally private – this should be provided by a private institution – which might mean

an insurance company; they usually have the necessary knowledge to calculate annuities and pay them out.

Connected with this is the issue of what and how the benefit in the end should be. Internationally it is discussed whether it should be defined in a contribution to be provided (DC plan) or a benefit to be provided (DB plan). In the case here it seems to be advisable to have an option to have either a DC plan or a DB plan. The typical approach will be a DC plan – generally all over the world DB plans are in retreat.
In case of a DB plan it has to be decided whether the employer or whether the fund should bear the risk.
In a defined contribution world, the retiree directly takes personal responsibility to manage investment, inflation and mortality risk. It is, therefore, essential for the retiree to evaluate those risks for each payout product. This requires the prospective retiree to measure the respective risk-return profile opportunities, to compare costs in terms of fees and loadings, to estimate the flexibility and the freedom of disposition, and decide about his own willingness to bear the risks as well as about the corresponding time preferences.
All these decisions may not have to be fixed by law but are up to the participants.

10. Marketing rules of pension plans

Marketing or public communication of private pension savings can be done only regarding to registered pension plan rules (registered in State Supervisory Authority).
And in case of marketing pure DC pension plans where investment return is not guaranteed – it must not allowed to advertise any guaranty on investment result or promise that historical investment result the same investment returns in the future.

In case of competing funds it might have to be considered to limit the costs of advertising. Due to international experiences otherwise excessive expenditures for advertising may be the consequence – and by that “eating up” part of the funds and thus being to the disadvantage of the individuals.

11. Individual accounts of pension plan participants

For each pension plan participant individual account should be created to accrue all contributions made, separately – individuals, employers or other private person, commissions and fees paid to Pension Management Company, State supervisory authority and custodian, as well as investment result should be registered in individual accounts.

12. Guaranties and information provided to pension plan participants

Pension plan participants should have the rights on all private pension capital accounted in the individual account.
All contributions made by individual (participant) or by employer on the behalf of employee should be accounted on individual account no later than next business day after contribution has been made.
Assets (cash, securities, real estate and other financial instruments) of pension plans should be kept separately (on separate balance sheet) from other assets of Pension Management Company. That means – each pension plan and Pension Management

Company has separate balance sheets and pension plan assets cannot be used to cover Pension Management Company liabilities.
In case of insolvency of Pension Management Company or custodian bank or employer, pension plan assets cannot be included in debtor (Pension management Company or custodian or employer) property.
Debt collection from private pension capital could be done only if pension plan member has done losses to third parties in criminal case.

13. Occupational pension arrangements

The private pension funds are aimed to supplement the state and state funded pension schemes. In general it should not be an alternative to the state funded pension component, but a supplement. This should be the very system also to be used by employers for providing pensions to the employees.

The basic decision has been made to have this system voluntary. This is in accordance with international experience but not anywhere and generally the case. It should be taken for granted that such a voluntary system needs some incentives to work successfully. Experiences from other countries show that a voluntary component without any incentives whatsoever will not be worth the efforts. Therefore almost all countries provide some kind of incentives. In case of a voluntary private pension funds the decisive aspect is that the environment (tax rules, legal rules etc.) is attractive enough to use this means for retirement protection. Other motivations for a private pension funds protection might be from an employer´s point of view to attract qualified personnel or being pressured by trade unions to establish such a system. From the employee´s point of view the attractiveness stems from tax incentives and from the general need for a sufficient old age income protection. The employee will also consider what will be the system with the best return and the system most secure since providing for retirement means providing for a time far in the future and for a time when the resources collected during working life cannot be acquired again.

Incentives for joining the system
In case of the third pillar there should be tax incentives for the employee; another issue is if there should be a cap on the amount that is tax deductible in case of the employee. A lot of countries work with a general cap for all efforts on retirement or all efforts to protect oneself against the risks of life (including life insurance, health insurance etc.). It is again an issue of tax expenditures and people´s need. A certain cap might be advisable. In consequence the retirement income in the end should be fully taxed.
It might have to be considered if the tax deductibility is to be linked to the use of the third pillar money only for retirement. So either the fund may not be permitted to make a payout before a certain date or the individual might have to repay the tax benefits when he draws the money earlier. In case also the employer joins the scheme it is more advisable to require the fund not to pay out early. The date should be linked to retirement or maybe a bit earlier. A possible date might generally 55 in case of Azerbaijan since it is a bit before the retirement age for women. In Germany this date is the age of 60 – all benefits paid out before are not deemed to be benefits for old age.
In this third pillar system there should be also the possibility of contribution by the employers. They might be interested to have a means to provide their employees with

certain kind of income protection in old age. This might be to attract people and generally provide them with social benefits. As a consequence also contributions of the employer have to be made tax deductible.
This in the end would mean a system where either only the employee pays the contribution or only the employer will pay the contribution or both will jointly do. All these forms are to be found internationally and also the combination of all of them. The amount of tax deductibility also may have to be fixed here – according to the same deliberations.

Persons to be covered
In case of a voluntary third pillar there should be generally no limitation on scope of person eligible to join the system. This means that also self-employed may join.
It might make sense to set a certain age limit in order to make clear that it is for working people. This may be 18 or 20 years of age respectively the typical age entering the workforce in Azerbaijan.

Lump-sum vs. Annuity
Another basic decision seems to be that the third pillar will generally pay out only a lump sum that means the amount the person has paid in and subject to the results of the management of the fund. This would also mean that the employer bears the investment risk – and on the other side – may enjoy the positive returns. The amount to be paid out in consequence may be inherited. The individual at a certain stage may opt for annuity that can be done by the fund managing the contributions paid in or by an additional institution.
If an individual decides in favour of an annuity the issue arises who should be in charge of administering the annuity. In the case of a third pillar system – in general totally private – this should be provided by a private institution – which might mean an insurance company; they usually have the necessary knowledge to calculate annuities and pay them out.
Connected with this is the issue of what and how the benefit in the end should be. Internationally it is discussed whether it should be defined in a contribution to be provided (DC plan) or a benefit to be provided (DB plan). In the case here it seems to be advisable to have an option to have either a DC plan or a DB plan. The typical approach will be a DC plan – generally all over the world DB plans are in retreat.
In case of a DB plan it has to be decided whether the employer or whether the fund should bear the risk.
All these decisions may not have to be fixed by law but are up to the participants.

Risks to be covered
Strongly connected with this is the issue of what risks should be covered. Generally it is clear that old age should be covered. This would mean that the amount will be paid out at retirement or within a certain period before.
To cover death (survivors) and invalidity as well would very likely mean a kind of conversion to an insurance approach. The system envisaged in the first place has a savings approach rather than an insurance approach. To cover invalidity and survivors may make it risk insurance and in that case would mean and require insurance calculations. It may be decided to simply make invalidity and death also cases for paying out the achieved amount. Depending on when this will happen the amount available might be small.

According to international experiences protection in case of disability or death (survivors) usually means that there will be taken into account also those years the individual would have spent with the system if invalidity or death would not have happened. So the systems usually calculate the final benefit on the basis of not only the years the person actually has worked but also the years he would have been otherwise able to work until retirement. This then usually is expressed in a specific benefit formula. So if disability and death should also be covered this would in the end mean that this would be a way following the insurance principle since in this case a risk is covered like in any insurance. This would also mean that in such a case inheritance is not possible since the contribution is also the equivalence for a risk.
In case of the third pillar this might be up to the decision of the participants. The contribution to the system has to be higher in case of coverage also of death and invalidity – due to the risk element. The alternative there is that the benefit amount is lower if staying with the same contribution.
The decision should be made when joining the program since it has to be part of the contract. If the decision is made later a recalculation might be necessary.

Funds and Asset Management
From a legal point of view it is important to decide on how and by what institution the fund should be administered. The same is with the question of collecting the contributions on the one side and asset management on the other side. Here it seems to be the decision that the fund as such and the asset management should be separated.
In case there are several funds it has to be considered whether the individual has the right to move from one fund to the other. If the person is given that right some other additional questions may arise. The one is the matter of the transfer rules, i.e. how the contributions can be transferred to another fund. In that case it has to be fixed if the individual has to bear the costs; if yes it may be advisable to limit the costs the fund may charge – to a fixed amount or to a percentage of the assets involved.
In case of competing funds it might have to be considered to limit the costs of advertising. Due to international experiences otherwise excessive expenditures for advertising may be the consequence – and by that "eating up" part of the funds and thus being to the disadvantage of the individuals.
Additional issues arise in case also the employer may pay contributions into the system that seems to be advisable in this case. Then a number of problems have to be solved. One is who decides on the fund to be paid in. It may make sense that the employer has a certain influence in this since he may negotiate better conditions for his employees due to his market power than the individual might be able to. In that case he will need to promise contributions provided that the employees join a certain fund. This would limit the choice for the employees. The other approach would be to simply require him to pay – voluntarily – contributions on behalf of the employee to any fund the employee will choose. This might make the system less attractive for both parts.
In case the employer may decide or co-decide the issue will be of whether the employer might be able to set up conditions for his contributions. So he might arrange that his contributions will only stay with the account of the individual if the individual stays at least for a certain period with the company. This is also called the issue of the vesting periods. EU standards are that these vesting periods may not extend three years – according to a new directive to be transformed into national law by the Member States by 2018. On the other hand it is clear that the contributions of the employee to the fund may not forfeit at all.

Issues in case of employer's contributions also might be that the contribution of the employee into that system would have to be fixed and that the possible contribution rate of the employer might have to be fixed in a contract.
In case of employer's contribution it may also happen that the employer has an exclusive contract for his employees with the fund. In case of termination of the labour contract the issue may arise whether the employee may stay in the fund – and to what conditions. The chance to continue membership in the fund should be made possible. Very likely and according to experiences this will not be the condition the former employer has negotiated but general conditions.

Contractual Issues
All this has shown that there are different legal relations to deal with.
If the employee or self-employed alone is contributing to the system there will be a contractual relation to the fund on which the contributions paid are based. There also might be a relation of the fund with an asset management institution. There might be even a contract between the individual and the asset management. The latter should be less likely and better the contract relation should be between fund and asset management and the fund being the primary contractor for the individual. Taking that into account the legal relation between the fund and the individual has to be taken as the primary source of concern. This would mean that concerns about consumer protection and right of participants have to be dealt with here.
If the employer is involved this very likely would mean that he would conclude the contract with the fund. In that case between those two rules on consumer protection might not be necessary but still general rules on responsibilities of the fund. In this case it also has to be dealt with the relation between employer and employee; this will very likely be the individual labour contract and in the Azerbaijan context not so likely collective agreements between trade unions and employers / employers' associations. This again would mean that things would have to be fixed in the labour contract and rules have to be set up.

Consumer Protection Issues
The issue of Consumer Protection and the Rights of the Participants becomes relevant with the Third Pillar in case there is a choice among the funds and the providers. Here this would mean that the participants have to be enabled to make a sound decision on choosing the fund and/or the asset management facility.
This issue also becomes relevant in an ongoing relationship.
This in the first place would mean that a fund would have to be transparent in the relevant figures. It is no argument in that case that the average participant may not be able to understand all the details. Transparency means that he generally should have the possibility to do that. This is also not only limited to average consumers but generally to those who contract with the funds. This has to be the case not only when concluding the contract but also in an ongoing relationship which means that the fund would have the obligation to report for example annually.
In this case it would also have to be dealt with the issue of termination of membership to the fund. Will in that case the money remain with the fund and be paid out in retirement or will the individual have the chance to get the money back. It seems to be advisable to keep the money in the fund or at least keep it in one of the third pillar funds since otherwise the tax benefits granted for retirement savings would have to be returned since otherwise misuse might be possible. It is an issue of the administrative

abilities of the tax authorities if they can control and supervise this return – otherwise it should remain with the fund(s) as suggested.
The final issue here would be that of the exact conditions of termination of the contract with the fund. It should not be possible without notice since the fund and asset management need a certain security to do investments properly. So the notice should not be too short in order to give the fund and the asset management the chance to do also medium-term investments. So this might mean that a termination is possible yearly.
In case of additional and separate asset management the question is whether there will be any kind of choice of the asset management company. In that case also the consumer protection issue is involved. It would have to be decided who is in charge of choosing the pension fund – and how.

Labour Law Issues
In case of labour law, i.e. when the employer is also participating or is paying all the contributions, it has to be made clear that the supplementary scheme has to have the legal basis in the labour contract or a collective agreement. There it should be fixed what the obligations of the employer are and also what the obligations of the employee might be. The employer may have to make clear what contribution he would pay into the fund on behalf of his employer and under what conditions. The conditions might be subject to control by provisions to be laid down in the Labour Code of Azerbaijan.
An issue might be that if the employer does not pay contributions for all his workers this should be non-discriminatory; if there are anti-discrimination provisions in the Azerbaijan Labour Code it might have to be examined if they are sufficient.
Another issue should be the rules on the consequences of termination of the labour contract. One is the vesting periods, i.e. provision which fix until what time the contributions paid by the employer might forfeit; sop for example the employer might set up a condition that his contributions will only be finally booked on the individual´s account if he stays with the company a certain number of years. Here he may not require more than three years, as is the case in the new EU law. The three-year-period is also to be found in the Insurance Law of Azerbaijan. The provisions on vesting periods should also make clear that there is no possibility to undermine this provision by providing to start contributions under the condition of staying with the company for a certain time so that the total time required exceeds the three years.

Cross-Border Activities
In this case there might be issues like allowing also foreign companies to pay into the system which should not be a real problem provided they do business with permanent workers in Azerbaijan.

14. Organization of pension plan asset management

Funded pension system implications for the country

Besides positive implications for the stability of the pension system, there is an added benefit for the country. Funding leads to gradual accumulation of significant financial resources in the country that, in turn, lead to the development of country's capital markets. Accumulated resources can be directed to finance country's investment needs. Country's vulnerability and dependence on external financing reduces thereby improving overall macro stability and investment climate.

Degree of capital mobility within the country and internationally is very important, as is existence of good (risk adjusted) investment opportunities. If domestic investment opportunities are underdeveloped and few, locally accumulated financial flows will be directed to foreign investments to a larger degree than justified by prudence and needs of diversification. This can cause tensions domestically and can weaken the system's support. Alternatively, if capital mobility is limited, and limits to foreign investments are introduced, it can depress local market yields and lead to lower risk adjusted returns for pension system participants.

Investment policy statement (IPS)

Investment policy statement outlines the general rules between a portfolio manager and a client. The statement provides the general investment goals and objectives of a client and describes the strategies that the manager should employ to meet these objectives. Specific information on matters such as asset allocation, risk tolerance, and liquidity requirements would also be included in an IPS (www.investopedia.com).

In designing rules and regulation for the asset management of the funded pension system, one can rely, to a large degree, on the same analytical set-up used in drafting IPS.

It's important to note that IPS is a dynamic document that can change depending on circumstances. Thus, also rules and regulation should be periodically reviewed to ensure their fit to the goals and objectives of the system.

Risk targets

Risk targets will be different for different pension plans and different strategies. In general, one can distinguish three broad investment strategies:

Investment category	Risk level	Return expectation	Typical investment allocation	Equity allocation
Conservative	Low	Low	High quality fixed income investments. No FX risk.	0%
Balanced	Medium	Medium	Fixed income. Credit risk. Some FX risk. Moderate equity risk.	0-50%
Active	High	High	Fixed income. Credit risk. FX risk. Significant equity risk.	Above 50%

One can distinguish much more investment categories depending on the need and strategy. Lifecycle funds can have dozens of investment choices, each one targeted at a focused age group.

As Private pension funds participants would be able to "retire" at the age of 55, and there will not be any eligibility age restrictions, average years until "retirement" would most likely be lower compared to state funded component. Thus, allocation to balanced and active pension plans is also likely to be lower, as a result.

Pension plan participant willingness to take risk could be different from their ability to take risk. It is typical that participants have relatively high-risk aversion, especially to pure DC schemes that do not guarantee safety of the principal. Risk aversion is also influenced by participant financial literacy, own financial experience, and culture, trust in the system, economy, safety of the financial system etc. Given the fact financial markets are relatively underdeveloped, 2008 financial crises is still well remembered and there is high turbulence in neighboring countries, participant willingness to take risk is likely to be lower than their ability to take risk. Thus, conservative and balanced structures are likely to dominate.

One should pay particular care about investment return communication and about improving financial literacy of the population. Short-term negative investment returns are inevitable. Even medium-to-longer term returns can be negative or significantly depressed in the aftermath of financial crises for extended period of time. At the same time, negative returns can quickly turn into positive and timing of investment returns is hardly possible. Education of pension plan participants is therefore very important. Emotional pro-cyclical behavior of pension plan participants can result in sub-optimal returns and high degree of participant dissatisfaction.
From the system point of view, it is important to view state funded pension component and private pension funds together with P1P/PAYG scheme, acknowledging the role of diversification, pre-funding and accumulation of local investment capital.

Return targets
Return target is to maximize investment return, given risk limits of each specific pension plan and given investment restrictions.
In order to preserve the real value of investment capital, it is important to achieve positive real investment return. If we assume expected inflation rate to equal 2.1% (based on experience during past few years), nominal returns for conservative pension plans should, on average, meet/exceed 2.1% while for balanced and active pension plans, they should exceed 2.1% to achieve real capital gain and add value.

One should also consider capital gains taxes and their applicability in the payout phase. Capital gains taxes reduce investment return in proportion to the size of the tax. One can consider if state funded component and private pension fund savings should or should not be tax exempt. It would have fiscal implications for the state and would affect paid out pension size.

In order to drive pension plan asset allocation and set a clear asset allocation, risk and return target, one can work out a specific investment benchmark. Authorities can set benchmark or it can be left to be worked out by the asset managers. Some countries require pension plans to have a benchmark, publish it and follow it with certain allowed deviations (tracking error).

Some countries set benchmark at the government/ministry/agency level by creating a special "wise man board" that review and set it each year. Our suggestion is to leave benchmark creation and review decision to the asset managers. In transition and emerging market countries, benchmark creation is often problematic due to relatively underdeveloped local capital markets and poor quality of investment data. Benchmark setting at authority level can also be problematic and can often be associated with responsibility for investment returns and can affect authority reputation, as a result.
Our suggestion is to leave benchmark decision to the asset managers and impose basic investment limits at the level of legislation. This would provide freedom of asset managers to run asset allocation within set limits according to their needs, strategy and investment competence. However, asset managers should be required to describe its investment approach, risk and return targets in the specific pension plan prospectus.

Other circumstances
Besides risk and return considerations, there are many other circumstances that should be considered.

Liquidity
Liquidity requirements influence asset allocation and specific asset class selection. Such asset classes as closed ended investment funds, risk, capital or real estate are typically relatively illiquid. Even some government bonds are illiquid and should be held to maturity to turn them into cash. Bid/ask spreads of securities can often be prohibitive, even if traded on a regulated stock exchange and would imply low liquidity.

Pension fund liquidity requirements will be driven predominantly by inflows and outflows that result from turnover in pension plan participants (especially when pension plan participants would be allowed to change pension plans or pension funds without any restrictions) and regular pension plan participant contributions into pension plans. Asset managers would typically have to keep certain liquidity reserve in order to be able to meet pension plan outflows. As pension system matures, people retirement would also cause outflows. Asset managers would also have to manage their internal investment liquidity to be able to meet their investment commitments and investment needs but usually it can be forecasted with a relatively high degree of accuracy.

Liquidity requirements influence pension plan ability to make relatively illiquid investments, especially long term investments. Liquidity requirements also affect the structure of investment portfolio and asset class selection.
Asset portfolio managers, based on their experience and assumptions, would have to evaluate what would be pension plan participant turnover, would it be net positive or net negative versus competitors, how would it relate to regular monthly inflows and current portfolio liquidity. If pension plan participant's turnover is relatively high, liquidity management can be critical.

Investment horizon

Investment horizon indicates when pension plan participants expect to withdraw their accumulated pension capital. Due to the fact that in private pension funds participant age is not limited and minimum term of pension savings contract would not regulated, investment horizon would be relatively undetermined. If young persons would apply for savings in private pension funds, asset managers would focus more to long term investments with ability to take more risk for better investment return. However, pension plan switching option requires pension plans to maintain relatively high liquidity reserves, thereby limiting pension fund ability to make long term investments.

Risk tolerance

Risk tolerance is expected to be relatively low. People, in general, as well also in Azerbaijan, are not very familiar with financial markets and financial instruments. Safety of principal would be very important and tolerance to short-term volatility and negative investment returns would be low. It is likely that higher proportion of people would choose conservative pension plans, compared to suggested age structure. Investment **experience** is important and often affects attitude towards risk. It would be prudent if pension plan participants would start with more conservative investment options and only gradually would increase investment risk to the maximum of their ability/willingness. Participants need to test their ability to withstand significant losses that frequently happen in financial markets against the market reality.

Special circumstances introduce unique characteristics that are relevant to achieve pension system goals. It could relate to geography limitations (do not allow investments in certain countries or group of countries), investment limits in certain industries, products or asset classes or ethical investment limits. We would suggest introducing as few limits as possible so that asset manager opportunity to achieve satisfactory long-term returns is not limited and asset allocation strategy setting is delegated to them in full extent.

Asset classes

We would suggest having a relatively broad selection of different asset classes. To ensure price transparency, information disclosure and regulation, most of them should be traded on regulated exchanges.

Asset classes can be split in 3 broad categories.

Asset class	Description
Fixed income	Includes government bonds, municipal bonds, agency securities, mortgage backed and asset backed securities, corporate securities, deposits etc.
Equities	Listed local and foreign equities. Equities can be further split by geography, developed countries vs. emerging markets, industries etc.
Alternative Investments	Risk capital, real estate, infrastructure funds, hedge funds etc.

Pension plan asset investments could be done directly (direct buying of bonds or equities, for instance) or through investment funds that, in turn, invest directly into investment securities or vehicles. With alternative investments, such as private equity, venture capital or real estate, we suggest that investments are done only through funds, especially at the initial stages of system development, as it provides higher degree of diversification and ensures management competence at the fund manager's level.

Foreign exchange (FX) risk

Foreign exchange (FX) risk should be considered when making investment decisions. It is also directly related with foreign investment making. Foreign investments, generally, improve diversification and investment returns. Diversification across various securities, asset classes, and countries can significantly reduce risk and enhance investment returns. However, foreign investments are typically done in foreign currency that exposes pension fund participants to FX risk. Taking into account that AZN (Azerbaijan manat) is not officially pegged to the US dollar (USD) and FX hedging market is not developed, it would be almost impossible for pension funds to hedge FX risk. Thus, foreign investments would come with the added volatility of FX risk. FX risk can be somewhat eliminated by investing in a basket of currencies (EUR, USD, JPY, GBP etc.) or to focus on USD investments only but it will not be possible to eliminate it completely. Central Bank's policy towards exchange rate management would be very important.

We believe that foreign investments should be allowed, especially for active pension funds that invest in equities. Foreign investments provide diversification and enhance returns. It also ensures adequate pricing of local securities, as their returns will be compared with the foreign peers. One can set a limit for the size of open FX position. 10% could be feasible for conservative pension plans while 30-50% would be adequate for active pension plans. Open FX position treatment can be changed if foreign exchange regime changes and currency becomes officially pegged to the dollar or basket of currencies, for instance.

One should note that FX open position limit in practice would, most likely, set limits for foreign investments. Only foreign investments denominated in AZN would not cause open FX position.

It is typical that pension fund managers hedge fixed income securities or choose only local currency denominated issues while equity exposure is often left unhedged. Limits on open FX position would allow pension funds to construct globally diversified equity portfolio and would be binding for the size of the position.

One can also set limits to country investments, either by identifying them directly or by identifying groups of countries, like European Union, OECD countries etc. We would suggest focusing on the markets where investment regulation and financial markets are well established, political risk is minimal and rule of law is well established.

Investment in derivatives would be allowed only for the purpose of risk reduction with pre-set limits on open positions to limit counterparty risk. One should also distinguish exchange-traded derivatives and OTC (over-the-counter) traded derivatives where counterparty risk management is more important.

Diversification
Diversification is critical and should be required by legislation. Several dimensions can be distinguished:

- By securities. Limit to investment in a single security (e.g., bonds, equities, deposits);
- By investment funds (e.g. open-ended, closed-ended, alternative investment funds);
- By investment issues;
- By issuers;
- By countries, regions;
- By legal entities (e.g. governments, municipalities, corporates, international organizations);
- By counterparties;
- Currencies;
- Credit risk;
- Other.

Diversification typically improves risk adjusted investment returns. It also reduces probability of single negative event wiping out significant part of the portfolio (e.g. Lehman brother bankruptcy in USA). At the same time, extreme diversification or over diversification is also not welcome, as is often associated with significant transactional costs and little added investment benefit. Over diversification can also create practical problems in portfolio management by increasing investment cost, fees and by limiting opportunities to get investment at adequate price. Suggested key investment limits are summarized in Appendix A.

Asset allocation
Asset allocation is typically a key determinant of investment returns. There are several approaches that investment funds use. One can distinguish 2 broad categories:

Categories	Description
Traditional	Asset allocation is set as a split between key asset classes (fixed income, equities, alternatives). Pension funds work out several pension plans - conservative, balanced, active, for instance, setting specific min/max limits for each asset class. One can also introduce limits towards geography, FX exposure, credit risk, duration risk etc. The key feature of traditional approach is that asset allocation change is not predetermined and is largely discretionary by asset manager within set investment limits.
Life-cycle	Life-cycle funds assume predetermined glide path and gradually reduce investment risk, by reducing exposure to risky investments as pension plan participants approach retirement. Funds are typically structured around expected retirement dates, say, 2040 plan, 2050, plan 2060 plan. Pension plan would start with relatively high allocation to risky assets and reduce it partially or completely by the date set by the pension plan. The closer a person is to retirement, the less risk it should take. Life-cycle plans solve with problems by automatically reducing the risk and thereby eliminating need to switch from active to balanced pension plans and from balanced to conservative, as person nears

retirement.

We would suggest leaving it to the asset managers themselves to choose which investment strategy and approach is more appropriate, given investment restriction, asset manager’s strategy and skills. However, even with “traditional” approach, one should consider how pension plan participant’s migration from active to conservative pension plans would be managed. It should be considered to what extent migration to lower risk pension plans is left to pension plan participants or asset managers/distributors and to what extent is it encouraged or set strictly by the state.
One can distinguish more approaches to asset allocation, like, for instance, constant risk approach where the risk level of the fund (typically expressed as investment volatility) is held constant at predetermined level. One can also distinguish between active and passive management, where asset class exposure is either managed and changed actively or is held fixed at predetermined levels. We would suggest that the final decision would be left to asset managers themselves.

For comparison of pension fund asset allocation in OECD countries, see Appendix B.

Hypothetical investment returns of pension plans*

Case A.

Assumptions based on current available returns, including risky local investments.

Asset Class	Expected Returns	Portfolio allocation			Expected pension plan return contributions		
		Conservative	Balanced	Active	Conservative	Balanced	Active
Cash	1,0%	5%	5%	5%	0,1%	0,1%	0,1%
Deposits	9,0%	50%	50%	40%	4,5%	4,5%	3,6%
Short term government bonds, mortgage bonds	3,0%	10%	0%	0%	0,3%	0,0%	0,0%
Medium term government bonds	4,5%	30%	20%	10%	1,4%	0,9%	0,5%
Local corporate bonds	11,0%	5%	5%	10%	0,6%	0,6%	1,1%
Developed market equities	7,5%		10%	17,5%		0,8%	1,3%
Developing market equities	9,5%		10%	17,5%		1,0%	1,7%
Fees					-1,5%	-2,0%	-2,0%
Total		100%	100%	100%	5,3%	5,7%	6,2%

**Return estimates are based on market returns as of January 2015 and expert assessment.*

Case B.
Assumptions based on current available returns, without higher credit risk investments

Asset Class	Expected Returns	Portfolio allocation			Expected pension plan return contributions		
		Conservative	Balanced	Active	Conservative	Balanced	Active
Cash	1,0%	5%	5%	5%	0,1%	0,1%	0,1%
Short term government bonds, mortgage bonds	3,0%	45%	35%	25%	1,4%	1,1%	0,8%
Medium term government bonds	4,5%	50%	40%	35%	2,3%	1,8%	1,6%
Developed market equities	7,5%		10%	17,5%		0,8%	1,3%
Developing market equities	9,0%		10%	17,5%		1,0%	1,7%
Fees					-1,5%	-2,0%	-2,0%
Total		100%	100%	100%	2,2%	2,6%	3,4%
*Return estimates are based on market returns as of January 2015 and expert assessment.							

In Case A exercise we estimate hypothetical portfolio returns of pension plans, given 3 types of investment strategies – conservative, balanced and active. To sum it up, expected returns vary from **5.3% to 6.2%** and can be approximated at 5-6%, net of fees. One could notice that significant part of the investment portfolio is invested in deposits due to their significantly higher returns, compared to mortgage bonds or government securities. This could cause liquidity issues, depending on deposit term structure and early redemption options and therefore should be managed carefully. Exposure to equities is assumed to be 20% in balanced funds and 35% in active funds. However, given relatively high local market yields, it would be reasonable to expect even lower allocation to equities in practice as long as local yields stay relatively high. Liquidity management of local investment portfolio would be particularly challenging, given low liquidity of local issues. In practice one should be ready to see much higher return dispersion than in the example. Risky investments can be very volatile at times of financial distress. Global developed markets fell close to 50% in 2008 while emerging market losses were 70% and even more in some markets. Heavy losses were followed by significant and prolonged gains. Some US equity indexes and close to their historical highs now.

Case B follows more conservative local investment strategy, by excluding local deposits and corporate bonds. Resulting returns are in the range of **2.2% - 3.4%.** Return expectations change significantly as we change asset class return assumptions. By investing in high-grade short term US or European bonds only, with fees at 1.5-2% level, return expectations would be negative. Fess would have to be equal to 0.5-1% to break even.
We have assumed relatively high fee level of 1.5-2%, based on the assumption that at initial stages assets under management will be relatively small while asset management, custody, distribution and other costs will be relatively high. As system develops, fees are likely to fall that can be encouraged also by the state.

Investment guarantees

Financial markets can be very volatile and financial crises happen relatively frequently. Pure defined contribution (DC) scheme does not provide any guarantees to the pension plan participants in the form of guaranteed fixed returns or guarantees on the safety of principal. During crises, it is common for pension plans to loose from 10-50% of accumulated assets and sometimes even more. Such significant investment volatility can negatively affect trust in the pension system and can discourage pension plan participants from making contributions.

Pension plan participants often prefer to have guarantees on their investment returns. There are several associated issues that need to be considered:

Issues	
What is guaranteed?	Nominal principal (sum of contributions) Real principal Fixed return Minimal return Principal before or after fees Other
Return over what period?	Annual return Return at retirement Return within investment period in particular pension plan Real return Other
Who provides guarantees?	Asset manager Independent 3rd party State or its agency Other
How guarantees are backed?	Derivatives Reserves based on actuarial calculations Not backed

Guarantees, in their essence, are similar to insurance policy and a premium that is paid for the insurance policy. Amount of premium is based on probability calculations. Over the short term, there is significant probability of well-diversified financial portfolio to experience significant financial losses. However, over the longer term, 10, 20 or 30 year horizons, probability to experience losses has historically been very low, at least in developed markets. Therefore, one could question the need for insurance and the rational of paying for it. Even if such guarantee is applied, it should be provided by the entity that with a high degree of certainty will be around in 30 or 40. There are very few that have such a track record.

Provision of guarantees is complicated by the fact that asset allocation structure of pension funds is not constant and that financial derivatives for hedging purposes might not be available (typical in transition and emerging markets). Moreover, as pension plan participants are allowed to switch from one pension plan provider to other, hedging of investment risks can become even more complicated, as asset allocation can change rapidly (e.g. provider A to provider B, active pension plan to conservative).

Guarantee of real returns (returns after inflation) is complicated by the fact that inflation protected securities are not provided in the local market. The fact that exchange rate closely follows US dollar also makes it hardly possible for local yields

to follow inflation trends (under fixed exchange rate local investment returns typically do not follow inflation over the short term). Thus, inflation hedging is hardly possible. Therefore, our suggestion would be, in case guarantees are required and are regarded as a necessary precondition for successful implementation of the funded pension system, they should be provided to the nominal principal (contributions) at the time of retirement and the entity providing them should be State or its agencies. State, based on actuarial calculations, makes necessary provisions that ensure its ability to meet the liabilities in the form of investment guarantees. This would require additional state financing and would have negative fiscal implications.

Some countries impose return guarantee provision to the asset management. We think it is not optimal. If, for instance, pension plan is obliged to produce positive annual return every year, that would lead pension plans investing only in very safe, short term securities, like, short term deposits and short term government bonds. Longer term investments or investments in equities, real assets or infrastructure, will be avoided, as they can provide negative absolute return over the short term despite much higher expected long term returns. Short term investing eliminates one of the most significant structural advantages of pension plans – ability to make long term investments. With this, the whole set-up of the system can be questioned.

Some countries use relative return targets vs. certain benchmarks or industry average performance benchmarks. This can also lead to sub-optimal investment results, herding behavior by pension plans and limited value added.

Hedging would be made easier if pension plans would have to meet very strict asset allocation and risk requirements. However, strict requirements reduce the room for maneuver and scope for the active management. In this case, one should consider what should be the number of pension plan managers and to what extent introduction of funded pension scheme is associated with capital market development and accumulation of financial assets that is redirected to support real economy and private investment projects.

Hedging and provision of investment guarantees could be made easier if investments are invested in developed foreign markets. Still, FX risk hedging option will be limited, as there are no instruments available in the market. Besides, as global short-term interest rates are currently close to zero, even negative, in some cases, it would be very hard to achieve positive investment returns by using derivatives as investment hedges. Investment structure could resemble that of State Oil Fund and even that wouldn‘t guarantee preservation of principal over the short term.
Role of guarantees should be also viewed in the wider context of overall pension system set-up, including PAYG pillar, minimal pension arrangements, state funded component and private pension funds.
By introducing guarantees to state funded component, diversification benefits of the system can reduce. Guarantee provision can create significant negative liabilities to the entity providing guarantees at the time financial markets experience negative returns. That, in turn, can create negative financial implications for the entity providing guarantees. With this, diversification benefits in multi pillar pension system are reduced.

Counterparties

Investment management is associated with active work with various investment counterparties. Key counterparties and their roles are summarized below:

Counterparty	Key functions
Custodian	Ensures safekeeping of assets. Follows investment restrictions and calculation of fund's net asset value.
Brokers	Execute orders in financial markets
Fund administrators	Calculate fund net asset value
Fund accounting	Prepares fund balance sheets and fills provides legal reporting
Distributors	Distribute pension plans to clients.
Funds and asset managers	Provide asset management services. Provide access to funds.
Regulators	Supervise asset management service provision
State representatives	Follow agreement with the state.
Internal/External audit	Audit service provision and functions
Other	Legal, IT, HR, etc.

The asset manager should closely follow operational and financial risks of all these counterparties as they can also negatively affect investment operations and returns.

Fees

Fees give motivation for asset managers and custodians to provide the service. Asset management fee level internationally is not fixed and can vary from 0.2% in some countries to 2% in others (calculation methodology is also very important and one should be particularly careful comparing fee levels internationally).

In general, fees should be related to costs and assets under management. Fees are also related to the kind of services asset manager is expected to provide that can vary significantly from country to country. In some countries, there is one fee covering costs of asset management, custody, distributions, marketing etc. In others, asset management fee would exclude distribution costs, custody costs, pension plan switching costs, fees on subscriptions and redemptions, marketing costs, fees payable to regulator and others.

It is typical that initially, when system is launched, fees would be relatively high, allowing asset managers to cover their costs and creating motivation for asset managers to join the system and cover the initial shareholders investments. When assets under management would start to grow, fees would be reduced by the pressure of competition or by legislation.

Fees have significant long-term impact on investment returns and accumulated pension capital. State should follow fee development and ensure that they are justified.

Some countries relate size of fees to the achieved investment performance, i.e. the higher the investment performance, the higher the fees. Academic evidence is mixed about the benefits of such system. On the one hand it aligns interests of asset managers and pension plan participants. On the other hand, it can lead to excessive risk taking and higher overall fee level. Exact implications depend on the specific structure of performance fees, alignment of interests and many other factors. As introduction of performance fees can be very demanding from operational point of view, we do not suggest considering them at initial stages.

We suggest that state funded pension funds would have pre-set fee limits while private pension funds, which are voluntary, does not have any explicit fee limits.

Fee levels also would vary depending on the complexity of the investment strategy provided. For a summary of operating costs and fees in selected OECD counties, see Appendix C.

Number of asset managers
We suggest that number of asset managers is not limited administratively. Anyone who can follow set legal requirements can enter the market and provide the service. In the same way, we do not suggest to regulate how many and what kind of investment plans asset manager should have. Only exception would be the requirement to all asset managers to have one conservative investment plan that does not invest in equities and is focused on preserving real value of the accumulated capital.

State as an asset manager
In some countries State fully or partially manages funded pension scheme assets or has done so in the past. In Latvia, State treasury alone managed pension 2nd pillar assets alone for the period of two years (from 2001 to 2003) and managed assets together with private asset managers until 2007 when it exited the business and split assets among private asset managers.
Benefits from state as asset manager are primarily related to perceived security and lower cost of service. However, potential issues are also multiple. Some of them are the following:

Issues	Description
Conflict of interest	State managers would have conflict of interest if, one the one hand, State issues government bonds, seeking lower returns and, on the other hand, state invests in own government bonds on behalf of pension plan participants, seeking higher returns.
Liabilities	The logic of issuing government bonds by the state and buying them up by state asset manager can be questioned. There is little added value from the state's point of view as financial liabilities towards future pensioners would still stay with the state and pension system would not really be prefunded.
Reputation	State asset manager's reputation can be negatively affected at the times when investment portfolio produces unsatisfactory investment returns.
Capital market development	There will be less capital market development if state alone would manage the resources. State can also have limited capacity and competence to review various investment proposals, and can often find itself in various conflicts of interest situations (e.g. financing of government owned enterprises)
Agency	State can create a special independent agency or a fund that would take over the management (similar to Oil Fund). However, making local investments and developing local economy can still be problematic. It would be much easier if such an institution invests only abroad but then local capital markets will not develop. If, however, local investments are allowed, one should take particular care in designing investment processes and decision-making.

Defined Benefit (DB) pension plans
Our primary focus so far has been on Defined contribution (DC) pension plans. Movement from DB to DC plans has been a trend internationally, given significant funding problems of DB pension plans that were elevated during the recent global financial crises. Global low yield environment poses yet another challenge for DB pension plans that leads them to seek return in even more riskier investments as it has

become impossible to achieve previously assumed risk free returns of 4-5%. This has led to the rise of DC pension plans, especially with life-cycle option.
Investment guarantees, described above, turn pure DC plans into hybrid or DB pension plans. Implications and requirements are described above.

Pure DB pension plans have to work out a process of how they would ensure defined benefits and perform risk assessment, estimation, management and provision making. Risk management process should be submitted and reviewed by the regulator. DB pension plans would have much more stringent capital requirements, as compared to DC plans, as DB plan providers have to show proven ability of meeting their liabilities. Rules on capital requirements are worked out by the regulator and supervised regularly.

Local investments
Introduction of funded pension scheme is often associated with the development of local capital markets and the rise of locally made investments. With time, depending on the amount of contributions, accumulated pension capital can be significant relative to the size of economy. OECD average accumulated pension capital for private pension plans was 74% of GDP in 2013 while in public funds – 19% of GDP (Source: OECD Pensions at a Glance 2013). Pension resources can be significant source of for the country's investment needs.
Allocation to the local economy depends on several factors:

Factors	Description
Legal requirements.	Allowed country investments. Limits on FX positions. Allowed financial instruments and risks.
Investment opportunities	Investments in the local economy are driven by local investment opportunities in fixed income, equity, alternative investment and fund markets. Without developing investment opportunities, investments and their local diversification can be limited. Estonia, for instance, is unique in the sense that it as a country has only minimal level of foreign debt, runs balanced budget according to law and does not issue government debt, as a result. Estonian pension funds do not have an opportunity to invest in locally issued government debt. Equity market, corporate bond market and fund market is not very developed. As a result, relatively small fraction, below 20% of all pension fund assets, is invested in Estonian economy that, to a large extent, is driven by the supply of financial instruments not by the demand.
Diversification	Even if local investment opportunities are abundant, significant part of investment portfolio should be invested abroad for diversification purposes. If local investments dominate the portfolio, especially risky investments, then at a time of a local financial market stress and economic problems, economic growth and government revenues can become highly correlated with pension fund investment returns. This is highly unwelcome. The strength of multi pillar pension system lies in its ability to diversify return and risk sources.
Macro stability	Pension fund flows can affect exchange rate stability and can influence general financial flows in and out of the country. Thus, macro stability context can also be relevant in some cases.

It is typical that asset managers have home bias and under similar circumstances, would prefer local investments to foreign. The pressure from local authorities or business groups often escalates this. It is critical to balance these needs and ensure that pension plan participant interests are prevailing.

Asset management set-up will have significant implications on the investment returns of pension plan participants, pensions system, country's capital markets, accumulated

investment capital and economy, as a whole. If properly designed, accumulated pension resources will provide long term investment financing for the local economy, thereby increasing productivity, stimulating economic growth and reducing country's dependence on external financing sources.

15. Custodian and its role in Pension Fund activities

The crucial point for ensuring that rights of members and beneficiaries are adequately protected is appointment of the custodian. This is especially important for pure DC plans where all the risks are borne by members and beneficiaries.
The importance of the appointment of the custodian is also stated in international standards and guidelines. In general, it is stated that custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.

The OECD Guidelines for pension fund governance, June 2009, further complement that, where appropriate, it may be required the appointment of an independent custodian.

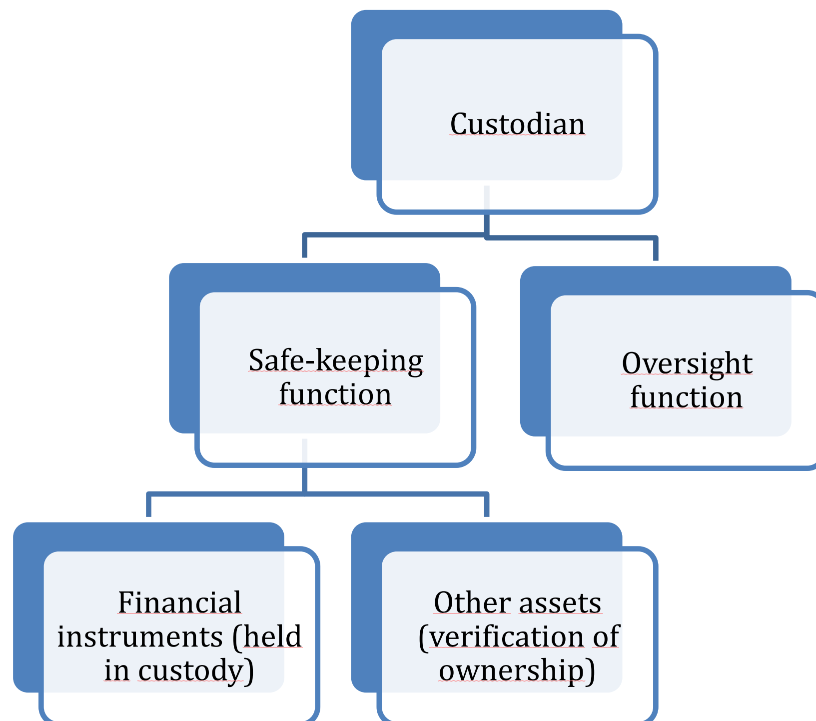
Besides holding the pension fund assets and ensuring their safekeeping, the custodian may also provide additional services such as securities lending, cash management, investment accounting and reporting, and performance measurement. In some cases, the custodian may also play an external 'whistle blowing' function similar to that of the auditor with respect to, for example, the investment of pension assets.

According to the OECD/IOPS Good Practices for Pension Funds' Risk Management Systems, January 2011, independent external parties, such as custodians, should be appointed as part of the risk management of a pension system. It is viewed as an external control mechanism.

In addition it is stated that mechanisms are needed to assess regularly the performance of the pension funds' external service providers, including those providing custody.

It is important to bear in mind that custodian function includes not only safekeeping of assets but also oversight function.
The custodian has two primary functions: to safe-keep assets and to oversee compliance with the pension scheme rules and applicable law.
Additionally, custodians can choose to delegate the safe-keeping of assets to sub-custodians, provided that some conditions are met.

Depending on the type of assets the custodian is entrusted with for safe-keeping, the tasks it will need to perform in order to fulfil its safe-keeping functions can take the form of custody – for financial instruments that can be held in custody – or record-keeping – for the other assets.



It is expected that the custodian should be required to at least:

- Ensure the financial instruments are properly registered in segregated accounts in order to be identified at all times as belonging to the pension plan;

- Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection;

- Assess and monitor all relevant custody risks. In particular, custodians should be required to assess the custody risks related to settlement systems and inform pension fund of any material risk identified;

Where the custodian has delegated its safe-keeping functions, the custodian should ensure that sub-custodians comply with these above mentioned obligations and especially the segregation obligations. This requirement is supposed to mitigate the consequences of the insolvency of the sub-custodian. The custodian should monitor the delegated safe-keeping functions.

There is a need to access the need and importance of having a custodian performing safe-keeping of assets and oversight functions for both DB and DC pension schemes.

It is essential that a custodian separate from the pension management company is appointed to exercise external safe-keeping of assets and oversee the activities of asset manager (irrespective external or in-house), in order to ensure that the assets are handled in due care and to mitigate the risk of fraud by the asset manager.
There is a possibility to introduce different custodian regimes depending on the type of pension plan.

More specifically:

- The appointment of a custodian for the safe-keeping of assets which can be held in custody should be compulsory to all pension management companies.
- The decision of imposing the appointment of a custodian for record keeping as well should be compulsory for all pension management companies.
- As for the oversight function:
  - The appointment of a custodian for oversight function should be compulsory to all pure DC pension plans.
  - In the other cases, this could be left optional to impose the appointment of a custodian in order to perform the oversight function.

Keeping in mind that the delegation of safe-keeping of assets to a custodian also involves some risks, it is relevant to include some further provisions on this matter.

In order to improve pension plan’s members and beneficiaries protection, it is relevant to clearly establish the relationship between the custodian and the pension management company. Therefore, it proposes that the appointment of custodians should be formalised in a written contract regulating at least the flow of information necessary to enable the custodian to perform its function.

If a custodian is appointed to ensure the safe-keeping of assets, a provision should be included stating that the pension plan’s assets should be legally separated from those of the custodian.

Additionally, the custodian should be liable to pension management company and pension plan’s members and beneficiaries for any loss suffered as a result of its unjustifiable failure to perform its obligations or its improper performance of them. In particular, it should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safe-keeping.

Under the principle that pension management company should have in place mechanisms to assess regularly the performance of external service providers, these should also include those providing custody and record-keeping services.

There could be seen the following advantages regarding the use of a custodian for the purpose of safe-keeping of assets:

- The custodian is required at any time to provide a comprehensive and up to date inventory of all assets under its safe-keeping;
- It ensures that the information is centralized in one place;
- It reduces the risk of fraud and operational risks of the pension management company;
- The custodian can alert the pension management company of a material risk identified in a specific market settlement system;

- It may be easier for the supervisor authorities to limit or prohibit the free disposal of assets.

Therefore, it is relevant to include further provisions in the legislation, in order to reduce the risk of a loss of assets or of right in connection with those assets, as a result of a fraud, poor administration, inadequate record-keeping, negligence or other operational risks within the pension management company. To ensure the adequate level of safety, it should, at least, provide:

- Ensure that financial instruments are subject to due care and protection;
- Keep records that enable them at any time and without delay identify all assets;
- Take the necessary measures to avoid any conflicts of interest or incompatibility;
- The supervisory authority, upon request, shall be informed about the manner in which assets are kept.

In addition to the safe-keeping of assets, custodians are an external control mechanism that can play an important oversight role.
On the oversight function, it should be ensured that a list of tasks that custodians should at least, perform in case they are appointed to perform the oversight function:

- carry out instructions of the asset manager, unless they conflict with the applicable national law or the pension scheme rules;
- ensure that in transactions involving a pension management company or pension plan's assets any consideration is remitted to it within the usual time limits;
- ensure that income produced by assets is applied in accordance with the applicable national law and the pension plan rules.

In addition the possibility to introduce the whistle-blowing duties for custodians should be examined, meaning that the custodian should inform competent supervisory authorities in case breaches of national laws or pension plans rules are revealed.
Furthermore, pension management companies should not be prevented from laying down other oversight tasks that a custodian could perform.
In fact, the current international experience shows that oversight tasks performed by custodians are especially important for DC pension schemes where the members bear all the risks, where not only safe-keeping of the assets but also oversight duties are delegated to custodians.
Finally, it will be relevant to require pension management companies to implement procedures which ensure that the tasks delegated to the custodians are being properly performed within the custodian.

APPOINTMENT OF A CUSTODIAN

Appointment of the custodian should be treated as a mandatory delegation of the respective function and therefore all requirements of the outsourcing should be applied also to the delegation of the custodian function to the third party although also some specific requirements should be applied in addition.

The custodian function should be entrusted only to the commercial banks operating in Azerbaijan and having received all necessary authorisations from the competent authority performing supervision of the commercial banks.

The process of the selection of the custodian should be fully entrusted to the board of the pension management company. The board of the company should freely choose the custodian by entering into the contract. The pension management company should also be able to break the contract immediately if any conditions of the contract or legislation are not met by the custodian. The written contract is essential for entrusting the custody services and there should be at least minimum requirements introduced by legislation to ensure fulfilment and harmonised approach. These minimum requirements should include procedure for exchange of information between the custodian and the pension management company, description of duties of the custodian in the sake-keeping as well as liabilities toward pension management company, oversight function envisaged over activities of the asset manager, rights of the pension management company and the supervisory authorities to require access to all information and documentation at any period of time.
The most important issue is to implement the legal tools requiring custodian always keep assets of the pension schemes separately from any other assets belonging to custodian itself or other clients of the respective custodian. The same rules have to apply if the sub-custodians are involved. There should be necessary means and tools implemented to ensure that assets belonging to the pension scheme are identified at any time.
The appointment of sub-custodians is also crucial issue that should be treated adequately. It should be made clear that appointment of sub-custodians relates only to safe-keeping function of custodian. The oversight function should not be delegated to third parties and should be performed by custodian itself. The safe-keeping function instead might be delegated to several sub-custodians to ensure proper execution of the function. However it should be ensured by legal and also contractual tools that the custodian always stays liable for assets entrusted to him in custody.
Potential conflicts of interest or incompatibility could be an obstacle for appropriate functioning of the safe-keeping and oversight duties and therefore should be avoided.
This could be very crucial where not only safe-keeping of assets but also some control tasks over investment process is delegated to the custodian to ensure best interests of the pension plan’s members and beneficiaries.
It would also be advisable to provide that pension management companies should lay down more detailed rules to ensure elimination of the conflicts of interest or incompatibility.

POWERS AND PROCEDURES FOLLOWED BY THE SUPERVISORY AUTHORITY

It is essential that supervisory authorities have all the necessary powers and means to supervise relationship between the pension management company and the custodian. It is especially important to ensure the adequate powers are given to the supervisor of the pension management company and good cooperation is established between supervisory authorities in case when there is no integrated supervision authority and the supervision of pension management company and custodian is carried out by separate supervisory authorities. There are two ways of ensuring these rights of the supervisor. One way is to establish direct relationship between the supervisors by

signing the respective contract and performing supervision of the custodian through the supervisor responsible for supervision of the custodian. Another way is direct supervision of the custodian and inclusion of the rights of the pension management company's supervisor to perform supervision of the custodian into the custodian contract. The supervisor must have a power to carry out on-site inspections on the premises of the custodians and obtain all necessary reports directly from them. It should be ensured that supervisor has necessary powers to intervene on custodian function if necessary. To ensure this the contract with the custodian should be subject to approval by the supervisory authority or notification (a priori or ex-post). It should be mentioned that the most appropriate way is to require the pension management company to get a prior approval by supervisor before the custodian starts to perform its duties.

CHANGE OF THE CUSTODIAN

The board of the pension management company has the right freely choose the custodian and also shift to another custodian. In order to make this shift smoothly and ensuring that operations of the pension management company are not affected by the shifting process there should be legal tools implemented providing that supervisory authority is involved into this process and shifting is possible only after approval of the new contract and shifting plan by supervisor. It is also advisable to provide legal rights of the supervisor to request extraordinary preparation of the report to the supervisor and if necessary also audit of this report prior to the transfer of the assets to the new custodian.

16. State supervision of Private Pension funds

Official reports

For reporting purposes a broad range of reports should be available for the supervisory authority to evaluate the financial situation of pension funds.

There has to be supervisory tools available to detect and prevent irregularities:
Pension funds are required to submit **regular financial reports**, which include:[43] financial statements; annual reports; the actuary's report; solvency notifications; auditors' reports; notifications on the investment portfolio and the acquisition of specific assets[44] and reports on intragroup transactions.[45]
The majority of reports are provided annually, but the supervisory authorities also receive reports on a quarterly basis (E.g. investments and coverage of technical liabilities).
Most of the reports contain figures for the previous end of year or quarter, but forward-looking pro forma reports such as stress tests and scenario reports may also required.

External auditors must audit the annual accounts of all pension funds.[46]

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[43] Based on international experience for assessing financial situation of pension funds
[44] E.g. real estate investments, paricipations etc.
[45] Intragroup transactions in case the pension funds belongs to a parent company. Then the parent company will usually report about intragroup transactions with the pension funds.
[46] Based on international experience, there could be exemptions for small pension funds whose accounts are audited at least every three years

The pension funds have also to submit a **business plan** that describes the risks it intends to cover.[47] The plan comprises also the articles of associations and agreements with other companies (subordination and profit transfer agreements) or contracts spinning off certain functions. The plan comprises also the risk management system (description of risks and conditions which shall secure that the future liabilities can permanently be met); and the internal control system including policies and procedures (purpose, organisation of the applicant). The business plan includes a projection of balance sheet and profit and loss accounts as required for supervisory purposes over a minimum period of three years, made up separately for each insurance class and gives information on the projected development of the business, including solvency margins.

Market analysis tool: Stress tests
To check whether or not the pension funds would still be able— even in the absence of countermeasures— to meet their accrued obligations to policyholders (e.g. to cover technical provisions and own funds requirements with the appropriate assets) including in the event of an ongoing crisis on the capital market.
This allows the supervisory authority to identify those companies that do not have an appropriate investment policy that enables them to cover risks.
The tests assess a potential reduction of the value of the assets under stress accounting for asset price risks (for bonds, equity and property prices) and Credit risk (determined by external ratings) of individual companies.

Further report are:

- Report of investments
    - Exclusively quarterly review: Composition of Assets (equal to Financial Statements)
    - Other (investment) reports, E.g. Investment in funds, real estate, participations etc.

- Forecasting

- Actuarial report

- Ad hoc-reporting[48]

- Risk reporting:

  The documentation should provide a systematic overview of risks, processes and key controls.

Complete and accurate information essential to the functionality of risk management must be available to the decision-makers. How the undertaking is to be managed is to be determined in line with the corporate strategy.

[47] Based on international experience
[48] The supervisory authority in Azerbaijan should have the right to request if its necessary information for special purposes

Documentation should include all material formulas, procedures, actions, determinations, decisions and, where applicable, justifications along with deficiencies identified and the resultant conclusions. Material changes made during the year to the risk strategy are to be recorded and communicated within the pension fund in a timely manner. The documentation must be comprehensible and verifiable for third-party experts.

All risks identified by management, which can have a sustainably negative impact on the undertaking's financial position, performance or cash flows are considered material:

Underwriting risk: Underwriting risk refers to the risk that the costs of claims and benefits actually paid may deviate from the expected costs accidentally or owing to error or change of circumstances.

Market risk: Market risk refers to the risk resulting directly or indirectly from fluctuations in the level and/ or volatility of market prices for assets, liabilities and financial instruments. It comprises currency risk and interest rate risk.

Credit risk (including country risk): Credit risk is the risk arising from default of or fluctuations in the creditworthiness (credit spread) of security issuers, counterparties and other debtors against whom pension funds have claims.

Operational risk: Operational risk is the risk of losses due to inadequate or failed internal processes or as a result of employee or system error or from external events. Operational risk also comprises legal risks, however not strategic risks and reputational risks.

Liquidity risk: Liquidity risk is the risk that the pension funds are not in the position to meet financial obligations as they fall due for lack of fungibility.

A variety of data and information from different corporate functions and academic disciplines can be used for risk management in pension funds, such as:

- sales,
- internal and external accounting,
- corporate planning, business development and company valuation,
- data storage and backup,
- asset management, including capital market information,
- premium rating, product development, actuarial function,
- claims management,
- mathematical/ statistical procedures.

From the supervisory authority's point of view, the documentation requirements presented here *do not represent a conclusive list for the risk report*, but rather name the areas that are to be documented at a minimum.

State supervisory audit issues

In general the supervisory authority "may take all adequate measures necessary to avoid or do away with abuses which endanger the interests of the insured of the pension funds".[49]

Once the insurance company has been granted a license to carry on pension funds business it is subject to *on-going* supervision. In this connection the duties of the supervisory authority are twofold:

- It has to collect and evaluate information, verify business documents and keep a close eye on all business operations to detect any irregularities (offences against the rules, unfair treatment of policyholders, financial problems) in time
- Should any such irregularities arise, the supervisory authority has to intervene and restore orderly conditions

The powers of the supervisory authority also cover personnel matters. It may, for instance, appoint a specially authorized representative to the board of directors or to the supervisory board of the pension funds.

The Azerbaijan supervisory authority may take the following enforcement measures in respect of pension funds that fail to comply with the legal requirements:[50]

- Prohibit payments to shareholders, policyholders and other persons if there is a risk of the insurance undertaking becoming insolvent.
- Prohibit the transfer of assets and the buyback of the undertaking´s own shares.[51]
- Require the supervisory board to dismiss management board members who have been found technically unqualified or unreliable.

Further important intervention powers are:[52]

- Appoint a special commissioner to whom may be transferred the powers of the management board.[53]
- Withdraw the license for failure to meet licensing requirements.[54]
- Report criminal offences to the Public Prosecutor's Office.
- Apply to the court for the opening of an insolvency proceeding.[55]

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[49] General rule, that granteds to allow intervention powers regarding obstacles (also those that are not mentioned in law)

[50] Based on international experience, see also blueprint No. 13 "Reorganization and liquidation of pension funds" by Bernd Schulte-Brinker

[51] See also blueprint No. 13 "Reorganization and liquidation of pension funds" by Bernd Schulte-Brinker

[52] Based on international experience

[53] As described above

[54] See chapter "Licensing rules for private pension funds" by Bernd Schulte-Brinker

[55] See chapter "Reorganization and liquidation of pension funds" by Bernd Schulte-Brinker

- Instructions issued by the supervisors are immediately enforceable or may be declared so by Azerbaijan supervisors.
- In such cases, instructions can be compulsorily enforced even if they have been contested or a case has been brought before the administrative court.
- To audit the business operations of the insurance undertakings on their premises, even without specific cause.
- To dispatch to meetings of the supervisory board and shareholders' meetings or meetings of the senior representative body representatives who shall be granted the right to speak on request.

Other State Supervision Issues

The international standards set main principles of the effective and adequate supervision. In particular:

The Core principle 7 of OECD Principles of Occupational Pension regulation says:

<u>*Core Principle 7: Supervision*</u>

Effective supervision of pension funds and plans must be set up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent mis-selling cases arising from irregularities in the distribution and expenses methods.

IOPS (International Organization of Pension Supervisors) Principles of Private Pension Supervision states:

Principle 1 : Objectives
National laws should assign clear and explicit objectives to pension supervisory authorities
Principle 2 : Independence
Pension supervisory authorities should have operational independence
Principle 3: Adequate Resources
Pension supervisory authorities require adequate financial, human and other resources
Principle 4: Adequate Powers
Pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives
Principle 5: Risk-based Supervision7
Pension supervisory authorities should adopt a risk-based approach.
Principle 6: Proportionality and Consistency
Pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent
Principle 7: Consultation and Cooperation

Pension supervisory authorities should consult with the bodies they are overseeing and cooperate with other supervisory authorities domestically and internationally

Principle 8: Confidentiality

Pension supervisory authorities should treat confidential information appropriately

Principle 9: Transparency

Pension supervisory authorities should conduct their operations in a transparent manner

Principle 10: Governance

The supervisory authority should adhere to its own good governance practices – including governance codes, internal risk-management systems and performance measurement - and should be accountable

These principles indicate how the adequate, effective and modern supervisory framework should be build. Pension Supervisory Authorities referred to in the Principles are defined as any entity, responsible in whole or in part for the supervision of pension funds, plans, schemes or arrangements in a country or in the subdivision of a country, whether invested with its own personality or not. The Principles are designed to cover the different types of supervisory structure. Pension products also come in many different forms (defined contribution vs. defined benefit, mandatory vs. voluntary etc.) and the pension systems of countries also differ greatly, having been shaped by many factors (from the nature of the state, to the level of economic development, and the pension market structure).
The objectives of private pension supervision focus on protecting the interests of pension fund members and beneficiaries, by promoting the stability, security and good governance of pension funds. Pension supervision involves the oversight of pension entities and the enforcement of and promotion of adherence to compliance with regulation relating to the structure and operation of pension entities and pension plans, with the goal of promoting a well as functioning pensions sector. In addition, achieving stability within the pension sector is an important part of securing the stability of the financial system as whole (as investments made by pension entities have a major impact on the real economy in many countries). Pension supervision should be mindful of financial innovation.

Pension supervision includes the monitoring of the activities of pension plans and funds to ensure that they remain within the requirements of the regulatory framework, essentially enforcing compliance with the rules. Supervisory activities vary depending on the regulatory and legal environment, policy choices and a variety of other factors. In general they may be defined as influencing changes in pensions provision that contribute to the achievement of pension supervisory objectives, either through direct intervention or guidance. The scope of supervision can encompass any supervisory activity that is primarily concerned with ensuring the requirements and limitations imposed on pension funds or plans are adhered to.

All these issues should be considered also when building up the supervisory framework here in Azerbaijan.

When building up the supervisory framework for the pension entities there are two main issues to consider: the content of the supervisory framework as well as form of the implementation.

THE CONTENT OF SUPERVISORY FRAMEWORK

First of all the supervisory approach should be considered. Due to the fact that the objective of all pension supervision is to improve the security of members' and beneficiaries' future benefits, **only a prospective approach is possible.**

The legislative framework requiring an appropriate combination of off-site activities and on-site inspections would appear explicit objective of the pension supervision.

Ensuring that all requirements are applied in a proportionate manner with regard to the nature, scale and complexity of the pension management company's risks is even more important in the case of pension entities than for other regulated entities.
Pension supervision should be built up considering both horizontal (applied on the whole sector) as well as vertical (applied on individual level) issues.

1. The objective of the pension supervision always is protection of the rights of the members and beneficiaries of the pension plans. The supervision should also ensure stability and development of the respective sector, as well as whole financial system. To ensure this objective the responsibilities of the pension supervision should be clearly stated into legislation providing clear mandate, powers and functions of the supervision.

Therefore the legislation should have a reference that pension supervision authority should supervise compliance of the activities of a pension management company with legal provisions. The pension supervision should have an obligation to ensure that pension management companies perform with a professional approach and stability, as well as to protect the legitimate interests and rights of the members of the pension plans.

2. It should be also ensured that pension supervision is politically and economically independent from any kind of impact.

Therefore a reference to the legal requirements providing operational independence and stating that pension supervision authority is an autonomous / independent public authority that regulates and monitors the functioning of the pensions market and its participants, makes independent decisions within the limits of its authority, executes functions assigned to it by law, and is responsible for their implementation. No one shall be entitled to interfere with the activities of the supervisor, except institutions and officials authorised by law.

3. Pension supervisory authorities should be granted adequate staff and access to resources.

The pension supervisory authority should have its own budget sufficient to enable it to conduct proportionate, effective and independent supervision. Funding, in part or in full, of the pension supervisory authority by supervised pension funds or plans could be considered, provided independence is maintained. Where fees are charged, the fee structure should be transparent.

The pension supervisory authority should hire, train and maintain sufficient staff with high professional standards and expertise, including appropriate standards of confidentiality and disclosure.

To ensure this the principles of forming the budget of the supervision entity should be described in law providing also sources of financing. The most appropriate way of financing is financing by the market participants however in the initial stage of this sector additional sources of financing for at least transitional period should be considered to ensure functioning of the authority and possibilities to hire well educated and experienced staff and also to provide adequate training program which is especially important in the growing phase.

4. Pension supervisory authorities should be legally empowered to undertake supervision and should be granted adequate powers and the capacity to exercise these powers.

The pension supervisory authority should have the power to conduct necessary supervisory functions, according to the nature of the pension system being supervised. Effective supervision of pension funds or plans should focus on legal compliance, financial soundness and control, minimum capital requirements, investment activity, good governance and integrity, actuarial examination, the supervision of pension plan or fund managers, and the provision for adequate disclosure of information to members. Powers should allow for relevant off-site and on-site inspection.

Pension supervisory authorities should have comprehensive investigatory and enforcement powers. The legal framework that defines conditions and circumstances under which the pension fund supervisor must intervene should be flexible enough to enable the pension supervisor to undertake preventative, protective or punitive actions.

The pension supervisory authority should have the power to conduct a full investigation when a problem is suspected or observed, obliging funds and other relevant parties (such as asset managers, custodians, auditors) to make documents and information available. Necessary powers include the ability to impose corrective measures and remedial actions if the authority's orders are not carried out. The scope of the powers may extend to the power to impose administrative sanctions such as fines, to direct management, to revoke licences and to refer matters for criminal prosecution. In some cases, powers may include the ability to issue binding regulation.

The pension supervisory authority should have clear and well-defined strategic supervisory goals for the use of intervention, enforcement and sanction powers, clearly establishing whether the goal of their action is preventative, protective or punitive and use the appropriate tools and powers accordingly. The supervisory authority should have a coherent, well thought-out policy for deciding on the mix of supervisory tools adopted and the ability to adapt this approach to changing circumstances.

To ensure this the legislative framework should cover the necessary means for pension supervision authority to perform its tasks, to issue regulatory provisions for pension management companies and take decisions.

For performing supervisory functions the supervisor should be entitled to make pension entities subject to a pension management company reporting requirements. The supervisor should have an obligation to inspect the operations of the pension entities regularly (at least every 3 years). The supervisor can authorise an official auditor or another person for this task. The supervisor should be entitled to request information on the audit of the annual accounts from the external auditor.

The supervisor should supervise compliance of the activities of a pension management company.
The supervisor should have an obligation to ensure that pension entities perform with a professional approach and stability, as well as to protect the legitimate interests and rights of the members of the pension plans.
The supervisory authority shall be entitled to conduct on-site inspections of the pension entity and request that a pension entity submits to it information and documents on its operations. A pension entity should have an obligation to submit to the supervisor all required information and present to it all documents; and a pension entity shall not refuse from doing it under the pretext of a commercial secret.
On the basis of the reports received and inspections and audits carried out, the supervisory authority should assess the soundness of the financial standing of a pension management company and, if necessary, instruct it on improving the financial standing. The pension management company shall implement the instructions by the established deadline.
The supervisory authority has to have necessary powers to provide sanctions and fines, as well as cancel the licences of the pension management companies and these powers should be clearly stated in law.

5. In order to use their resources efficiently, pension supervisory authorities should adopt a risk-based approach, and a suitable risk-assessment methodology should be established.

The move towards risk-based supervision can be undertaken gradually, combining this technique with more traditional rules-based supervision as the supervisory authority and pension industry develop the necessary expertise.

The introduction of risk-based supervision should be seen as a movement along a continuum from one extreme of complete reliance on a rules -based system to one where the emphasis of supervision is a function or risk.
It is advisable that in the initial stage the pension supervision is using compliance based approach to ensure pension management entities comply with the rules and principles set by legislation. However the risk based approach should be seen as further development of the supervisory framework and legislation should provide that supervisors are able to evaluate the systemic risks of the private pension sector by analysing potential risks and stress tests results and planning supervision measures for the next period. External occasions which can also influence the potential risks should be monitored and taken into account in daily supervision. The legal framework should ensure that the respective legal tools are in place to mitigate potential risks. The risk mitigation mechanisms used would depends on the nature of the potential risks, different mechanisms could be used for risks arising from the potential risk areas identified for a single entity but which may in its turn influence the whole sector and risks that potentially may have an impact on the whole sector itself.

6. The remedial actions and if necessary sanctions imposed by the pension supervisory authority should be proportional to the amount of risk posed by the fund to its members and beneficiaries and the pension system as a whole - taking into account the nature, scale, complexity and seriousness of the potential compliance irregularities relating to the relevant party - and should represent the most efficient use of supervisory resources. The long –term

nature of pension funds should be taken in consideration and unnecessary pro-cyclical behaviour should be avoided.

The extent of supervisory demands placed on pension funds or plans and associated parties being supervised should be in accordance with the value expected to be derived. During the decision making process, a balance should be struck between the potential benefits of the supervisory action and the costs and impact on pension fund members and beneficiaries and, where appropriate, plan sponsors.

To ensure proportionality of the supervisory actions and sanctions the supervisory authority should have the manual describing how actions, corrective measures and sanctions are grouped and applied. This would ensure equal treatment of all situations as well as elimination of subjective factor.

7. The pension supervisory authority should consult, as appropriate, with the pensions sector when determining its approach to supervision.

The pension supervisory authority should be empowered to exchange information with other relevant supervisory authorities, subject to legal and confidentiality requirements. This includes cooperation with other authorities or departments involved in pension supervision (for example conduct of business supervisors) both nationally and internationally (particularly where cross-border pensions are involved), as well as with authorities supervising other relevant financial institutions or markets and law enforcement agencies. Cooperation should be for both efficiency purposes (avoiding overlaps and promoting economies of scale and scope) as well as promoting pro-active preventative measures (e.g. tackling financial crime).

To ensure consultation and cooperation the legislation should provide necessary legal tools. It should be mentioned into the legislation that one of the functions of the supervisory authority is to cooperate with foreign supervision authorities and participate in international organizations of the supervision institutions. This creates the legal basis for the supervisor to go into agreements with foreign pension supervisors to ensure proper supervisory activities in case cross-border activities occur.

However it is more important to cooperate and consult on local basis. This is especially important if the pension supervision does not belong to the integrated supervision of whole financial market but has been established separately. In this case there should be legal background provided to ensure that pension supervisor is able to cooperate with other financial supervision authorities here in Azerbaijan, providing that supervisory authority is eligible to cooperation and information exchange agreements (memorandum of understanding) with supervisory authorities in other countries ensuring that these agreements meet the necessary secrecy requirements as well as internal cooperation agreements with other supervisory authorities in Azerbaijan. It is also important that pension supervisor regularly consults with market participants. The most appropriate way to ensure this is to establish consultation panel where stakeholders can take part. Therefore legislation should provide reference to empower supervisory authority to create such consultation panel.

8. The pension supervisor should only release confidential information if permitted by law (with fines or even prison sentences imposed for breaches). Staff should be bound by internal codes of confidentiality, -also after leaving the authority.

IT systems used by supervisors should include limited access restrictions to protect confidentiality and special care should be taken regarding the security of the supervisory authority's database for reasons of effective data protection.

The supervisory authority should publish its policy on how confidential information will be treated. A suitable balance should be struck between conduct of business supervision (where disclosure can be used to influence the behaviour of the supervised community), prudential supervision (where confidentiality is important to protect the interests of particular supervised entities), and system integrity, according to the nature of the pension system.

The pension supervisor, in regard to non-public information, should, when requested by the providing authority, keep information confidential and maintain appropriate safeguards for the protection of confidential information within its possession.

To ensure this legislation should provide supervisory authority duty to treat confidentiality. It should be ensured also that supervisory authority is required to develop code of ethics stating that the employee of the supervisory authority must not disclose information that has come to his knowledge when performing professional duties, as well as must not use it for any purposes that are not connected with performing professional duties or specific work task, including in order to turn against any person, institution, or to use in any other way in private interests. The employee also should observe confidentiality in his performance and take the necessary steps to diminish to maximum the possibility to unlawfully obtain limited accessibility information at his disposal.

It also should be ensured that employment contracts of supervision authority's employees include duty to treat confidentiality.

9. Pension supervisory authorities should adopt clear, transparent and consistent supervisory processes. The rules and procedures of the pension supervisory authority, and updates thereof, should be published. The pension supervisory authority should generally operate in a transparent environment and should provide and publish a regular report – at least annually and in a timely manner – on the conduct of its policy, explaining its objectives and describing its performance in pursuing those objectives.

The pension supervisory authority should be subject to regular audit and reporting requirements which allow for the assessment of how well the authority is fulfilling its responsibilities and ensuring the mandate and functions of the pension supervisory authority cannot be changed on an ad hoc basis.

To ensure this the legislation should provide that supervisory authority develops and maintains the official webpage where all the information about decision taking processes and procedures applied to the pension entities should be included. The legislation also should provide that supervisory authority has to prepare the annual report that should be audited by external auditor and set the structure and timeline for

approving. The transparency should be also ensured through establishing consultative panel. The legal basis for establishing it should then also provide by legislation.

10. Good governance of pension supervisory authorities can be summarized in four categories: **independence**: requiring clarification of the authority's responsibilities and powers, processes for appointing its governing board and the ability to secure resources and operate without undue influence; **accountability**: involving external audits, suitable internal organisation and measuring performance; **transparency**: ensuring that the authority's objectives and achievements are understood, and that a consultative relationship with industry is established; **integrity**: requiring codes of conduct, discretion to apply powers, internal controls and competent staff.

To ensure this pension supervisor's responsibilities and powers, processes for appointing its governing body as well as other issues connected with operation of the supervisory authority should be stated in the legislation. Supervisory authority should be provided with full rights of an independent/autonomous public institution and, in compliance with its goals and objectives should regulate and monitor the functioning of the private pensions sector. The authority should make independent decisions within the limits of its authority, execute functions assigned to it by law, and be responsible for their execution. No one shall be entitled to interfere with the activities of the supervision, except institutions and officials authorised by law. The authority should be governed by its governing body acting independently and being professional.

The authority should have internal documentation prescribing, e.g., internal working regulations, risk management regulations, regulations on planning and assessment of working performance, working performance evaluation arrangements, regulations on prevention of officials' conflicts of interest, the procedure on developing annual work plan, the procedure on developing strategy, regulations on application of the remuneration system, procedure for determining salary, etc.

It would be advisable to establish internal audit function that would also oversight that there are clearly documented procedures for decision-making, processes for risk and performance management, to review the consistency and transparency of the decision making process, the effectiveness of risk management practices and the efficiency and propriety in the use of resources.

It should be also provided by legislation that the decisions and administrative acts of the pension supervisory authority might be appealed in the court.

<u>THE FORM OF IMPLEMENTATION OF SUPERVISORY</u>

The form of implementation decided prescribes the structure of the supervisory authority. There could be different kind of structures: specialized, partially integrated or integrated.

There are different advantages and disadvantages for each of them.

Looking at current situation of the supervision of the financial sectors in Azerbaijan, currently there are three separate supervision authorities performing financial market participants' supervision. There is no regular interconnection or information exchange observed between these competent authorities.

The pension supervision therefore could be implemented in three different ways:

The first option would be integrated authority. There could be considered consolidation of the supervision and creation of the single competent authority to be entitled for authorization and supervision of all financial market participants. The positive sides of this approach would be application of single supervisory approach for all components and stages for the pension management function. The main disadvantage to be mentioned is crucial restructuring of whole supervision system of the financial market that will need the careful impact analysis before being considered. Also according to official of the Azerbaijan creation of single supervision authority has been discussed before and refused therefore this option although there are many beneficial factors for the financial markets would not be considered as the main possibility and another option needs to be considered firstly.
The second option would be partially integrated authority. There could be considered incorporation of the pension supervision into one of three existing supervisory authorities: banking supervision, financial markets supervision or insurance supervision. When considering the most appropriate authority for integration of the pension supervision the Central Bank of Azerbaijan (CBA) providing supervision of the banking sector is the one to be mentioned firstly. The positive aspects of this integration to be mentioned is that the CBA is already providing banking supervision therefore supervision of pension management companies and custodians would be provided by the same authority ensuring interconnection and information exchange at adequate level. As a negative impact creation of some administrative burden to the CBA should be mentioned as well as assignment to the CBA the functions that are not related to its main objective.
The third option would be specialized authority. This option would follow the current approach of sectorial division of the supervision. Analysing current structure and functions of three existing supervisory bodies and bearing in mind importance and potential volume of the pension management function the most appropriate way to consider seems to be creation of the separate supervision authority being responsible for authorization and supervision of the pension management companies. This supervision agency will need to have strong cooperation with CBA supervising banks because custody function should be mandatory outsourced to the commercial banks.
As already mentioned above the most appropriate for the Azerbaijan is considered third option to establish specialized authority performing pension supervision. However taking into account possible voluntary approach for both components: funded and non-state pensions there is a risk that pension industry would be developing very slowly and therefore creation of the separate authority at least at the initial stage would not be seen as cost effective approach. Therefore second option – possibility to integrate pension supervision into the CBA should be considered.

<u>FINANCING OF SUPERVISION</u>

The most appropriate way of financing the supervision is to finance it from the market participants, or more precisely from members' contributions. This would ensure independence of the supervision from political and economic pressure and provide financial independence. However at the initial stage it would not be possible to ensure this model of financing simply because there would not be enough funds accumulated to provide necessary financing for successful supervision. Therefore at initial stage financing form the state should be provided.

17. Insolvency issues in pension funds activities

Insolvency issues of asset manager (if outsourced) and custodian
To ensure proper protection of the rights of the members and beneficiaries the legislation should ensure that in case the asset manager (if this function is outsourced) or the custodian of the pension plan has been recognised insolvent and bankruptcy procedures have been initiated, or the asset manager or custodian has been deprived of the relevant licence, a new asset manager or custodian shall be appointed by a decision of the board of the pension management company and the assets belonging to the pension plan shall be transferred to the new asset manager or custodian.
To ensure this procedure the legislation should provide that:
Assets of pension schemes shall be kept, recorded and managed separately from the assets of the pension management company, custodian, as well as asset manager itself and other assets under the management thereof.
If a pension management company, custodian or asset manager has been declared insolvent or is being liquidated, the assets of pension plans may not be included in the property of the pension management company, custodian or asset manager as a debtor.

The pension benefits capital accumulated in an individual account may not become the property of the asset manager, custodian or employer in any case. Recovery against the pension benefits capital shall be directed only if it has been recognised by a court judgment that the pension plan member has caused losses to the third parties by committing a criminally punishable offence.
It should be mentioned that there is significant difference between how insolvency of asset manager or custodian could affect the activities of the pension management company and members rights.
The asset manager (if this function is outsourced) is providing instructions to the custodian and assets are not kept by asset manager himself and also ring-fenced from any assets of the asset manager. Therefore the only issue in case asset manager is no longer able to provide it's services is to ensure that the process of choosing the new asset manager is done effectively and without any delay.
In case of insolvency of the custodian the situation is different. The custodian is keeping the assets belonging to the pension plans therefore the problems of custodian is directly affecting operations of the pension management company and rights of the pension plan members. Therefore it is very important that legislation prescribes effective and rapid process of transferring all assets to the new custodian and renewing operations of the pension management company. Therefore assets of the pension plan should be ring-fenced and kept separately and all assets should be transferred immediately to the new custodian even before insolvency procedure is started. This transfer should be done in close oversight by supervisory authority performing supervision of the custodian and legislation should prescribe process of the transfer and give necessary powers and duties to the supervisor to ensure transfer of these assets immediately after operations of the custodian are suspended. Therefore involvement of the custodian's supervisor in the process of the change of custodian is crucial.

Insolvency issues of employer

1) Protection fund

To protect the interest of insured in the event an employer becoming insolvent in Azerbaijan, a special *protection fund* could finance the payments. Protection funds exist in Germany, USA, UK and Switzerland.

The Pension Security Association („PSV") is the statutory agency providing insolvency protection for occupational pension schemes.[56] The sole purpose of this mutual insurance association is to guarantee occupational pensions in the event of an employer becoming insolvent in the Federal Republic of Germany. The insolvency insurance covers all schemes where the fulfillment of earned claims to an occupational pension is jeopardized by the employer becoming insolvent.

Such schemes include:

1. direct pension commitments, also referred to as direct commitments

2. indirect pension commitments through

   a) pension relief funds,

   b) direct pension insurance plans – only in the case of revocable rights or irrevocable entitlements if these have been assigned, presented as security or pledged – and

   c) pension funds.

The capitalized values of both the pensions requiring continued payment and the insurable pension entitlements are financed in the year of insolvency from the contributions received by the PSVaG.

The required levels of contributions are calculated at the end of the year and apportioned to all of the employers subject to compulsory contributions. A characteristic feature of this process is the fact that the contribution rates reflect differences in claim volumes from one year to the next. In other words, an increase in the claim volume results in an increase in the rate of contributions and a reduction in the claim volume leads to lower contribution rates.

The Pension Security Association transfers old-age pension obligations assumed as a result of an employer becoming insolvent to a consortium currently numbering 50 life insurance undertakings.[57]

2) Insolvency of an employer without protection fund

In other countries, there is no kind of "protection fund" for employer available:
If an employer who makes contributions has been recognised insolvency and insolvency procedures have been initiated, the pension plan of employees and the

[56] So called "PSV- Pensionssicherungsverein PSVaG"
[57] The executive insurer of the consortium for the PSVaG is Allianz Lebensversicherungs-AG, Stuttgart

relevant collective participating contract shall be terminated unless the new employer takes over all rights and obligations of the previous employer. The pension plan participants may continue participation in such pension plan with the new employer. Also the insured can be a member of the pension fund and change to a personal pension plan.

For Azerbaijan it has to be decided, wether there has to be implemented a "protection fund" in case of employer's insolvency granted the claims of policyholders. This caused costs for the employers, who have to pay contributions to the protection fund but would enhance the confident of customers regarding the pension funds system.

On the other side, when there will be no protection fund, in case of an insolvency of an employer, the contract could be terminated unless the new employer takes over all rights and obligations of the previous employer.[58]

Conclusions

To protect the interest of the insured in the event an asset manager, custodian or employer becoming insolvent in Azerbaijan, special protection measurements have to be implemented.

Against this backdrop, it is important to protect the rights of the members and beneficiaries. To secure the interest different relevant aspects has to be mentioned, as described above.

For Azerbaijan pension funds it has to be considered, what kind of protection it is most suitable.

18. Reorganization and liquidation of pension fund

Private pension systems play a major role worldwide, complementing retirement income from state sources.

In case of fundamental financial obstacles of the pension funds, the supervisory authority has to react immediately in an appropriate manner. It may take all adequate measures necessary to avoid or do away with abuses that endanger the interests of the insured. Interventions and more general supervisory measures are described in chapter "State supervision of pension funds".

There must be risks that clearly indicate that the continuation of the pension funds is almost impossible or at least endangered. Such risks should be proven on the basis of the ongoing supervision. If the risks predominate, a discontinued business and/ or liquidation is the possible way out. A pension fund shall be liquidated only with the permit of the supervisory authority.

Reorganization measures

Supervision should possibly have a preventive effect and it is the duty of the supervisor to prevent the interests of the insured being impaired.

In regulated markets the supervisory authorities are allowed to take measures to improve the financial and/ or organizational structure of pension funds.[59]

[58] This is status quo in most countries

[59] See also chapter "State supervision of pension funds" by Bernd Schulte-Brinker

The supervisory authority shall be authorized to require the pension funds, the members of their management boards and other managers or persons controlling the pension funds to provide information about all business matters. The pension funds have to provide information or submit these documents currently.[60]

If the own funds[61] of a pension funds fall, or threaten to fall, below the solvency margin, the pension funds shall submit to the supervisory authority for approval a plan for the restoration of a sound financial position, so called **solvency plan**.

If there are any indications that the financial position will continue to deteriorate, the supervisory authority may restrict or prohibit free disposal of the assets of the pension fund.

If the own funds of a pension funds fall below the amount of the guarantee fund[62] or are not eligible for inclusion in this fund in the required amount, the pension fund shall, upon request, submit to the supervisory authority for approval a plan for the short-term procurement of the necessary own funds, so called **financing plan.**

Additionally, the supervisory authority may restrict or prohibit free disposal of the pension funds assets.

This has to be applying accordingly, also if a pension funds does not establish adequate technical provisions, fails to provide adequate coverage for its technical provisions, or deviates without the permission of the supervisory authority from the requirements pertaining to the location of the assets.

If there is evidence to suggest that the pension funds may not be able to fulfill its liabilities under the pension plans, the pension funds shall submit to the supervisory authority a plan detailing how it intends to improve its financial position, so called **financial recovery plan**. The plan must explain how the pension fund intends to ensure its ability to meet the solvency requirements in the near future. The financial recovery plan should contain the following information with regard to the subsequent three financial years:[63]

- Estimates of operating costs, in particular current general expenses and commissions,
- A detailed list of estimated income and expenditures,
- A projected balance sheet,

[60] The reorganization measures described in this chapter are based on German supervisory practice. Nevertheless in regulated insurance markets, the supervisory authorities are allowed to react on obstacles occurred at pension funds. Against this backdrop it varies in details. *In the end, the supervisory authority ought to have the power for reorganization.* Then the supervisory authority has to decide on itself, the appropriate way to reorganize a pension fund. Of course it depends on the appearing obstacles in each case.
[61] The minimum size of own funds shall be three million AZN Manat (equivalent to Europe: 3 million Euros)
[62] To ensure that their liabilities under the pension contracts may be fulfilled at all times, pension funds are obliged to maintain own funds free of all foreseeable liabilities in an amount not less than the solvency margin, which is determined in relation to the total volume of business. One-third of the required solvency margin is deemed to be the guarantee fund.
[63] In Germany it is prescribed to elaborate a forecast for three years, a longer duration is more uncertain

- Estimates of the financial resources that will be available to cover insurance liabilities and the required solvency margin.

The supervisory authority's right to demand further information should be remain unaffected at all times.

If an assessment of the financial recovery plan reveals that the rights of the policyholders are at risk because the financial situation of the pension fund is deteriorating, the supervisory authority may, in order to ensure that the pension fund will be able to meet the solvency requirements in the near future, require that the pension fund maintain a greater amount of own funds.

The financial recovery plan shall form the basis for calculating the higher required solvency margin.

In order to safeguard the interests of the insured, the supervisory authority may require that the value of all assets eligible as own funds be adjusted, in particular if their market value has changed considerably since the end of the preceding financial year.

If there is a risk of an investment jeopardizing the solvency of the pension fund, the supervisory authority may also issue orders in cases where the investment is not part of the restricted assets.

Furthermore the supervisory authority should be able to prohibit payments when the pension funds relates to an insurance group.[64]

To audit the business operations of the pension funds on their premises, even without specific cause, the supervisory authority ought to be able at all times.[65]

If as a result of reorganisation of the pension fund members of the council or board of directors of the pension fund, chief actuary, head of the internal control service of the pension fund are changed, the relevant pension fund shall submit the documents referred to the supervisory authority.[66]

If as a result of reorganisation of the pension fund new pension funds are created, the documents regarding to licensing shall be submitted to the supervisory authority about them.[67]

The supervisory authorities shall be allowed to react on obstacles occurred at pension funds. Against these backdrop measurements varies in details. In the end, the supervisory authority ought to have the power for reorganization. Then the authority has to decide on itself, the appropriate way to reorganize a pension fund.

[64] E.g. paying dividends or profit transfers to the pension funds parent company
[65] See also chapter "State supervision of pension funds" by Bernd Schulte-Brinker
[66] Fit + proper criteria
[67] All necessary documents, see chapter "Licensing rules for private pension funds" by Bernd Schulte-Brinker

Creating a pension funds supervisory regime for Azerbaijan it is important to allow the relevant authority to take reorganization measures to help pension funds to solve financial or organizational obstacles. It has to be stated, that the supervisory authority may take **all adequate measures** necessary to avoid or do away with abuses that endanger the interests of the insured.[68]

Liquidation

There are different ways to handle a pension funds with fundamental financial problems, as described in the previous chapter.

In case an insolvency of a pension funds is unavoidable, a liquidation phase has to be started. A pension fund shall be liquidated only with the permit of the supervisory authority.

The supervision shall also extend to the liquidation of a pension funds and the "run-off" of existing insurance contracts if business operations are prohibited or voluntarily discontinued or if the licensing to carry on business is revoked.[69]

The supervisory authority may revoke the license for pension funds if:

1. the pension fund no longer satisfies the requirements for licensing,
2. the pension fund seriously breaches its obligations under the law or the operating plan, or
3. there is evidence of irregularities so serious that continuation of business will jeopardize the interests of the insured.

The supervisory authority may revoke the license for the whole of business operations if the pension fund is unable to carry out the measures set forth in the solvency plan or financing plan.

The license shall be revoked upon opening of insolvency proceedings. Revocation of the license shall not bear upon actions of the insurance undertaking legally required as part of the insolvency proceedings. Revocation of the license means that the undertaking is prohibited from writing new business, increasing or renewing existing policies.

The supervisory authority may require the dismissal of managers, and prohibit these managers from performing their duties if

1. evidence becomes known, which would also justify the refusal of an license,
2. the managers intentionally or negligently violate the supervisory provisions.

The supervisory authority may only file a petition for the opening of insolvency proceedings against the pension fund.[70]

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[68] See above; this also refers again to chapter "State supervision of pension funds" by Bernd Schulte-Brinker

[69] See also chapter „State supervision of pension funds", chapter "License termination of pension funds", or chapter "Licensing rules for private pension funds" by Bernd Schulte-Brinker

[70] See also chapter "Insolvency issues of asset manager (if outsourced), custodian or employer", by Bernd Schulte-Brinker

The meeting of stockholders may not take a decision on termination of liquidation of a pension fund until liabilities in relation to the pension scheme participants have been fulfilled completely.

In case of liquidation of a pension fund pension scheme participants have the right to all accumulations for pension benefits in their individual accounts.

The pension benefits capital accumulated in the pension fund to be liquidated shall be transferred to another pension account in accordance with an order of the supervisory authority.

The management board shall notify the supervisory authority as soon as the pension fund has become insolvent. This shall apply accordingly if the assets of the pension fund are no longer sufficient to cover its liabilities. This notification requirement shall replace the duty of the management board in accordance with other statutory requirements to file a petition for the opening of insolvency proceedings in the case of insolvency or over indebtedness.

The insolvency court[71] must immediately forward the order to open insolvency proceedings to the supervisory authority.
The supervisory authority should be allowed to demand information on the status of proceedings from the insolvency court and the insolvency administrator at any time. *The insolvency court is finally responsible for any further measures.*[72]

Conclusions
It is important to allow the relevant supervisory authority to take reorganization measures to help pension funds to solve financial problems or regarding organizational drawbacks.
The supervisory authority shall be able to require solvency plans, financing plans and financial recovery plans. In general it may take all adequate measures that are necessary to avoid abuses that endanger the interests of the pension plan participants.
It is the task of the supervisory authority to avoid an insolvency of a pension funds *in advance*, nevertheless in the case of insolvency, supervision shall also *(ex post)* to be aware of the liquidation of a pension funds.

19. Tax incentives for savings in private pension funds

The ultimate goal of tax relief to funded, privately managed pension schemes is to reward private saving in order to ensure a higher standard of living in retirement, both by encouraging more private saving and by contributing to the final sum. The efficiency and cost of these tools clearly depend on whether additional savings are made. There are many differing factors that can influence peoples' pension saving such as advice from financial advisers and encouragement from employers.

Within this framework, several countries consider that tax relief plays an important role as an incentive for individuals to join and participate in pension schemes.

[71] If available, or another responsible authority in Azerbaijan
[72] Based on international experience

Providing such tax relief can be expensive. The Organisation for Economic Cooperation and Development (OECD) projections suggest that, while demographic changes will mean an increase in revenues from taxation of pension income from funded schemes, the costs of tax relief will continue to outweigh revenues collected. [73]

Benefits of tax incentives are uncertain

Furthermore, there is a lack of clear evidence for the efficiency of using tax relief to encourage citizens to invest more in pensions. For instance, it is not clear that tax subventions actually create additional savings rather than simply diverting existing savings. If savings are merely diverted, tax relief will be both expensive and inefficient as it rewards savings that would have taken place without it. Another issue regarding tax relief is who benefits both in terms of greater incentives and greater savings. Evidence from the US 401(k) pension plans shows that middle and lower earners are more likely to respond to saving incentives with 'saving creation', and higher earners with 'saving displacement'[74]. However, while this might suggest that tax relief is better targeted at those with lower to middle incomes, evidence from the USA, UK and Canada also suggests that the take-up is higher among higher earners (in terms of participation and contribution levels) [6].

The design of certain tax relief systems seems thus to favour higher earners, while the complicated nature of tax relief can result in confusion. What is more, it is often only those on higher incomes who have access to independent financial advice to take full advantage of tax relief.

In some countries, there are additional advantages for individual pension savings through **direct state support** (e.g. Germany and Austria). **Matching contributions** or significant pension contribution subsidies allow the targeting of lower earners who need to save more, and would offer much better value for money for smaller savers. It is also much easier to understand and so would better target those without financial advice. Given the lack of clear evidence regarding the fiscal incentives of tax relief and the substantial costs to public budgets, there is scope for countries to look at tax relief options, particularly regarding the effects on adequacy and sustainability.

Occupational private pension arrangements and tax incentives

In case of the private pension funds there should be tax incentives for the employee; another issue is if there should be a cap on the amount that is tax deductible in case of the employee. A lot of countries work with a general cap for all efforts on retirement or all efforts to protect oneself against the risks of life (including life insurance, health insurance etc.). It is again an issue of tax expenditures and people's need. A certain cap might be advisable, for example, 10% from gross income of employee. In consequence the retirement income in the end should be fully taxed.

It might have to be considered if the tax deductibility is to be linked to the use of the private pension savings money only for retirement. So either the fund may not be permitted to make a payout before a certain date or the individual might have to repay

[73] Pablo Antolin, Alain de Serres and Christine de la Maisonneuve (2004), 'Long-term budgetary implications of tax-favoured retirement plans', Economics Department Working Papers No 393, OECD.

[74] Sheena S. Iyengar, Wei Jiang and Gur Huberman, 'How much choice is too much?: Contributions to 401(k) retirement plans'.

the tax benefits when he draws the money earlier. In case also the employer joins the scheme it is more advisable to require the fund not to pay out early. The date should be linked to retirement or maybe a bit earlier. A possible date might generally 55 in case of Azerbaijan since it is a bit before the retirement age for women. In Germany this date is the age of 60 – all benefits paid out before are not deemed to be benefits for old age.
In this private pension funds there should be also the possibility of contribution by the employers. They might be interested to have a means to provide their employees with certain kind of income protection in old age. This might be to attract people and generally provide them with social benefits. As a consequence also contributions of the employer have to be made tax deductible – applicable to employer part of state social contributions and corporate income tax as well.
This in the end would mean a system where either only the employee pays the contribution or only the employer will pay the contribution or both will jointly do. All these forms are to be found internationally and also the combination of all of them. The amount of tax deductibility also may have to be fixed here – according to the same deliberations.

General rules for tax incentives
In principle, most savings vehicles, including pension funds, involve three transactions that can be subject to taxation. That is:

- when a contribution is made to the savings instrument.
- when investment income and capital gains accrue to the savings vehicle.
- when funds are withdrawn.

A savings scheme is usually considered as being taxed favorably when its tax treatment deviates from a regime that treats all sources of income equally from a fiscal standpoint (the so-called comprehensive income tax regime). In a pure comprehensive income tax system, savings are made out of taxed earnings and the accrual return on funds accumulated is also subject to an income tax. In return, the withdrawal of assets from such saving vehicles is fully exempted from taxation.
Such arrangements are known as “taxed-taxed-exempt” (TTE) schemes.

Using this as a benchmark, there are several ways in which tax incentives can be provided. One is a regime that taxes the portion of income that is consumed, but that exempts the portion that is saved for future consumption (the so-called expenditure tax regime). In a pure expenditure tax regime, both the funds contributed and the accrual return on accumulated funds are thus exempted from taxation.
In return, the benefits are treated as taxable income upon withdrawals. The pure expenditure tax system thus achieves fiscal neutrality between current and future consumption, since all savings are tax-exempt. Such arrangements are commonly referred to as “exempt-exempt-taxed” (EET) schemes. However, tax favour does not necessarily always entail tax deferral. Indeed, for a given tax rate, an equivalent incentive can be provided under a “taxed-exempt-exempt” (TEE) regime, commonly referred to as a “pre-paid” expenditure tax. In the case where the discount rate is equal to the rate of return, and contributions and withdrawals are subject to the same marginal income tax rate, these two regimes deliver the same net present value of revenues to the government – in following table:[75]

[75] OECD Economic Studies No. 39, 2004/2
TAX TREATMENT OF PRIVATE PENSION SAVINGS IN OECD COUNTRIES

Alternative pension tax regimes, current dollars[1]

	EET	TEE	TTE	ETT
Pre-tax contribution (A)	100.0	100.0	100.0	100.0
Tax (B)	–	25.0	25.0	–
Post-tax initial asset (C = A – B)	100.0	75.0	75.0	100.0
Net accrued income (D)	33.1	24.8	18.2	24.2
Asset at retirement (E = C + D)	133.1	99.8	93.2	124.2
Tax on withdrawal (F)	33.3	–	–	31.1
Net pension income (G = E – F)	99.8	99.8	93.2	93.2
Memorandum item:				
Net present value of total tax[2]	25.0	25.0	30.0	30.0

1. Assumes a 10 per cent pre-tax rate of return, 25 per cent marginal tax rate and three years of investment.
2. Assumes the discount rate is equal to the rate of return.

Conversely, tax-deferral is not necessarily synonymous with tax preference given that under similar conditions, an ETT regime is identical to the TTE regime in terms of the net present value of revenues to the government. In addition, some tax support can be given also within the spirit of a comprehensive income tax regime. This is the case, for example, when the return on saving is taxed at flat rate that is lower than the marginal rate faced by most wage earners. Hence, a whole range of possible tax combinations going from EEE to TTT can be applied on specific savings vehicles and rates can be varied within each to alter the incentive.

Practices of taxing private pensions in the OECD countries[8]

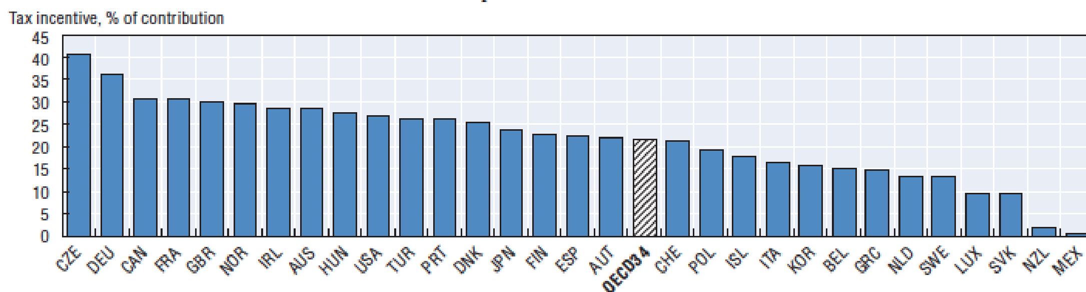
As regards the practice of taxation of private pension plans, a vast majority of countries apply a variant of the EET regime. Ten countries (Austria, Canada, Finland, Greece, Iceland, Netherlands, Norway, Poland, Switzerland, and the United States) come close to the pure EET regime in which withdrawals are subject to the progressive income tax rates. Another twelve countries (Belgium, France, Germany, Ireland, Japan, Korea, Mexico, Portugal, Slovak Republic, Spain, Turkey and the United Kingdom) also apply an EET regime, but one where withdrawals are generally taxed more leniently than in the first group of countries or where contributions are granted a tax credit rather than a full deduction. For instance, the United Kingdom, Ireland, Spain, France, Mexico and Turkey allow a partial tax-free withdrawal of benefits in the form of a lump sum, while France, Germany and Turkey allow a similar tax privilege to annuity pension income. In Mexico, Turkey and the Slovak Republic, pension income above a specified tax-free limit is taxed at a relatively low rate. Graph with tax incentives for private pensions: [76]

Kwang-Yeol Yoo and Alain de Serres

[76] Pensions at a Glance 2013 OECD and G20 Indicators.

6.6. Tax incentives for private pensions

2003 parameters and rules



Source: Yoo and de Serres (2004).

http://dx.doi.org/10.1787/888932907908

Taking into account that in Azerbaijan personal income tax incentive based savings product is only life insurance policy with minimum contract time for 3 years – fully EEE tax regime, also for private pension savings should be applied the same rules to receive personal income tax advantages. To avoid too high state budget expense constraints there would be advisable to introduce maximum limit for savings with tax advantages, for example 10% from gross salary.

To promote both – life insurance savings as well as private pension savings, these limits should be separated: 10% from gross salary for savings in life insurance not less than 3 years (it would be advisable to increase contract period up to 5 years) and 10% from gross salary for private pension savings. For each type of savings apply both – individual and employer contributions. Respectively, total amount of tax-free (EEE regime) savings would not exceed 20% from gross salary.

Also self-employed persons should be involved in tax-free savings vehicles – up to 10% from taxable income could be invested in private pension funds and added as deductable expenses.

For an employer who makes contributions on behalf of their employees could include these contributions in deductable expenses and for employee’s personal income tax and state social contributions would not be applied (no either employees part and employers part).

Also for persons who would make contributions on the behalf to their family members or other private persons, personal income tax incentives would be applicable. There would be necessary to decide if such contributions would be included in the same limit for tax incentives or may be some other 10% from gross salary limit should be introduced. That would be stimulating wider participation and would increase protection in retirement those persons (for example, women with several children) who can not be enough long time employed to contribute for state pension.

In following table there is proposal for personal income tax rules for long term savings which would be applicable for life insurance savings and savings in private pension funds separately.

Personal Income tax incentives for individuals with long term savings					
	Individual contributions	**Employer contributions**	**Individual contributions**	**Employer contributions**	**Contributions for other private person**
	Life insurance contracts 3Y+		**Private pension savings in private pension funds**		
	Up to 10% from gross salary		Up to 10% from gross salary		Up to 10% from gross salary
Contributions	Exempt	Exempt	Exempt	Exempt	Exempt
Capital gains	Exempt	Exempt	Exempt	Exempt	Exempt
Benefits*	Exempt	Taxed	Exempt	Taxed	Exempt
Tax regime	**EEE**	**EET**	**EEE**	**EET**	**EEE**
** only contributions part would be applied for personal income taxation*					

Totally persons would use up to 30% from gross salary to make savings for themselves or other persons with personal income tax incentives.
In the beginning stage such approach with so high tax incentives level would be acceptable and in the future that could be revised regarding to development of long term savings development.

20. Related laws which regulates Private pension fund activities

There are several other laws that could be influenced or should be revised regarding to establishment of private pension funds:

1) For personal and self employed tax incentives – Law on Personal Income Tax
2) For personal end employer state social contributions incentives – Law on State social contributions
3) For capital gain taxes – Law on Personal Income Tax
4) For corporate income tax incentives – Law on Corporate Income Tax
5) To exclude private pension funds services from value added tax – Law on Value Adds Tax
6) To exclude Private pension funds from corporate income tax payments – Law on Corporate Income Tax. Reason for that it, that pension funds perform social role in society.
7) Labour Law – regarding of definition of employees remuneration package
8) Consumer Protection Law

21. Public awareness and financial education needs by introducing of private pension funds

With the introduction of funded, privately managed schemes, pension systems have become far more complex. People may be asked to choose between various pension scheme providers and they are presented with options concerning the investment of their contributions.
For incentives in scheme design to work and for pension markets to function, people increasingly need to make informed decisions about pension products, their savings and about the length of their working life and the timing of their retirement.

As scheme members are asked to take more responsibility for their pension they need to better understand financial issues in order to make informed choices. Indeed, those who are less ‘financially literate’ are less likely to benefit from more complex financial arrangements and therefore less likely to save for retirement.
Without financial education, those who are confronted with a wide choice or complexity will tend towards inactivity. **This underlines the necessity to use automatic enrolment and default options for workers who may not be motivated to make informed choices.**

Promoting financial education
Education differs from information as the former combines the latter with skill building and motivation to change behaviour. Both have been found to be successful: for example, an awareness campaign was undertaken in Ireland to promote understanding of how the pension system worked. The action saw a simultaneous increase in take-up of personal retirement accounts, particularly among its target age bracket of 25–35 year-olds. As such, awareness in combination with financial literacy may not only improve the situation of the specific customer, but also boost the financial services market by making it more competitive.
Several initiatives can be done to provide financial education and a range of sources from financial supervisory authorities, adult literacy agencies, debt advice clinics, social workers, financial industry federations, microfinance organisations, consumer representatives, education authorities, individual financial firms and housing authorities provides information. Above all, national authorities should be as the main drivers of such initiatives.

Appendix A

Sample selected investment limits summary

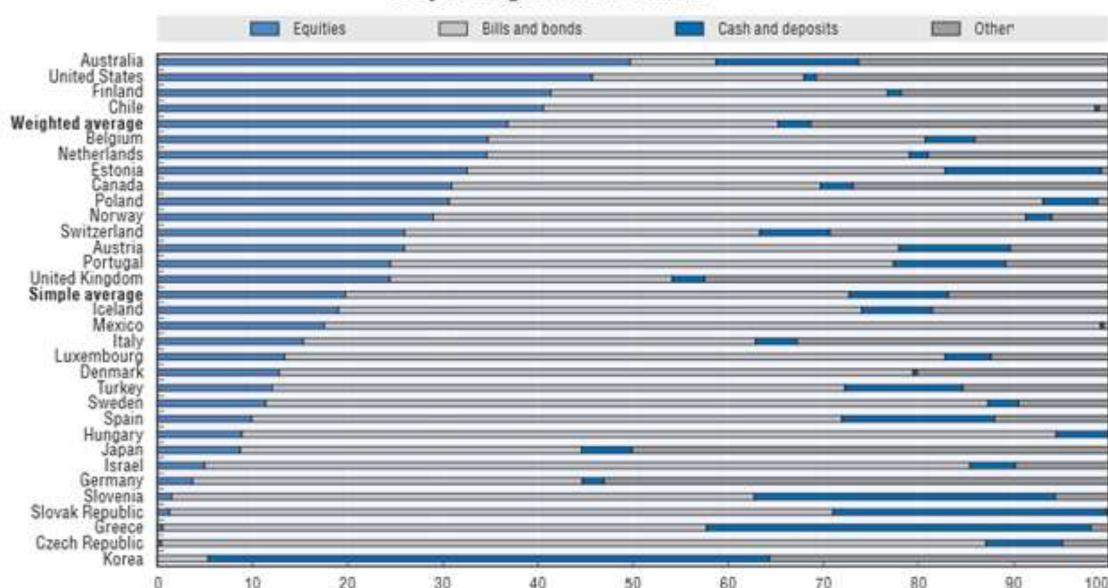
		P3P	P2P	
Limit name	**Description**	**All**	**Conservative**	**Active**
Max 10% in one issuer (corp debt)	The limit monitors that the share of corporate debt securities from one issuer does not exceed 10% of the fund value	X	X	X
Max 5% in one issuer (equities)	The limit monitors that the share of equities from one issuer does not exceed 5% of the fund value			X
Max 10% in one issuer (equities)	The limit monitors that the share of equities from one issuer does not exceed 10% of the fund value	X		
Max total 20% in unlisted corporate debt securities	The limit monitors that the aggregate investments in non-listed corporate debt securities does not exceed 20 % of the fund value.		X	X
Max 0% issuers outside EEA and OECD, except AZ	The limit monitors that corporate debt securities and equities are listed on regulated markets in member countries of EU, EEA, OECD and AZ.	X	X	X
Max 35% in government bonds (ex AZ)	The limit monitors that the share of government bonds issued by one country does not exceed 35% of the fund value. Local government bonds are excluded	X	X	X
Max 0% government bonds outside EU/EEA or OECD (ex AZ)	The limit monitors that the issuers of government bonds are member countries of EU, EEA or OECD.	X	X	
Max 0% government bonds outside EU/EEA or OECD (ex AZ)	The limit monitors that the issuers of government bonds are member countries of EU, EEA or OECD or traded on regulated markets in EU or EEA.			X
Max 10% government bonds outside EU/EEA/OECD traded on EU/EEA reg market (ex AZ)	Max 10% government bonds issued by a country outside of EU, EEA and OECD, traded on regulated markets in EU or EEA.			X
Max 20% single issue government bonds	The limit monitors that the share of a single government issue does not exceed 20% in case the total share of that issuer (government) exceeds 35%	X	X	X
Rating OECD countries investment grade	The limit monitors that bonds issued by member states of OECD have at least investment grade rating. (Only OECD member countries which are not member countries of EU or EEA are included in the limit)	X	X	
Least number of issues	The limit monitors that the number of government issues in the fund are at least 6 in case the total share of that issuer (government) exceeds 35%	X	X	X
Max 5% in one municipality (ex AZ)	The limit monitors that the share of bonds issued by one municipality (ex AZ) does not exceed 5% of the fund value		X	X
Max 0% municipalities outside EU/EEA and OECD (ex AZ)	The limit monitors that munic bonds are listed on regulated markets in EU, EEA and OECD		X	X
Max 35% in one municipality	The limit monitors that the share of bonds issued by one municipality does not exceed 35% of the fund value	X		
Max 10% deposits in one credit institution	The limit monitors that the share of deposits in one credit institution does not exceed 10% of the fund value. Overnight deposits excluded		X	X
Max 15% deposits + securities in one CI	The limit monitors that the aggregate share of deposits in one credit institution and financial instrument issued by that credit institution does not exceed 15% of the fund value		X	X
Max 20% deposits in one credit institution	The limit monitors that the share of deposits in one credit institution does not exceed 20% of the fund value. Overnight deposits are excluded	X		

Max 0% deposits credit institutions outside EU/EEA (ex AZ)	The limit monitors that the credit institution/counterparty is a member state of EU or EEA and that the credit institution has received a license to operate as a credit institution.	X	X	X
Max 25% deposits + securities in one CI (AZ)	The limit monitors that the aggregate share of deposits in one credit institution and financial instrument issued by that credit institution does not exceed 25% of the fund value	X		
Max total 50% in foreign currency	The limit monitors that the total exposure in all currencies does not exceed 50% of the fund value.	X		x
Max total 10% in foreign currency	The limit monitors that the total exposure in all currencies does not exceed 10% of the fund value.		X	
Max 10% one real estate investment	The limit monitors that the share of single real estate investments does not exceed 10%. (Only bonds with Security type REAL ESTATE are currently included in the limit)	X		
Max 0% real estate investments outside EU/EEA (ex AZ)	The limit monitors that real estate investments are registered in member countries of EU or EEA (ex AZ).	X		
Max 15% total investments in real estate	The limit monitors that the total share of real estate investments does not exceed 15% (only bonds with Security type REAL ESTATE are currently included in the limit).	X		
Max 10% in one investment fund	The limit monitors that the share of a single fund investment does not exceed 10% of the fund value	X	x	x
Max 0% investment funds outside EU/EEA and OECD (ex AZ)	The limit monitors that the country of registration of investment funds are member states of EU, EEA or OECD (ex AZ)	X		
Max total 10% in closed funds	The limit monitors that the aggregate share of Non-UCITS funds does not exceed 10% of the fund value			X
Max 0% investment funds outside EU/EEA (ex AZ)	The limit monitors that the country of registration of investment funds are member states of EU or EEA (ex AZ)		X	X
Min 70% in regulated markets	The limit monitors that the share of investments in regulated markets is at least 70% of the fund value	X		
Max total 50% in equities	The limit monitors that the share of all equities and equity related instruments does not exceed 50% of the fund value.			X
Max 5% derivatives each counterparty	The limit monitors that the derivative exposure (Futures, options and swaps) of a single counterparty (not credit institution) does not exceed 5% of the fund value	X		
Max total 5% in venture capital	The limit monitors that the total share of venture capital investments does not exceed 5% of the fund value.			X
Max total 50% in repo obligations	The limit monitors that obligations arising from repo transactions (in absolute values) do not exceed 50% of the fund value	X	X	X
Max 0% derivatives outside regulated markets	The limit monitors that derivative instruments are traded on regulated markets in a member state of EU, EEA and OECD or that the counterparty has received a license to operate as a credit institution in a member state of EU or EEA.	X	X	X

Appendix B

8.7. Pension funds' asset allocation for selected investment categories in selected OECD countries, 2011

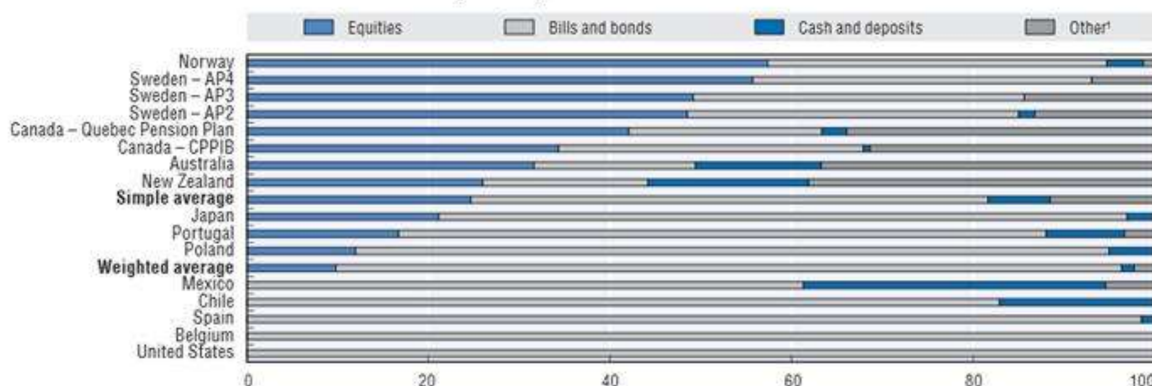
As a percentage of total investment



Source: OECD Pensions at glance 2013

8.8. Public pension reserve funds' asset allocation for selected investment categories in selected OECD countries, 2011

As a percentage of total investment



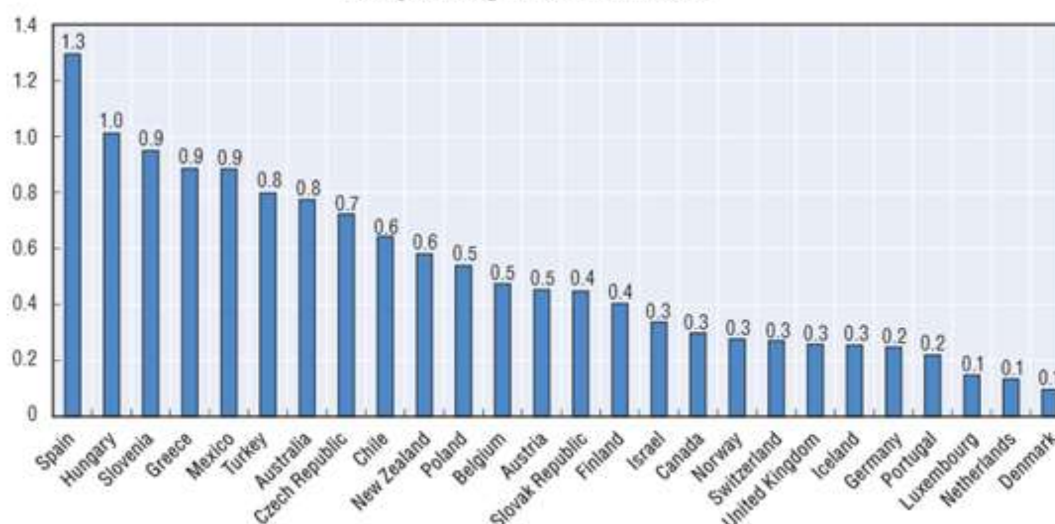
1. The "Other" category includes loans, land and buildings, private equity, unlisted infrastructure investment, hedge funds, commodities, and other investments.

Source: OECD, Global Pension Statistics.

Source: OECD Pensions at glance 2013

8.11. Pension funds' operating expenses as a share of total investments in selected OECD countries, 2011

As a percentage of total investment



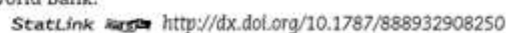
Source: OECD, Global Pension Statistics.

Source: OECD Pensions at glance 2013

8.12. Average administration fee in DC systems in selected OECD countries, 2011

	Fees on (%)			
	Contributions	Salary	Assets	Returns
Austria			0.50	
Chile		1.42		
Czech Republic			0.60	15.00
Estonia			1.49	
Greece			0.90	
Hungary	4.50		0.80	
Israel	4.07		0.35	
Korea			0.70	
Mexico			1.50	
Poland	3.50		0.46	
Slovak Republic (2nd pillar)	1.50		0.30	5.60
Slovak Republic (3rd pillar)			0.083-0.165	
Spain (occupational)			0.19	
Spain (personal)			1.44	
Turkey	3.52		1.80-2.55	
United Kingdom			1.50	

Source: National supervisory authorities' data, IOPS, OECD, World Bank.



Source: OECD Pensions at glance 2013