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Pension Reform: Intermediate Results

Over several recent months, the key issue in the discussion on the *Strategy of Long-Term Development of the Pension System of the Russian Federation* prepared by the RF Ministry of Labor was reform of the funded component of pension.

The critics of the mandatory funded component in Russia usually point to its following drawbacks: low yield on investment; absence of any funding sources for the transition period (the contemporary employed generation has to bear a 'double burden': provide financing for the contemporary generation of pensioners and accumulate resources for their own retirement), and lack of any mechanism that can guarantee a yield on accumulated pension savings.

At the same time, the approach that was initially suggested in the *Strategy's* draft – to lower to 2% the size of the insurance contribution tariff for the pension system's funded component (based on an insured person's decision) and to allot 4–6% to the 'solidarity' component of the labor pension – was fraught with some significant risks:

- the lower tariff would have resulted in a significantly increased ratio of the cost of the funded component's administration to the size of contributions;
- Russia's international financial reputation would have seriously deteriorated, because in the eyes of investors the mandatory funded system's shrinkage is associated with a poor state of government finances and unstable investment climate;
- social tension would have heightened: a) the Public Opinion Foundation's latest survey has indicated that only 8% of those respondents whose labor pensions' funded component is held by independent pension funds are in favor of lowering the size of contributions to the funded component, while 44% are against that measure; b) perpetually changing 'rules of game' increase the overall feeling of instability.

In this connection, a compromise was found. On 23 November 2012, in the second and third readings, the RF State Duma approved the draft law 'On Introducing Alterations in Some Legislative Acts of the Russian Federation on Issues of Mandatory Pension Insurance'. By the new law, it is established that:

- those citizens who have already chosen an independent pension fund or asset manager will retain the possibility to transfer the 6% mandatory pension insurance contribution to the funded component of their pension;
- only 2% will be deducted to the mandatory funded component of their pension from the earnings of those citizens who have not chosen any independent pension fund or asset manager (the so-called 'silent ones'); while 4% of the tariff will be redistributed in favor of the insurance component of pension.

The entry into force of this decision is delayed until 2014. For an entire year (2013), people will be able to think over their choice as to where to allot the contribution in the amount of 4% of their earnings – to the funded or insurance part of the labor pension. It remains unclear how often they will be able to alter their decision, once made, after 1 January 2014. It seems that they can probably make this choice with regard to 4% of their earnings on an annual basis, for each successive year. All the previously paid contributions will remain in the system to which they have been originally paid. This restriction is explained by the fact that, in the distributive system, all available funding is immediately spent on the payment of pensions to the currently retired persons. To make it possible for citizens to transform into savings their monies paid into a distributive system, it will be necessary to create special state reserves – which will undermine the very idea of a distributive system, because money cannot be simultaneously spent on the contemporary generation of pensioners and reserved for future redistribution if the currently employed citizens change their mind and opt for the funded component.

The necessity to actually make a choice as to where to allot the remaining 4% of their earnings – to keep it as their own saving or to effectively spend it on the payment of pensions to the currently retired generation – may urge many people to shake off their habitual passivity and to make a choice between an independent pension fund and an asset manager. Under that scenario, the share of such people may increase from its current level of 15–20% to 40% of all insured persons born after 1967. In that case, no more than 0.5% of GDP may additionally go to the 'distributive' component in 2014. If, however, people do not become more active in making their choice between an independent pension fund and an asset manager, the RF Pension Fund's budget will increase by 0.7% of GDP.

As before, the issue of a radical improvement of investment cost-effectiveness and society's demand for pension savings remains unresolved. A solution can be provided though implementing the following measures.

1. Expansion of the list of available instruments for investing pension savings, including a radical diversification of the ways to invest pension savings (while still keeping a considerable portion of the invested money on the Russian stock market).

2. Broader implementation of a 'passive' strategy for investing pension savings (global asset investment):

- if a citizen has failed to make an individual choice of an investment portfolio, the 'by-default' option in any independent pension fund must envisage investing in global assets; in this connection, the portfolios selected 'by default' must be made subject to some additional constraints on the size of administrative costs;
- the performance of independent pension funds and asset managers must no longer be estimated on the basis of their reporting a positive nominal yield by the results of each reporting period, because their compliance with this requirement has resulted only in lower yields. Instead, the performance evaluation criterion must become a comparison of a yield on investment with a change in the relevant index.

As a result, the following benefits will be achieved:

- high yields on pension savings over long-term periods due to the dominant role of stock in the structure of investment portfolios;
- high investment safety due to investment diversification;
- lower administrative costs due to a reduction in management expenses;
- social justice (lower differentiation of the size of yield on mandatory pension savings for people with similar risk-proneness).

3. Applying the principle of a life cycle to pension saving investment. Capital markets' history testifies to the fact that, over longer periods of time, investments in stock are not only associated with real positive yields, but represents the most cost-effective method of investing money. At the same time, stock markets are prone to significant fluctuations. A solution to that problem can be provided by means of implementing the principle of a life cycle in the management of pension savings when, while employed people are young, practically all their pension savings are invested in stocks; as people become older, the share of reliable bonds in their portfolios gradually increases. As a result, for a better part of their employment history, their savings are invested in the highest-yield instruments (chosen from among relatively liquid instruments); when retired, they are insured from the stock market's volatility because a considerable portion of their portfolio is transformed into safe bonds.

4. The creation of a system for insuring the safety of pension savings similar to that of bank deposit insurance.

5. Expansion of the list of financial institutions allowed to participate in the formation of pension savings, by means of including therein insurance companies and credit institutions.

6. Increasing the transparency of institutions participating in the formation of pension savings (improvement of the information disclosure procedure).

7. Implementation of state-of-the-art risk-oriented methods of supervision and control over the quality of pension saving investment.

8. Restriction of citizens' access to their pension savings prior to their retirement age and the right of choice of annuity period (for life without the possibility of inheritance, or for a certain period with the right to inherit). This will result in a significantly increased social demand for the funded pension system, because it will thus be turned into 'saving for a rainy day' for the middle class, which people can use for the following purposes:

- to buy medical services or additional medical insurance for the participants in the funded system, or for their next of kin;
- to pay for the education of the participants in the funded system, or of their next of kin;
- to buy some socially important services - for the participants in the funded system, or for their next of kin;
- to buy immovable property or to use pension savings as a pledge in a housing mortgage loan.

Without improving the quality of the funded and distributive components of the pension system there will be no point for people in making a choice between the two. Under an 'inertia-dominated' scenario of development, the distributive component will be able to provide a pensioner with the size of annuity somewhere between the subsistence level and twice that amount, while the amount of savings will be increasing at a rate close to the growth rate of inflation, thus making it impossible to ensure a socially acceptable replacement coefficient. The situation can be radically changed only on condition of a significant improvement of the cost-effectiveness of pension savings investment and the implementation of decisions aimed at improving the ratio of the length of employment history to the length of retirement.