

# INSTITUTIONAL PRINCIPLES OF THE FUNDED PENSION SYSTEM IMPLEMENTATION

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## **Abstract**

The main task at the present stage of the socio-economic development of our country is the implementation of a European model of the pension system that would meet the requirements of a market economy. That is why the pension system in Ukraine is completely changes. The main strategic vector in the system of further pension system reforms in Ukraine is the introduction of a funded pension system. The functioning of funded pension systems in developed countries is accompanied by a number of macroeconomic, investment, management and other risks. This forces the development and implementation of specific models of pension institutions work and the creation of special systems of state supervision over the pension institutions. Under the institutional components of the mandatory cumulative level of the pension system, we mean the creation of a proper system of regulation and supervision that can reliably protect the rights of its participants (beneficiaries). In order to create such system we should implement the legislation that would consolidate supervisory functions in the field of funded pensions and establish the necessary powers, independence and institutional capacity of the supervisor authority. It is much more difficult to reach a consensus on the model and baseline parameters of the mandatory cumulative pension system because of the large number of bills under consideration in the Verkhovna Rada. For constructing the second level of the pension system, it should be used the combined model that will ensure the centralization of the expenditures part of the system. Next, the development of the system should be based on the existing software complex of the Pension Fund of Ukraine, which will allow avoiding the significant expenses onthe development of new software and the maintenance costs will be transferred from beneficiaries to the budget of the Pension Fund of Ukraine. Among the set of basic parameters of the mandatory cumulative level of the pension system, particular attention is drawn to those that determine the range of pension contributions payers and the size of such contributions. The most effective approach is to maximize the involvement of the economically active population in funded pension funds, emphasizing their personal responsibility for own well-being at retirement age, taking into account the social risks of different income groups. World experience shows that the basic building principles of a second level pension system in Ukraine should be: minimizing the administrative costs of system participants by achieving the “economies of scale” effect; minimization of government spending on supervision; ensuringstate control on payment of contributions; ensuring transparency and clarity of the system for participants; reducing the risks of pension assets loss; ensuring competition in the field of asset management.

**Keywords:** funded pension system, funded pension fund, non-state pension funds, institutions, state regulation.

## **INTRODUCTION**

The development of Ukraine as a highly developed social state should become a strong foundation for comprehensive innovative development of the country, integration into the European Union, the basis for the development of a state with a competitive socially oriented market economy, capable of ensuring human development, decent living standards and quality of life. One of the strategic directions of the movement towards a socially oriented economy is the

implementation of the pension reform, which envisages the creation of a multi-level pension system that can meet both demographic and financial challenges.

The present stage of economic development in Ukraine is characterized by institutional transformation, which consists in the emergence, development and strengthening of market rules of economic behavior and market institutions (organizations) and their replacement by the old institutions – rules and organizations inherent in the administrative-command system. In the majority of post-Soviet countries, there is a widespread belief that the norm and the optimal form of institutional system capable of providing a high level of economy and quality of life is the institutional environment created today in the leading Western countries.

In the economical literature the institutional environment is seen as the compilation of the basic political, social, lawful and economical rules. That defines the frames of the human behavior and creates the basis for the production, exchange and distribution. V. Savchenko states that the institutional environment is a clear, streamlined set of institutions that determine the framework conditions for the functioning and development of economic entities [1].

## **RESEARCH RESULTS AND DISCUSSION**

The formation of effective and modern pension institutions is only at an early stage. This is due to the inconsistency of pension reform, which has evolved from a full-fledged structural adjustment to repeated attempts at permanent change; lack of political will in the ruling elites to take responsibility for the negative consequences of reform (if they arise); difficult economic situation; high level of shadowing of the economy; chronic deficit of the Pension Fund budget and as a result of large expenditures of the State Budget of Ukraine to cover it; a significant number of legislation on the accrual and payment of pensions to different categories of population; the accumulation of surcharges, allowances and benefits in the pension system that undermine its financial status. At the beginning of its independence, Ukraine failed to accept the nation-wide doctrine of forming effective retirement institutions, primarily non-state institutions, as the most important component of additional retirement income directly related to the wage system, demographic and labor market policies. All this results in the absence of well-defined goals and action programs in the field.

Some publications on the development of institutions suggest that the spontaneous process of formation of market environment institutions and the mismatch of interaction between them became the main reason for the unsatisfactory results at the beginning of the state formation and caused difficulties during the crisis period of Ukraine's development [2]. Therefore, the key task at the present stage of socio-economic development of our country is a clear construction of a balanced European model of a multi-level pension system, which is based on a funded pension system as a new pension institution. For its effective implementation and functioning, it is necessary first of all to form its main financial institutions, regulate their activities, determine the powers and peculiarities of financial relationships between them regarding the storage and use of second-tier pension assets.

Despite the fact that the functioning of the compulsory system of compulsory state pension insurance was declared by the Law of Ukraine "On Compulsory Pension Insurance" No. 1058-VI of July 9, 2003, it has not been implemented since then. The funded component of retirement insurance, which aims to achieve the global long-term goals of social and economic development of the country, is based on the principles of accumulation of funds of insured persons in the Cumulative Fund and the financing of the costs of life insurance contracts and lump sums. A characteristic feature of the system is its dualistic character. On the one hand it acts as a social institute and on the other as a source of long-term investment. Given this, it is possible to distinguish the advantages and disadvantages of the system (Table 1).

Table 1. Advantages and Disadvantages of Compulsory State Pension Insurance

<b>ADVANTAGES</b>	<b>DISADVANTAGES (potential threats)</b>
<ul style="list-style-type: none"> <li>- reduction of social tension in society;</li> <li>- strengthening of insurance principles;</li> <li>- increasing the independence of the pension system from demographic factors;</li> <li>- increasing the amount of pension payments;</li> <li>- increase of financial literacy of the population;</li> <li>- increasing the motivation of the population to participate in the non-state pension system;</li> <li>- reducing the fiscal burden on employers;</li> <li>- accumulation of significant amounts of financial resources – creation of a source of long-term investments in the national economy.</li> </ul>	<ul style="list-style-type: none"> <li>- high dependence of the system from the economic and financial state of the country;</li> <li>- financial resources distraction from the solidary system (at the beginning stage);</li> <li>- increased sizes of the administration system;</li> <li>- availability of the changes risks in the price of the assets to the side of decreasing;</li> <li>- dependence of the inflation processes;</li> <li>- lack of the gender aspects inclusion;</li> <li>- availability of the risks of unskillful management of pension accumulation;</li> <li>- political risks of costs usage for the purpose of the budget deficit financing;</li> <li>- high spending associated with the implementation of accumulative system.</li> </ul>

Source: created by the author on [3, 4]

The successful implementation of the pension reform defines the search and systematization of institutional factors, that influence the system of the accumulative pension insurance and its institutional environment, also the possibilities and paths of its transformation, oriented on the increasing the level of population's social foundation. The institutional factors of the formation of the accumulative system of the pension insurance system (Figure 1) include the political, lawful and economic rules of the game, and also the socio-cultural factors [5].

The institutional components of the mandatory retirement savings system include:

- adoption of basic legislation;
- type of functional model;
- outline of the basic parameters of the system (time of entry, subjects, circle of payers of pension contributions and the size of such contributions, rights and obligations of the subjects of the system, mechanism of protection of pension assets, directions of their investment, etc.).

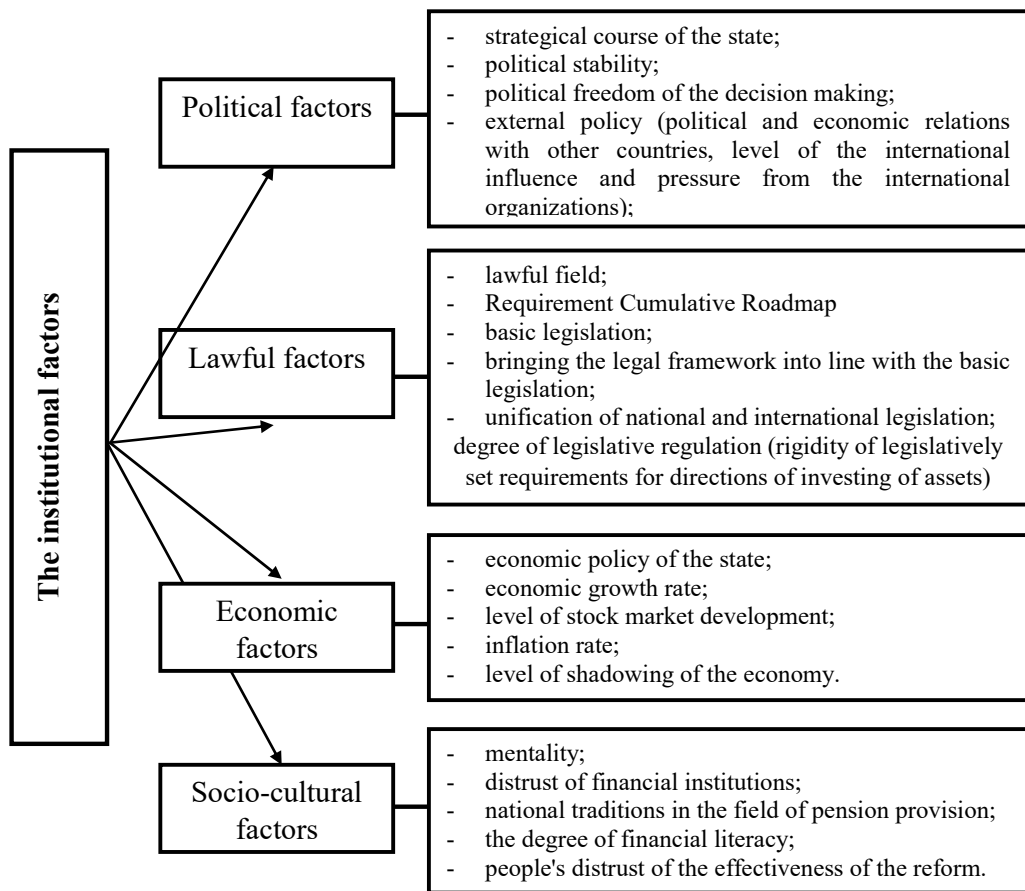


Figure 1. The institutional factors of the formation of the accumulative system of the compulsory state pension insurance system

Source: created by the author on the basis of [3-5; 13; 16]

One of the main conditions for the start of operation of the second level is the adoption of a separate law on the introduction of the compulsory system of compulsory state pension insurance. Currently, there are several bills in the Verkhovna Rada with almost similar names regulating the mechanism of implementation of the second level – No. 2854 of December 29, 2006, submitted by the Cabinet of Ministers of Ukraine; No. 4608-1 of May 19, 2016, submitted by the Group of Deputies and taken as a basis (Bills 4608-2, and 4608-3 tabled as alternatives), No. 6677, submitted by MPs Solovey Y.I., Veselova N.V., Ryzanenko P.O., and No. 600 dated August 31, 2018, developed by the NCSFM. In fact, the bills summarize the results of more than a decade of discussing second-level implementation issues, most of the provisions of these projects contain the same approaches to the mechanism of introducing a cumulative component, regulating relations in this area, while at the same time differing in several conceptual bases, each of which may affect functioning.

We analyze the bills by certain criteria (table 2).

Table 2. Comparative analysis of bills on the introduction of the compulsory system of compulsory state pension insurance

Criterion	Bill №2854	Bill №4608-1	Bill №6677
Type of organizational model	Mixed: centralized initially – Cumulative Pension Fund. After 11 years, switching to a mixed model – Accumulation Pension Fund (AF) or Non-State Pension Funds (NPF) at the participant's choice	Centralized creation of a Cumulative Pension Fund	Decentralized through the system of non-state pension funds
Date of introduction	01.01.2009 meeting the requirements for economic growth of the country over the last two years by 2% compared to the previous one and the balance of the PFU budget	01.07.2017 (4608, 4608-1)  January 1 of the year following the year in which the PF budget deficit is reached (4608-3)	01.01.2018
Participants	persons under 40 years old, participation is required	persons who have not reached retirement age (persons under 35 who are entitled to a retirement pension on preferential terms - compulsory participation in relevant occupational retirement benefit schemes)	persons under 35 years, participation is required
Voluntary participation	provided	provided	provided
The size of the deduction rates	min – 2% max – 7%  a wage increase is required to compensate employees for losses	min – 2% max – 5%	min – 2% max – 7%
Administration	Pension Fund of Ukraine	Pension Fund of Ukraine	Pension Fund of Ukraine + NPF Administrators
State guarantees for saving money	Missing	provided for the amount of insurance premiums paid, taking into account inflation	provided through participation of NPF in deposit guarantee system (Deposit Guarantee Fund)
Benefits	availability of competitive principles; the right to choose the insured person between public and private financial institutions; ability to diversify strategies	simplicity of state control; the maximum financial resource that facilitates the financing of large-scale state projects	ensuring competition in the market for funded pension insurance services; the distribution of potential risks among dozens of non-state pension funds; ability to diversify strategies
Disadvantages	dispersion of monetary resources; complications of state control; financing of the state structure at the expense of the budget	lack of choice for the insured person; lack of market competition	dispersion of monetary resources; complications of state control; the difficulty of choosing for the participant due to the low level of financial literacy
Need for additional financial resources	4 billion of UAH	missing	missing

Source: developed by the authors on the basis of [6-12]

According to the analysis, the main conceptual differences of the submitted bills are the type of organizational model of the system, its administration, the existence of state guarantees for the preservation of funds and the need for additional financial resources.

One of the differences is the rejection of a centralized model of the accumulation system for the accumulation of second-tier premiums through the creation of a Cumulative Pension Fund and the transition to a decentralized model through non-state pension funds that meet the criteria of the Law of Ukraine "On Non-State Pension Insurance" [13]. That is, compulsory (second tier) retirement savings are formed in non-state pension funds (tier 3) selected by citizens, together with voluntary retirement savings. This model assumes that only certain administrative functions, such as collecting insurance premiums, maintaining personal records, etc. provided by the Pension Fund, will remain centralized. However, due to the low level of financial literacy of the population, the crisis of distrust in financial institutions, taking into account the performance of non-state pension funds for more than ten years, the lack of reliable instruments for investing pension savings in the stock market, to implement a decentralized model at once is quite risky. Therefore, in our opinion, the best option is the mixed model proposed by Bill No. 2854. The mechanism of introduction of the system is reduced to its phased implementation with a gradual shift of emphasis from state supervision and regulation to the personal responsibility of citizens for their own pension well-being. That is, the first stage is the introduction of a centralized system, concentrating pension assets in the Cumulative Pension Fund under state control and management (full responsibility of the state), and in the second (after 11 years) - decentralization of the system and giving citizens the right to choose a non-state pension fund (NPF).

The obligation to participate in the system implies a gradual coverage of a large contingent of cumulative pension insurance. This requires such requirements as: the simplicity and accessibility of the regulatory framework to be understood and understood by all actors in the process; the mechanism of the administrative system for rapid recording of the whole range of insured persons is established; the capacity of the institutional infrastructure to process and systematize a large amount of information; ensuring control over the receipt of insurance premiums. Effective solution of these problems is possible only with a high degree of centralization of information and cash flows, accounting procedures, control functions, which is possible only if they are consolidated at the PFU level as a single administrative center [14].

In foreign countries, various models of functioning of mandatory funded pension systems are used: from rigidly centralized, in which only investment activity (ie, management of pension assets) is transferred to private hands, to fully decentralized ones, in which state participation is reduced exclusively to regulation of pensions, provision, supervision of the entities providing services to members of such systems and consolidation of key data flows. The main advantage of the centralized model is the low level of administrative costs, which is achieved through economies of scale. Instead, it is considered that a decentralized model, which has a mechanism of market self-regulation, thanks to competition (this almighty "market power"), is

better able to meet the diverse needs of different participants in the mandatory funded level of the pension system, giving them the freedom to choose pension-based pension services acceptable value for money. However, in recent times, a number of countries, including those with advanced financial markets and pension systems, have resorted to the creation of centralized models or models in which national and private pension funds would function equally.

The prerequisite for the introduction of a mandatory cumulative level of the pension system is, first and foremost, the creation of a proper system of regulation and supervision that can reliably protect the rights of its participants (beneficiaries). To this end, legislation should be enacted that would consolidate supervisory functions in the field of funded retirement provision and establish the necessary powers, independence and institutional capacity of the supervisory authority. Relevant Bills – “On Amendments to Certain Legislative Acts of Ukraine on Consolidation of Functions in State Regulation of Financial Services Markets” (No. 2413a, or the so-called “split”) [15] and “On Amendments to Certain Legislative Acts of Ukraine on Protection of Investors from Market Abuses capital”(No. 6303-e) [16] were submitted to the Verkhovna Rada for consideration in 2016.

Among the set of basic parameters of the mandatory cumulative level of the pension system, particular attention is drawn to those that determine the range of payers of pension contributions and the size of such contributions. The provisions of the Law on Compulsory State Pension Insurance and the two bills (the MPs and the NCSFM) are similar in these respects: only the members of the system (working population) are payers of pension contributions, and the pension contributions are paid at the rate of 7% (current legislation and deputies' legislation) or 15% (in the published version of the NCSFM bill) of the total income of the system members.

This approach should aim to maximize the involvement of the economically active population in participating in retirement benefits, emphasizing their personal responsibility for their own well-being at retirement age. However, when determining the conditions of retirement, not only age-related risks, but also other anthropogenic risks (loss of work, illness, disability, etc.) that are particularly vulnerable to the poor, should be considered. For our country, this problem is particularly acute because much of the working-age population, to some extent even those employed in the formal economic sector, remains poor.

The existence of a mechanism for the protection of retirement savings and state guarantees is one of the key points in the introduction of a funded system of compulsory state pension insurance. Given that the system is mandatory for participation, initiated by the state, the mechanism and conditions of introduction are fixed by law, the state, represented by the government, is responsible for macroeconomic indicators of development, the state itself should be the ultimate guarantor of saving the pension funds of citizens. There is no prospect of implementing any pension reforms in the country unless its citizens are convinced that their pension savings will be maintained. Rather, on the contrary, in the event of mistrust of the pension system, any deductions will be seen as a waste of money at best, and at worst, as the desire of the state to enrich itself at the expense of its citizens [19]. Real protection provides for the organization of reliable physical

storage and investment of funds to at least offset their inflationary depreciation, storage costs, management, etc. at the expense of investment income.

Equally debatable is the effectiveness of the cumulative system given the high level of inflation in the country (and thus the possible depreciation of retirement savings), the risks associated with the under-qualification of companies that will invest retirement assets, the transparency of competitions among such companies, abuse and corruption factors, lack of awareness of the public about the fundamentals of the pension system, and lack of trust in government bodies.

## CONCLUSION

Therefore, the basic principles of building a second-tier pension insurance system in Ukraine should be:

- minimizing the administrative costs of system participants by achieving the "economies of scale" effect;
- minimizing government spending on supervision;
- ensuring control by the state on payment of contributions;
- ensuring transparency and clarity of the system for participants;
- reduction of risks of loss of pension assets;
- ensuring competition in the field of asset management.

It should be remembered that in developing and building a system of institutions, the mechanical copying of the positive experiences of other countries has almost never been successful. This is due to the fact that specific successful institutions are copied, which are effective in one situation and have completely unforeseen consequences under other conditions. It is necessary to design new institutes that fulfill the same functions but are compatible with the peculiarities of national social and cultural capital, the carriers of which are informal institutions. Therefore, the main task of reforming the pension system is a thorough development and consistent systematic implementation of a long-term program, which would be based on the concept of adapting the desired institutional innovations in the field of pension provision to real-life official, and, above all, unofficial, non-public institutions that were formed social, economic and socio-cultural life of the country. The social significance of the accumulation system determines diligence in the development of conceptual concepts of its implementation and further holds the Government of responsibility for the consequences of such steps.

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