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Rational Pension Supervision

**First Experiences of Central and Eastern European States
in Comparison with Other Countries**

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Introduction:

Goals and Subject Matter of the Report

New financial institutions, pension funds, are being established in Central and Eastern Europe, that are also an important element of the social security system. They provide an additional source of income in old age. This source is all the more important insofar as public, pay-as-you-go pension systems in many countries are having problems with meeting previous pension commitments, which were often excessively generous and did not take into account potential changes in demographic conditions and the labour market.

Pension funds are primarily business entities whose financial success brings benefits to their participants – future old-age pensioners. At the same time, though, these are social institutions, as they contribute to securing income in a socially difficult situation – for old age. Their goals thus include both high effectiveness, leading to the increase of invested premiums so that these provide income whose growth rate would not be lower than the rate of wage growth, coupled with a high level of operational safety to make sure that future benefits can be paid at a level ensuring, at least, that the real value of invested premiums is maintained.

Pension funds work simultaneously towards the two goals – economic and social – and these goals are interlinked. Success in achieving the economic goal increases pensioners' future incomes, and the security of attaining an appropriate level is achieved automatically. On the other hand, relentless striving for a high rate of return carries a risk factor. The highest indices are achieved on the most risky investments. However, regulation of the funds' operations in the name of their safety limits the chances for attaining higher returns – not only because investment freedom is limited, but also because safety instruments are costly and reduce the amount of resources possible to invest. Reconciliation of the two goals of pension funds, the economic and the social, is therefore a difficult problem requiring great competence.

Societies in Central and Eastern Europe are very sensitive to the issue of the operational safety of new financial institutions, and especially pension funds. One can still observe mistrust of capitalist institutions, while initial experience with private entities such as banks, savings societies

and insurance companies has not always been positive. In this situation, ensuring safety by introducing a whole arsenal of security and guarantee regulations together with the regulations on establishing funds becomes a political goal that conditions the very passing of laws on private pension funds.

The subject of our consideration will be the experiences relating to pension fund regulations from the point of view of their safety of operations in five countries of Central and Eastern Europe. These countries represent two groups. **The first includes Hungary and Poland**, where the decision to establish pension funds was made earlier on. Thus, they can now share their own, though modest, experience, especially Hungary. Moreover, the debate in both countries was very extensive and heated [Ferge, 1998; Golinowska/Hausner, 1998]. **The second group includes Bulgaria, Estonia and Lithuania**, the countries that passed laws on pension funds in 1999. In this period, it was the issue of introducing regulations on the safety of operations and on guaranteeing a specified level of benefits from pension funds that was extremely relevant.

In analysing the socially safe functioning of pension funds, special attention has been devoted to institutions supervising the pension funds.

The present work was developed in the following order. The first step involved the identification of risks and their ranking according to the degree of danger (cf. Part 1). In the second chapter we discuss the instruments for safeguarding against and reducing the appearance of risk. For these instruments, it was important to define them, as well as to analyse the legal regulations, administrative standards, financial management standards, codes of ethics, the formula and competence of supervisory institutions, and the working of the market. Before presenting the principles and means of balanced supervision over pension funds, in Part 3 we have pointed out the basic dilemmas of achieving a balance between economic and social goals. Next, we have attempted to show the proper balance between regulatory instruments and self-regulation in order to achieve a fund's balanced operations in terms of both effectiveness and safety (cf. Part 4).

The fifth part of the report shows the practical experience of other countries, including those with much more experience in this area than can be found in Central and Eastern Europe. Taking into account the history of pension funds' development in these countries, we observe two roads of development of safety institutions.

One way is to establish these institutions *ex post*. First, funds were established, without any special supervisory regulations, and operated for many years without any disturbances, or with only minor ones, until a large-scale scandal emerged. As a consequence, regulations were created to prevent excessive risks. In the United States in the 1970s, there was the ERISA package of regulations, and in the United Kingdom a dozen or so years later, after the scandal with Robert Maxwell's pension funds, the Good's Commission was established which went on to prepare a proposal for supervision.

The second way involves establishing supervision *ex ante*, at the same time as the regulations on pension funds. This solution is characteristic of the Latin American countries, which undertook pension reforms in the 1980s and 1990s, introducing a capital pillar. The countries of Central and Eastern Europe are also undertaking safeguard regulations *ex ante*.

The *ex ante* road is more difficult insofar as one has to be able to identify any potential threats to the funds' safe operation and have a good knowledge of the various instruments (preventing dangers) and their functioning in a balanced way from the point of view of reconciling effectiveness with social goals.

The last chapter presents the modest experiences of five Central and Eastern European states. The report ends with conclusions and recommendations, while the extracts of law on supervision over pension funds are cited in the appendix.

The project was conducted in co-operation with three research teams from partner institutions:

1. Audrone Morkuniene, Elena Leontieva, Aneta Lomovska (the project co-ordinator), from the Lithuanian Free Market Institute (LMFI), Lithuania.
2. Maria Prohaska, Ivaylo Nikolov, from the Center for the Study of Democracy, Bulgaria.
3. Ramil Pärdi, the Jaan Tonisson Institute, Estonia.

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Part I

Analysis of Risks Related to Pension Funds' Operations

The risks related to the functioning of pension funds will be analysed from the point of view of a participant in the new system – the future recipient of benefits [1]. We assume that a risk is the probability of the emergence of a situation in which the value of assets (collected premiums and profits from investing them) on an individual pension account is lower than the optimal level possible to attain. The appearance of a risk results in the loss of real – due to the drop in real value – and potential income of the benefit recipient, and its appearance depends on various factors. The broader the definition of risks, the more factors there are involved. To identify risks, it is useful to divide them into **internal risks**, which can be counteracted by a given fund, and **external risks**, which the fund may be threatened by, regardless of its actions [2].

The term "pension fund" used subsequently in the paper denotes both an organisation managing the assets gathered in the fund (in Polish terminology called a pension society) and the fund itself, meaning the gathered assets, unless issues are discussed that require the two to be precisely differentiated.

I.1. External Risks

Analysing external risks against which a fund is unable to work out the proper safeguards, the following risk factors can be mentioned:

- weaknesses of reform implementation,
- political pressure on the investment decisions of pension funds,
- weakness of legal regulations, including the lack of supervisory bodies or their badly defined role,

- weakness of the pension system's partners,
- underdeveloped capital markets,
- risk of interest rate changes,
- risk of foreign exchange rate changes, and
- risk of inflation.

Weaknesses in the implementation of pension reform carry the **danger of deviations from the programmed pension system model** that has been approved. This risk may be caused by pressure from certain groups of interest. If the public authorities are unable to resist that pressure, the initial rules are abandoned and new ones introduced. One example of applying pressure to change the approved solutions in Poland involves demands to abandon the investment limits in force, and demands to introduce tax-related benefits for organising the "third pillar" and participating in it. When joining a fund is voluntary, tax-related benefits can have a strong impact on increasing the motivation to participate.

Another source of deviations from the approved pension model can involve **changed political set-up as a result of elections**. This risk consists in generating new legal regulations as a result of implementing different ideological concepts, as well as the policymakers' striving for short-term goals, e.g. resulting from a heavy budget deficit. Though political risk is much greater in public pay-as-you-go systems [3], it can also occur in the privately managed section (of the pension system). In such cases, it is very important to agree on the draft with the political opposition before it becomes the subject of a parliamentary debate.

Deviation from the approved model of changes and political pressure on the funds' investment decisions are dangerous external risks. On the one hand, they may seriously shake social trust in the proposed reforms, while on the other, such changes obviously arouse the distrust of private organisations interested in taking part in pension fund

[1] It is possible to analyse the risk in other distinctions than, as proposed here, in dichotomic approach: the pension fund as the financial institution versus its members. For example, Turner (1996) proposes the analysis of risk bearing between pension fund, its sponsors, workers, employer and government.

[2] Other approaches are also widely used. The risk in pension plans can be considered in three market areas: labour market, financial market, and political market. Cf. Turner (1996).

[3] It is worth noting the great effort required for all the political forces and social partners to achieve a compromise when passing the law on pension funds in Poland [cf. Golinowska, Hausner, 1998].

management. Changes made during implementation may also increase the cost of the new system.

The next important external factor is **the lack of cohesive legal regulations for pension funds**, in particular the improperly defined role of supervisory bodies.

First of all, the new institution of the pension system may be badly placed in the existing system of supervisory organisations. If the supervisory organisation is separate i.e. only for pension funds, an unclear division of competence between it and existing organisations for supervising other players on the financial market is possible. Situations of under-regulation may appear, for instance if the new supervisory body's range of competence does not include investment processes, while the Securities Commission – established for such a purpose – considers itself relieved of the duty of supervising pension funds in this respect. Another example of vagueness in this area that is currently apparent in Poland is supervision of employee pension programmes. Wherever the form of the pension system's third pillar is not an employee fund, then apart from the Office for Pension Fund Supervision (UNFE), there are two institutions that can be authorised to supervise pension programmes. These are the State Office for Insurance Supervision, because these are life-insurance based programmes; and the Securities and Exchanges Commission, because these are investment-type programmes assigned to trust funds.

Secondly, dangerous situations can occur as a result of **the excessive "openness" of supervision regulation**, namely in assigning an important role to supervisory bodies' discretionary decisions, and/or accepting vague (insufficiently specified) rules of action towards the funds. In the countries undergoing transformation it is especially important to define precisely the rules for division of responsibilities and to develop clear procedures. It seems that in a situation of lack of experience and lack of systematic standards of behaviour, under-regulation can be more dangerous than excessive regulation. Moreover, in cases of under-regulation, there is too much room for political pressuring and political decision-making.

Another area of potential danger for pension funds could be the **weakness of partners operating in the whole pension system**. The issue here is the lack of coordinated actions among institutions regulating and administering the whole pension system, in both the public and private sectors. The weaknesses in the pension system's public part may result mainly from insufficient adaptation behaviour in situations when unexpected trends appear [4]. Lack of preparedness for the possibility of difficult and unexpect-

ed situations leads to tension and undermines social trust in the new system. In Poland, this risk appeared following technical problems on the part of the Social Insurance Company (ZUS) (the public pension institution) with transferring premiums to private pension funds [cf. Skrobisz, 1999].

In the area of private fund management companies, the weakness may involve a tendency towards institutional oligopoly, which leads to a **lack of healthy competitive behaviour** under conditions of high barriers to entering the retirement benefit market. This risk can appear especially at a later period, after the pension fund market structure forms and strengthens, when the fight for customers weakens. The lack of competitive behaviour can also occur due to over-regulation of the funds' operations, e.g. through the requirement for a minimum rate of return. Being long-term savings organisations, pension funds can occasionally record lower profitability than the required minimum for the whole system. In a situation where the deficit is to be financed from the assets of the management company, pension funds – fearing infringement of their assets – often give up their own long-term investment policy in favour of copying the leaders.

One factor that effectively restricts pension fund management is **under-development of the capital market**. This factor is especially important in the emerging markets, which are undertaking to build new market institutions as part of the transformation process. The experience of other countries, such as Chile, shows that pension funds can contribute to the development of those markets, but on the condition that the market is prepared for absorbing a significant demand for financial instruments [5].

Good functioning is conditioned by the proper scale of **absorptiveness of the domestic capital market**. Experts estimate that in Poland, given the present state and dynamics of development, the capital market will be able to absorb the funds' demand for securities in stock-exchange trade for the next two to three years. It is very likely, however, that later on, in a situation where the number of available financial instruments is limited, pension funds will be unable to invest effectively due to both the market's limited size and the fixed portfolio structure (limits on investing in a given instrument).

The capital market's development could be hampered not only by the insufficient rate of privatisation but also due to the lack of regulation of some areas of the market. One example of such a drawback in Poland is the market for public trading of debt securities, and corporate and municipal ones in particular [Kozłowski, 1999].

[4] In Hungary, excessive criticism of the old solutions caused the population to move towards private funds to a much greater degree than expected. This trend also appeared in Poland despite the greater level of safeguarding against it. In Kazakstan, participation in capital funds was made obligatory for all insured persons, regardless of the fact that such a decision is simply unprofitable for people with a longer period of being insured.

[5] Vittas (1999) argues that if pension funds operate in a conducive regulatory framework, they have a beneficial interference on financial market development.

Areas that require proper market standardisation and regulation for pension funds to be able to invest in them include public infrastructure and real estate. Until there appears the possibility of daily valuation of securities from those markets (debt securities, debenture bonds, etc.), pension funds will be unable to invest in them. In the case of the real estate market, as yet unresolved ownership issues are an additional difficulty delaying its regulation.

The under-development of the capital market is also linked to lack of stability. No one needs convincing as to the existence of this risk. Sudden changes in the prices of assets undermine investment strategies.

The next external risk is the **possibility of a downward business cycle**. Market analyses using different methods and assumptions aim to minimise the risk of wrong decisions, including those related to movement of share prices on the stock exchange. However, this risk cannot be eliminated completely.

The same is true for the **risk of foreign exchange rate changes** (investments in foreign securities) and for the **risk of interest rate changes** (investments in debt securities). These risks are external elements that are an inseparable feature of the investment process. One of the possible strategies for limiting these risks is to purchase certain derivative instruments. However, this kind of safeguard is only just forming on "young" capital markets. Decision-making in the emerging markets thus carries a higher risk than on developed capital markets.

Inflation is an important risk that carries substantial weight in Central and Eastern European post-communist countries. When inflation is high (a two-digit figure), a rational and safe investment policy is seriously threatened. In Poland, the single-digit scope of inflation (since 1998) enabled private companies to enter the "pension industry". It should be noted that in the first half of the 1990s, in spite of serious discussions of experts on pension reform, private financial institutions could not be counted on to get involved. This was mainly due to the high inflation risk, which at that time was the greatest barrier for private organisations' participation in the new system.

1.2. Internal Risks

There are three main areas of pension funds' operations where internal risks may occur, and these shall be analysed here.

They are:

- 1) administrative (fund management),
- 2) social (rights of fund members), and
- 3) business operations.

1.2.1. Administrative Risks

Administrative risk concerns the organisation managing the fund (the pension society). The risk may involve the inability for conscientious and effective management of the entrusted funds.

Inadequate administration of a pension fund's resources can be due to several factors. It may occur due to the **management personnel's low qualifications**. With insufficient competence, especially in financial management, it is hard to make accurate and sensible decisions.

The condition involving high qualifications is also related to the issue of **division of competence in the society's management board**. The division of tasks and responsibility should be clear and specific. This is made possible by, among other things, internal decision-making procedures (by-laws) leading to individual responsibility.

Another threat to the funds' effective operations can be a **functional imbalance between actions for the benefit of shareholders and those for the benefit of fund participants**. The pension society board has its clients – fund members – on the one hand, but it also represents the interests of the shareholders – founders of the society. The latter may pressure the board to invest the fund's resources in projects related to their own business operations. This kind of pressure may lead to engaging resources in projects that do not bring profits to the fund's participants, while being a cheap source of capital for the society's founders. If a pension society's board succumbs to pressuring, this will be the beginning of unjustified transfers of assets between the pension fund and the administrating company, or between different programmes for different groups of participants.

Other potential risks threatening the interests of insured persons might involve management take-over processes and pension society consolidation, and finally the announcement of a society's bankruptcy.

Moreover, the administration process may lack standards concerning financial matters, such standards that are usually followed by institutions wanting to be perceived as professional businesses. This risk could involve improperly prepared financial reports and inadequate bookkeeping. When such standards exist, the problem may lie in the fund board's capacity to comply with them. Inadequacies in this respect may lead to erroneous decisions, while on the other hand, the fund's financial situation can be purposely distorted in the report system.

1.2.2. Social Risks

Social risks include endangering the rights of insured persons in terms of participating in a fund or the worsening of conditions of obtaining benefits. Social risks are not uniform.

Violation of the interests of insured persons can have a variety of aspects.

Firstly, the information reaching clients considering joining a pension fund may be distorted. When wanting to decide whether to participate, potential members of capital funds are entitled to complete and reliable knowledge of their rights and possible alternatives. Clear and honest information should be provided both by the mass media and by the **person dealing with direct sales of retirement services** (the pension fund's salesperson). Information provided by the media should not be misleading and should not refer to other alternatives (funds) in the form of a negative campaign. The key element, however, is a face-to-face meeting between the client and the fund's salesperson. Due to the large degree of complexity of a pension fund's functioning, prospective clients often have to rely on the salesperson's knowledge and advice. A salesperson, on the other hand, may persuade clients to join the fund without having their genuine interests at heart. This occurs, for instance, when a commission-based motivation system that focuses only on signing up new members is used with salespeople. If, in addition, a salesperson is attached only briefly to the pension fund, there exists the possibility of falsifying data on fund membership.

A risk that can directly strike fund participants is the **lack of standards safeguarding the participants' interests when entering into an agreement with the pension fund**. The source of this lies in the asymmetry of information between the fund's agent and the prospective client concerning possible solutions. The risk appears when the agreements on pension fund membership are vague or ambiguous. A person joining a fund may wrongly understand the agreement's unclear content, while comparing alternatives when making a choice is difficult if there are no standards on the contents of agreements.

In the event of a disadvantageous financial situation, a fund may strive to change the terms of the agreement in order to reduce participants' future claims. Thus, social risk may appear **in the way changes are made to the pension agreement** that could be detrimental to the fund's members.

Unequal treatment of fund participants may also emerge in the form of **unequal division of income from the fund's investments**. Invested resources generate an income whose distribution may turn out to be disproportionate in relation to each member's contribution. Then, a given group of insured persons would gain more from the income generated by investment than others.

Equally important are limitations related to switching fund membership. We know from experience that unlimit-

ed client freedom leads to high administration costs due to a high rate of insured persons' fluctuation. Restrictions for participants should be minimised, however, and should be as uniform as possible for all the funds.

In a fund that not only increases the resources obtained from premiums but also pays out benefits once members reach retirement age, there is the possibility of the risk of **paying out lower benefits in a given fund compared to others**. The social risk lies in the fact that a fund participant comparing the benefits received by other persons with similar social status and a similar pre-retirement career may consider their own pension to be too low. Of course the sources of this type of danger are found in other areas, mainly in the level of fund management costs or investment policy effectiveness. One should remember, though, that if such remissness is excessive, this could lead to a strong social reaction expressed in a sense of losing out in relation to other benefit recipients from the private system.

1.2.3. Risks Related to the Fund's Business Operations

In analysing the **economic aspects of risk**, we will focus on the following two areas:

- 1) the investment process,
- 2) the fund's day-to-day operations.

Investment risk stems from the nature of a pension fund's operations, consisting in increasing the collected resources in the long term [6]. Obviously, in view of changing market conditions, investment operations of any organisation on the capital market carry a risk.

The primary risk in the investment process is **a fund's low profitability**, which means the fund has not worked out the optimal profitability rate that it is possible to attain under a given set of conditions. It should be noted that we are talking about optimal profitability, namely that which is possible in the current market situation.

Another approach involves relative profitability – compared to other funds. Leaving aside the criterion of evaluation here, this risk means that a fund generates lower income than is possible to achieve.

Errors in managing a pension fund's resources may result from, for example, the **lack of professional market analyses**. Here again we touch on the issue of suitably high qualifications, which are essential in fund management. A bad or incomplete analysis of the market and the appropriate instruments may lead to another threat, namely an inappropriate investment strategy. **Diversification of the investment portfolio** for a given rate of return may be

[6] According to Turner (1996), the capital market risks are grouped in the following groups: financial market risk, risk due to malfeasance, inflation risk, interest rate risk, risk due to the financial performance of the plan sponsor.

both **too "risky"** (when the risk is underestimated) or too conservative (when the estimated risk is greater than the real risk). The issue here is on what scale the pension funds will invest in company shares, and what part will be invested in debt instruments.

It is worth noting that the reference point in risk diversification comprises not only the level of investment risk but also the **period of investment**. A fund's investment policy should take into consideration the interests of the fund's members, which may be mutually exclusive. For a young employee whose prospects for membership in the fund span several decades, a policy of greater investment in shares will be more appropriate. As we know, in developed capital markets the rate of return on such investments in the long term is greater than it is on bonds. For an older person, with a dozen or so years membership, such portfolio diversification could be too risky, and may cause a given person to sustain losses due to the possibility of short-term fluctuations.

The risk of investing in preferred projects or investments recommended by the shareholders of the company managing the fund has already been discussed, but it is worth mentioning here as well, as it is one of the fundamental dangers that could potentially lead to low investment effectiveness. One could say that it includes all the analysed dimensions: economic, social and administrative.

The last area of risk in investment operations involves **bad management from the point of view of liquidity**. In the investment phase of a fund, the main element of uncertainty is the scale of predicted payments into the fund and the period of undisturbed inflow of premiums. Maintaining the proper level of liquidity is more important in the phase of paying out benefits, which is delineated by the members' retirement age. Analyses from the point of view of the liquidity criterion are also important for the fund's investment policy (purchasing various financial instruments). This is because such structures of engagement of resources are possible that limit the flexible introduction of favourable changes, which in turn reduces the effectiveness of the investment policy. The purchase of "bad" packages (similar to "bad debts" in the banking system) can also be detrimental to liquidity. In the emerging markets, the possibility of selling inconvenient securities is probably more limited.

As we have mentioned, investment operations are not the only area where economic risks can occur. A separate area comprises those factors of day-to-day operations that have a negative impact on the fund's financial condition.

Firstly, this can be a **vague division of assets between the society (management company) and the pension fund**. If the fund's finances are not clearly separated from the management company's, shareholders in the pension society or shareholders in its founding organisations may file claims on the resources of the pension fund, which is imper-

missible. Such shortcomings may result in the **risk of resources of fund participants being taken over** (by somebody else).

The high costs of fund management, in effect leading to decreased retirement benefits, can be a dangerous trend. From the point of view of a pension fund participant, fund management costs are determined by two factors. The first is the **level of fees and commission received for managing the fund**. It seems that in the countries undergoing transformation, where there is still a deficit of qualifications in investment advisory services, these costs may lead to a somewhat high level of administrative fees, despite extensive competition on the retirement services market in its early period.

The second element that could carry the risk of high management costs involves **external costs**, or transfers made from the pension fund to other financial institutions for specialist services, e.g. to a bank where the fund's resources are deposited or to the company maintaining a register of fund members. Firstly, services ordered by the pension society may be performed improperly or incompletely, which increases costs and has a negative impact on the fund's profitability. Secondly, the transfer of resources could be disproportionate in relation to the cost of the services.

The final risk in day-to-day operations comprises **weaknesses in the proper valuation of assets**. The value of assets, and especially the value of a participation unit in a pension fund, is one of the important elements taken into account when choosing a pension fund.

1.3. Ranking of Identified Risks

Though the presented description of risks points to the main danger areas in the functioning of the funds, it does not show which of these areas are the most important in the countries under consideration. That is why experts from the countries taking part in the study specified such risk groups using a point method of risk grading.

Each risk area was to be allocated a degree of danger. For this purpose, a five-degree scale of risk was chosen, expressed in assigned points, in decreasing order. This means that "1" marks those areas in the functioning of a pension fund that carry the greatest risk. Consequently, "5" was assigned to those risks that are of minimum importance. Moreover, it was decided that in those areas where the degree of risk is 4 or 5, there is no need to develop special remedial measures. On the other hand, in areas where the degree of risk is higher (1 – 3) a more in-depth analysis will be necessary, leading to the development of specific safeguards (instruments).

In the countries covered by the analysis – Bulgaria, Estonia, Lithuania and Poland – the risk most dangerous to the funds' functioning was perceived to be the lack of cohesive legal regulations, and erroneously defined functions of the supervisory body (1 point). The risk of lack of competitive behaviour on the part of pension funds was also considered important, especially in the context of a lack of reliable information on a fund's financial situation (2 points). Areas where the degree of danger was considered moderate (3 points) included under-development of the capital market, a downward business cycle, and weakness of the financial institutions providing services to pension funds. The other groups of external risks, including political risk or instability of the domestic currency (inflation), were seen to be unimportant.

In considering the dangers from internal risks, the evaluations are harsher than those described above. This is especially true for economic operations and members' rights (social risks). In economic operations, the areas considered the most burdened with risk (1 point) are as many as five:

- inappropriate diversification of the portfolio from the point of view of risk,
- inappropriate diversification of the portfolio from the point of view of the insured persons' interests,
- investing in investments suggested by the pension society's (management company's) shareholders,
- improper valuation of the fund's assets, and
- ambiguous rules for separating the assets of the society from the assets of the pension fund.

The risk of inaccurate analyses and financial planning as well as the danger of losing financial liquidity (the risk of investing in difficult-to-sell instruments) was also seen as highly probably (2 points). A moderate value was given to two kinds of economic risk: high management costs and foreign exchange rate risk (3 points). In the case of Poland, this last area was the only one given four points among economic operations. There was no risk in the economic operations category that received the lowest mark of five points.

In the social area, or that concerning the rights of persons participating in a pension fund, the most dangerous areas were: (1) the lack of standards protecting the clients' interests at the moment of signing the agreement and (2) the way changes are made to that agreement, which could lead to losses for the client. The other groups of dangers (restrictions on switching to another fund and the unequal distribution of income from investment operations) were also considered important (2 points). The only exception is the risk of discriminating against certain social groups in terms of access to participation in a fund, which was seen as being moderate. This seems apt, mainly because this kind of risk is not very probable in countries where the capital pillar of pensions is introduced as an obligatory element.

In the area of pension fund management, the experts thought that the greatest risk was the excessive involvement of the pension society management in operations other than the functions for the benefit of pension fund members. Thus, the main danger is pressure on the pension society management from its shareholders. The other administrative areas, except the risk of ambiguous division of tasks and responsibilities, were also assessed as being dangerous. There were no weak marks (4 or 5 points) in the group of administrative risks.

One should note that the overall assessment, which sums up the experts' evaluations in the analysed countries, was significantly different in some areas than the view taken by experts from Poland. This was especially true for assessment of the danger from external risks, where the differences in evaluation were the greatest. Contrary to the overall assessment, most of the external conditions were considered important in the case of Poland (1 to 2 points). Apart from bad legal regulations, the factors considered the most disadvantageous included the public pension system's inefficiency and high inflation (1 point). Also considered "dangerous" are the badly defined role of supervision, the lack of healthy competition between the funds in winning clients, under-development of the capital market, and its instability (2 points). In evaluating the situation in Poland, there was no external factor that was perceived as being moderate, while the other groups were seen as unimportant. For internal risks, the differences were small, not exceeding one point, and consequently will not be described in detail.

It seems that the distance in evaluations of external risks between Poland and the other countries is the effect of longer experience due to the earlier introduction of pension reform. Just under a year from the enactment of the main regulations allowing private pension funds to be established (from 1 January 1999), a number of shortcomings were observed in Poland, which will be discussed later (cf. part 7.1. of this report). Among the greatest dangers for the funds' functioning in Poland is the lack of flexible action in the public system. This is an important conclusion from Polish experience for those countries where the funds are just beginning to operate and where unpredicted, external weaknesses of reform have not revealed themselves yet.

The above analysis of risks of pension funds shows how many factors, both external and within the funds themselves, can threaten the interests of future benefit recipients. In addition, taking into account the necessity to gain public trust in the new pension system institutions, including pension funds, it is necessary to create a set of solutions that will protect the funds from the emergence of these risks. These instruments are particularly important when capital funds appear as an obligatory part of the reformed pension system.

Part 2

Instruments Safeguarding Against the Appearance of Risks in the Operations of Pension Funds

The analysis of potential risks in pension fund operations, presented in the first chapter, has shown the most important danger areas for effective operation. These risks have been presented as potential risks, as they do not have to emerge if the proper instruments are included in the new pension system. These instruments' basic function is to minimise the risks of participating in private pension funds. The issue here is not only about legal safeguards aimed at establishing state supervision over private pension funds, but also the development of self-regulation mechanisms.

This part of the report will present the possible, basic kinds of instruments safeguarding against the emergence of risks in the functioning of pension funds. These instruments play a varied role in individual phases of introducing the new pension system. Some are of key importance at the design stage of the new pension system model, up to the moment when the necessary legal regulations are passed, while others are important when the new system is started up. Others still gain importance with the passage of time as new solutions consolidate.

Taking into account the as yet modest experience of pension reform in Central and Eastern European countries, one can identify the following kinds of **instruments** that correspond to the identified risks in pension funds' operations:

– The first kind of instrument involves **education on securing income for old age**. The target of such education is both the population as a whole and different groups of participants in the pension system. Such education in the countries undergoing transformation plays an important role in the understanding and acceptance of the system changes. The aim is to deal with false ideas about the way old-age pensions are financed, show the need for individual saving and describe future dangers that giving up the reforms could lead to. Moreover, thanks to a public debate on the new institutions – pension funds and the companies (pension societies) managing them – people are growing accustomed to new solutions. It is furthermore possible to gain full social confidence in the new institutions, as well as social control by introducing solutions correctly.

Equally important is more thorough education of participants in the pension system: employers as payers of premi-

ums, employees – represented by trade unions for example, benefit recipients represented by pensioner organisations, prospective shareholders in the pension societies managing the pension funds, and administrators of the public pension system. One important element is to show both the good and bad experiences of other countries. These experiences should be comprehensively demonstrated, with the participation of experts who, thanks to their personal status and attitude, are reliable.

It is also important to supply **solid knowledge on the pension systems and reforms to the participants of the legislative process**. Considering both the election cycle (the fact that legislative authorities have a specified term in office) and the inertia of previous solutions, especially in the social area, the reform's authors need to convince [legislators] of the need to introduce changes, as well as ensuring these changes are passed. With this aim in mind, it seems essential to educate both ministry officials, who initiate new acts of law, and deputies and senators (especially those working on the acts in the appropriate committees), so that they respect the logic of the presented draft in their legislative work and do not succumb to pressure from groups of interest or to populist demands from certain employee groups.

The education of the media community, journalists and columnists who are responsible for the way the new concepts are presented (to the public) is impossible to overestimate. This presentation needs to be reliable and comprehensible. Moreover, it should promote the future benefits of introducing the reforms – not only the benefits related to individual pension levels, but also those related to the stability and solvency of the system as a whole. Good economic education of the public is the preliminary condition for the reform's success. This instrument is most important in the first phase, when the new pension system is being designed, and during the process of its passage.

– The public's education is linked to **promotion of the new system solutions**. Promotional activity differs from social education in that the former is conducted at the second stage of reform, when the structure of the new pension system is already decided. The target of the promotional activity is broad public opinion, to which the reform pro-

gramme is addressed. In most cases this means the working population. Promotional campaigns can be carried out by various entities, both public authorities responsible for reform implementation (in Poland, the Government Representative for Social Security Reform) and the Office of Supervision, as well as the new emergent institutions (private pension funds). Thanks to promotion based on solid information it is possible not only to familiarise people with the new pension system but also to prepare the funds' prospective clients for making the decision to participate.

– Another important group of tools safeguarding against risk includes **the developed legal regulations** that form the basis for pension funds' operations. Legal regulations make it possible to prevent risks, especially internal ones. For example, **a legal structure of the funds** that clearly separates the fund as the collected assets of its participants from the pension society as the management company allows for greater protection of the gathered resources of fund participants. Also important are **the legal requirements for prospective fund founders**, which usually set tight conditions for entering the market. The law also specifies the conditions for the management of the funds' finances – day-to-day operations, investment activities and so on.

It is important the passed acts of law form a cohesive whole. This means that the regulations should provide a good platform for introducing the pension funds into the existing legal and economic system. It is worth adding that developing cohesive laws is a dynamic process and will be especially intensive in the reform's initial period. It will not lose importance later, though, because regulations require continuous adaptation to new situations.

– Once acts of law have been passed, there comes the important process of **forming new pension system institutions**. In Central European countries, the supervisory body is usually established first, and then the pension funds.

When establishing the supervisory body, the important issue is whether it will be a specialised body supervising only the retirement services market, or linked to supervision over the whole financial services sector. It is also important whether or not the supervisory body is politically and financially independent, namely to which institution it is responsible to for its actions, and what the sources are of its budget revenue. A certain role is also played by the procedure of the supervisory body in obtaining its regulations from its superior organisation, and the election

method (the appointment of the supervisory body's chairman).

When establishing pension funds, one essential process is that of obtaining a licence for the pension society managing the pension fund and registering the funds in the appropriate registers.

– The nature of **the control and supervision over the whole pension fund system by a specialised institution** is determined mainly by the legal regulations, which give that body the appropriate competence. However, the practice and effectiveness of supervision is also influenced by other factors, including the pension funds' capacity for representing their interests.

Polish experiences show that besides the operation of pension funds, the other important area for supervision is the **system's public segment**. Supervision over the public system is especially important when it is responsible for collecting the whole of the premium and transferring the appropriate share to the funds.

– **Developing professional and ethical operational standards**. Besides complying with existing laws, the pension funds develop their own standards of conduct, which may be accepted and obeyed by all the market players. In civilised market economies, various procedures or rules of conduct (for accounting or customer service) are obvious and are obeyed – these are standards developed from years of experience. The funds will usually comply with them because they want to be perceived as professional institutions. In the countries undergoing transformation, however, many standards of conduct do not function yet, likewise even in the area of pension funds.

– **Self-regulation in areas of healthily competitive behaviour**. It can be expected that in specified situations, competition among the funds in order to gain clients will act as an instrument safeguarding against risks. This is especially true of the period of promoting new solutions, when most people to whom the reform programme is addressed will be deciding about joining a pension fund.

However, taking into account that the market for private pensions is a market with tight entrance restrictions, there may appear trends towards oligopolistic behaviour, neglecting the interest of fund members. This can occur particularly in the latter period. Restrictions on switching to a different pension fund can lead to this.

Part 3

Dilemmas Related to Sound Pension Fund Operation and Types of Supervision

The instruments, or tools, presented in the previous chapter form general guidelines. They are far from a ready-to-use arrangement for a specific country. The appropriateness and effectiveness of specific solutions largely depends on factors that characterise a given country's situation: its level of economic development, the population's affluence, traditions of business culture and co-operation, etc. The safe and effective operation of pension funds in a given country requires a proper set of tools that do not necessarily have to be universal, but whose deviation from the general rules should not be so numerous as to change the basic mechanism of the instruments' functioning. And if these deviations do occur, they should be rationally justified.

When constructing these instruments, the legislator faces many dilemmas. These may result from the contradiction between the goals of the system's new institutions and the tasks of the instruments used to safeguard against risks. We have identified the following dilemmas that need to be resolved in order to ensure a sound basis for the funds' functioning:

– The first dilemma involves **the conflict between social goals and effectiveness goals**. For private pension funds, the main criterion of operation is effectiveness aimed at achieving the optimal rate of growth of invested resources under given conditions. This does involve a risk, however. For the state, on the other hand, the funds' safety and stability is important, due to the desired social acceptance of the reform. Administrative or legal limitations – most often used towards investment policies – mean that the scale of operations is limited, which reduces in turn the funds' profitability. This price is much higher when the capital pillar is obligatory, because then, as mentioned above, supervision by the state is stricter.

– The second issue concerns **the character of pension fund supervision**. Taking into account the experiences of other countries, two models can be identified. Supervision over the funds can be **reactive**, when it acts in emergency situations and assumes greater independence of operation for the funds. One can say that it emphasises a more spontaneous development of the pension sector. **Active super-**

vision, on the other hand, anticipates any serious deviations on the part of the funds and undertakes day-by-day monitoring of practically all the fund's actions. In this option, the scope of regulation is broader, and we observe strong prerogatives for the supervising body.

The countries undergoing transformation may be encouraged to use the active model due to the lack of standards for administrative procedures and financial management, as well as the lack of ethical standards of conduct (e.g. a code of ethics for customer service). The reactive option, on the other hand, can be supported by the argument of ethical, i.e. careful, treatment of the developing, early retirement market, which could be "suffocated" by inflexible legal regulations hampering its development.

– One of the key elements for effective operation of pension funds is **the nature of relations between private pension funds and the supervisory body**. In practice, let us mention two possible variations of co-operation. The first involves close co-operation in taking up disputable issues and reaching a joint position. The second scenario assumes a conflict of interests and methods of operation. The pension societies, through their representatives, develop an alternative position and make use of lobbying (in parliament, for instance) to force through their own solutions. It seems that the former scenario ensures to a greater degree that operations will be safe and more effective.

– Also important is how the relations develop between funds themselves, especially in competing for participants. This is expressed in the **way they carry out advertising campaigns**. It seems there are two optional modes of action. The first involves honest and rational competition, with reliable information on the terms of participation in a fund, the financial results and management costs. The second possible option involves 'unethical' competition, introducing aggressive means of persuasion, without offering full information, and showing other funds in a negative light. As we mentioned above, a fund's promotion should be carried out in a rational way.

– Another problem for funds' efficient operation is **the nature of the financial policy implemented**. Should it be bolder and more risky, which means engaging the portfolio

more seriously in publicly traded shares, for instance, or should it be a conservative policy investing most of the resources in state debt securities?

– The previous issue is also linked to **the range of possible investments in foreign securities**. This is not just a technical problem. In stable Western markets the investment risk is much lower than on the undeveloped markets in the countries undergoing transformation. Thus it is in the interest of the new system's participants to have the majority of a fund's resources engaged in securities issued abroad. However, pension funds are a stimulator of

the domestic capital market's development and of the level of investments in the economy. That is why the public authorities will work towards limiting investments abroad in the interest of the economy and to stimulate the development of the domestic capital market. Which is more important: **the interests of insured persons, or the interest of the economy as a whole?** This dilemma is pointed out by Nikolas Barr in his analysis of the reforms undertaken in the countries of Central and Eastern Europe [Barr, 1999].

Part 4

Balanced Supervision of Pension Funds

Previously, we considered the areas where risks appear in pension funds and what instruments can be used to counteract those risks. In this chapter we shall attempt to answer the question: What instruments can be used to counteract

Table 4.1. External risks and instruments in the functioning of pension funds

Risks	Instruments
Weaknesses in reform implementation	Social education of experts, politicians and mass media
Political pressure on the funds' investment decisions	Systemic and legal solutions separating politics from business
Weakness of legal regulations in force, the lack of supervisory bodies or their badly defined role	Educating policy-makers Information about solutions used in other countries Taking into account the possibility of the supervisory body undertaking legislative initiatives Amending regulations aimed at effective supervision
Weakness of institutions administrating the pension system, including the public sector (ZUS)	Legal regulations Integral supervision over the pension system
Weakness of institutions in the financial sector (the depository bank, other institutions)	Legal regulations Business ethics Supervision of the financial sector
Under-development of capital markets	Consistent privatisation Developing new financial instruments
Risk of interest rate changes	Developing new financial instruments
Risk of foreign exchange changes	Consistent anti-inflation policy and good macroeconomic policies
High inflation	

Table 4.2. Risks and instruments in the administrative area of pension funds

Risks	Instruments
Low management personnel qualifications leading to bad management	Requirement for the proper managerial qualifications in the licensing process Supervisory action
Unclear division of competence	Requirement for internal division of responsibilities Professional standards of conduct for the funds
Functional imbalance between actions benefiting pension society shareholders and fund participants	Regulations safeguarding against conflicts of function Requirement of the clear separation of the assets of the fund and the society (management company) Supervisory actions of a state institution
Improper accounting and/or weaknesses in enforcing existing standards	A framework chart of accounts specified by law Professional standards of conduct for the funds Independent audit

effectively the risks to pension funds' functioning, while taking care not to stifle the funds' proactive and effective behaviour with excessive regulations and supervision?

Each group of risks has been analysed separately and the appropriate tools for combating them have been listed.

Let us start by analysing the external risks. It seems that in most cases, elements of social education and the development of good and cohesive legal regulations will be good instruments (cf. Table 4.1). Educating experts and politicians

can prevent political risk, and help in developing efficient solutions and a well-placed role for state supervision over the funds. The key element will involve skilfully using the experience of other countries and developing one's own model of changes.

The risk of administrators' weaknesses damaging the pension fund system can be avoided thanks to good regulations, including those that guarantee efficient supervision over the public sector institution and the organisation that

Table 4.3. Risks and instruments in the social functioning of pension funds

Risks	Instruments
Inadequate or untrue information about the terms of participating in a fund	Educating salespersons Requirement of qualifications confirmed by an exam The possibility of clients' filing complaints against a fund Professional standards of conduct Code of ethics
Lack of standards safeguarding the interests of participants when signing an agreement with a pension fund	Educating the shareholders Professional standards of conduct Code of ethics
Methods of changing the terms of the agreement undefined or defined to the participant's detriment	Requirement of access to information on the financial consequences to the participant of the proposed changes The possibility of filing a complaint to the supervisory body against the fund's functioning
Limitations on switching funds	Regulations ensuring the possibility of leaving a fund The possibility of filing a complaint against the fund's functioning to the supervisory body
Discriminating against or in favour of specified groups of participants	Requirement of criteria of participation defined by law The possibility of filing a complaint against the fund's functioning to the supervisory body

Table 4.4. Risks and instruments in the economic activity of pension funds

Risks	Instruments
In the investment process	
Low effectiveness	Self-regulation through competitive behaviour Requirement of covering the deficit from the management company's resources
Improper policy of investment portfolio diversification	Legal requirement to invest in specified financial instruments Guaranteed minimum rate of return
Investing in the management company's own projects or in recommended investments	A ban or significant restrictions on such solutions Supervisory actions
Lack of financial liquidity	Developed standards of safe conduct
In day-to-day operations	
Flow of resources breaking into the fund's assets for the benefit of shareholders	Requirement of clear separation of the fund's and management company's assets Supervisory actions
High costs of fund management	Self-regulation through competitive behaviour
Improper valuation of assets	Legal regulations on valuation Supervisory actions Professional standards of conduct

transfers premiums to the private pillar (in Poland – the Social Insurance Institution, ZUS). In the countries of our region, given the under-development of the capital market consistent and decisive privatisation of further state property is essential.

It seems, however, that in view of most administrative risks, good regulations and an effective supervisory body are the essential condition (cf. Table 4.2). The risks of the management board's low qualifications and the lack of clear decision-making rules can be eradicated by defining the conditions that need to be met, especially at the moment when the fund starts operating. The risk of an imbalance in the management's actions for the benefit of fund participants and management company founders requires constant and active supervision.

There is also room for the funds to develop standards [themselves] (e.g. on the issue of the management company board's high qualifications). The problem of improper accounting can be secured by way of obligatory legislative solutions, but also based on developed standards. The requirement for an independent audit is conducive to compliance with the principles of reliability.

In the area of social risks, for which Table 4.3 lists the appropriate instruments, we find mixed solutions. Because these risks directly concern a fund member, the possibility of filing a complaint with the supervisory body is a new instrument not presented earlier. Actions taken on the initiative of the supervisory body alone do not seem sufficient.

When considering a client's access to reliable information, the decisive instrument will be not so much effective

supervision, but rather a code of ethics and standards of conduct. If such standards are lacking, it is possible to use the legal requirement of a state exam to be passed by agents offering fund membership, which should partly eliminate persons ill-equipped for the job.

The instruments for economic risks are presented below in Table 4.4. In this, the last area of the analysis, the list of risks and instruments is different again. The proper instrument counteracting a relatively low profitability in relation to other funds involves, on the one hand, competitive stimuli on the market and, on the other, legal solutions guaranteeing the interests of insured persons (covering a deficit in resources from the pension society's [management company's] assets). The reaction to improper diversification of investment risk can be legal requirements (investment limits) and effective supervision over the funds' investment operations. For the risk involving liquidity of assets, it is sufficient to take advantage of the standards of conduct of financial institutions that are experienced in operating on the domestic capital market.

In day-to-day operations, the risk of unjustified transfers from the fund to the pension society has to be protected by good legal solutions and effective supervision. It seems that in the operating costs, self-regulation through competitive behaviour is an effective tool, especially since cost levels can be an important element when new participants choose a pension fund. On the other hand, control of cost levels by law or through administrative measures would seriously limit the autonomy of making any kind of decision.

Part 5

The Practice of Supervision Applied in Other Countries

Introduction

Pension funds, or institutions whose function it is to collect and invest resources securing incomes for old age, were established earlier than public pension systems. Many well-known companies created pension systems for their work force in the early 19th century at the time of the industrial revolution. By securing their employees' old age, employers were implementing a development mission. With time, when public systems developed widely in the late 19th and early 20th centuries, occupational pension schemes became of secondary importance. They became part of what we call the second pillar. The importance of occupational pension schemes decreased even more in the late 20th century. They became part of the third pillar of securing income for old age. The second pillar is made up of general capital solutions.

Pension funds today can be found in both the second and third pillars. These are usually institutions under private management that invest collected pension premiums. The premiums are voluntary or obligatory for participants, paid individually or collectively, transferred to the fund directly or via some other institution (financial or administrative). The legal status of pension funds varies. Thus, there are mutual insurance organisations, closed life-insurance organisations, non-profit organisations, and increasingly frequently today – joint stock companies. At the end of the 20th century there has been a tendency to standardise the legal formula of pension funds. The model for this standardisation is based on the solutions that emerged in the 1980s and 1990s in Latin America. Supervision over pension funds is also taking on a universal character, even though in specific solutions, there are still differences that grew out of local traditions.

5.1. Experiences of Latin American Countries

This section, devoted to the region of Latin America, consists of two basic points. The first provides an overview of both the development of pension reforms and the provi-

sions applied in their supervision. The second point discusses the institutional aspects of pension supervision in Latin American countries.

5.1.1. The Development of Pension Funds in Latin America

Interest in pension funds in Latin America results from the fact that they are an important aspect of the widespread securing of income for old age, and in some countries have replaced the public system. This is therefore not a supplement to expansive, pay-as-you-go public financed systems, but a segment of the same if not greater importance than the public segment.

Why is it that, particularly in the countries of Latin America, the public and pay-as-you-go pension system is being replaced increasingly widely with a capital-based, privately managed system? Simplifying the issue a little, one can point to two important reasons. The first was linked to the poor condition of public systems, unbalanced and "damaged" by political decisions. As Jose Piñera, the author of the reform in Chile, said, "We built the new system on the ruins of the old one" (1996). The second reason was linked to the modernising mission of a new generation of politicians in Latin America, as pension funds became a source of capital for the development of domestic investments.

Pension reforms in Latin America went in three directions. Today we can say there are three new model solutions [Mesa-Lago and Kleinjans, 1997]. The criterion differentiating these models involves the proportions and relations between the public system (pillar one) and the newly established pension funds (pillar two).

The first model is a substitutive model. It involves completely or largely replacing the old system with the new one. This was the road taken by Chile (1981), Bolivia (1997), El Salvador (1997) and Mexico (1997).

The second is a mixed model, consisting of introducing the new segment while diminishing the old one. However, both segments still exist. This road was taken by Argentina (1994) and Uruguay (1996).

The third model is a parallel model. This means that pension funds appeared independently of the public system

reform. They develop as an alternative, and as competition for the public system. This was the road taken by Peru (1993) and Colombia (1994).

Despite the varied methods of reforming the pension system in Latin America, their common element is the high degree of universalism in the construction of pension funds as institutions. As these are privately managed organisations and at the same time ones replacing a large part of the public systems, they are subject to relatively strong supervision.

The funds' investment policies are mostly determined by the applicable limits specified by law. On the other hand, the low degree of development of the capital markets is a strong limitation.

That is why funds in the great majority of countries in the region invest mainly in securities issued by the state sector. Mexico is a typical example, where investments in company shares are not permitted yet, and close to 95% of assets are invested in the state sector (cf. Table 5.2). Peru-

Table 5.1. Latin America: Pension funds in reformed pension systems of selected countries (June 1999)

Country	Starting Date	Number of pension funds	Number of affiliates (thousands)	Average number of members in the fund (thousands)	Fund assets (USD thousands)
Argentina	May 1994	14	7,475.2	533.9	13,861.2
Bolivia	May 1997	2	448.9	224.5	380.7
Chile	May 1981	8	5,996.0	749.5	33,245.9
Colombia	April 1994	8	3,181.8	397.7	2,476.0
Costa Rica	August 1995	8	113.3	14.2	120.3
Mexico	February 1997	14	14,622.2	1,044.4	8,821.9
Peru	June 1993	5	2,106.5	421.3	2,082.5
El Salvador	April 1998	5	670.1	134.0	118.2
Uruguay	September 1995	6	15.0	2.5	476.9

Source: FIAP (1999)

The choice of reform strategy had a significant impact on the development possibilities of pension funds. The data in Table 5.1 show that Argentina and Mexico have the largest number of currently operating funds (14). The largest number of fund participants is also in those countries. However, one has to consider the fact that these countries have relatively large populations. The calculations in the table show how varied the average number of participants per fund is. The volume of assets gathered by the funds is greatly influenced by the degree of a system's maturity. One case in point is Chile, where the reform was carried out more than a decade earlier. The assets of funds operating in Chile account for more than half the resources amassed in all the countries under analysis.

vian funds are an exception, as they invest most of their assets in the company sector. Another significant area of investment is that of securities issued by financial institutions (e.g. bank certificates of deposit), accounting for 25% to over 30% of assets.

Detailed analyses of investment limits show that in practice, the upper limits set by law are frequently not reached by pension funds. This is the case, for instance, in Argentina, Chile and Peru, as illustrated in Table 5.3.

As can be seen from the figures, restrictions do not necessarily require the aggregated amount to coincide with the legal upper limit. Also, individual funds usually establish

Table 5.2. Portfolio composition in selected countries of Latin America (June 1999)

Country	Total	State sector	Corporate sector	Financial sector	Foreign sector	Liquid Assets	Other
Argentina	100.0	52.8	19.6	25.4	0.3	1.9	-
Bolivia	100.0	66.6	-	29.4	-	4.0	-
Chile	100.0	37.3	18.6	31.6	12.4	0.1	-
Mexico	100.0	94.7	2.7	-	-	-	2.6
Peru	100.0	6.5	93.3	-	-	-	0.2
El Salvador	100.0	68.7	-	31.3	-	-	-
Uruguay	100.0	63.9	6.4	25.0	-	4.7	-

Source: FIAP (1999)

Table 5.3. Argentina, Chile and Peru: Comparison of investment limits and actual share of assets (June 1997)

Assets (% of fund)	Argentina		Chile		Peru	
	actual	maximum	actual	maximum	actual	maximum
Public-sector bonds	49.3	50	37.7	35/50	11.5	40
Private-sector bonds	4.8	28	3.8	30/50	16.2	35
Certificate of deposit	17.8	28	8.4	30/50	33.6	50
Equities	21.8	35	29.3	35/50	34.8	30
Mortgages	0.4	28	17.0	35/50	0.5	40
Others	5.9	—	3.8	—	3.4	—
Total	100.0	169	100.0	165/250	100.0	195

Source: Rofman, R. and Demarco, G. (1998)

lower-than-legal upper limits of their own, to avoid incurring the costs of asset liquidation when changes in the portfolio are required. Another reason for the lower-than-legal limits in Argentina is that the supervisor values the funds, and, in exceptional cases, this may result in differences between official prices and those assumed by the pension-fund managers.

Guarantees

Guarantees in the new pension systems are aimed mainly at safeguarding fund members against the risk of the fund's bankruptcy, and consequently against the risk of losing their benefit payments. On the other hand, in the case of people not covered by the fund system (e.g. the poor and the homeless) or those who will be unable to make a sufficient contribution towards their pension (e.g. the unemployed), the public authorities are organising a system of other social security measures.

In Chile there are four types of guarantee:

- Those who are not entitled to pension benefits (including the minimum pension) provided by the mandatory system receive a social allowance in the amount of 12% of the average wage.
- Those who have a record of no less than 20 years of service are paid the amount lacking to the minimum pension if the money accumulated on the individual account is lacking.
 - An average investment return is guaranteed.
 - Pension benefits are guaranteed if the insurance company goes bankrupt. The guarantees cover 100% of the minimum pension and 75% of the sum above the minimum wage up to a certain ceiling. All guarantees are paid from one budget, except for the average investment return, which is secured by pension funds themselves.

If investment return is at least 2% higher than wage growth, no guarantees are necessary. Problems evolve when low-paid workers quit to join the informal sector after paying contributions for 20 years. But in such cases only the difference between the minimum pension and the accumulated money is covered.

Another problem is that 12% of the average wage (i.e. the social assistance mentioned above) is below the subsistence level, while 25% of the average wage is below the poverty line. This problem may be solved by offering a higher minimum pension for those who have contributed for a longer period of time, e.g. by paying a fixed amount for all plus 0.5% for each year contributions were paid.

All Latin American countries with private pension systems apply a related minimum investment return guarantee. Each fund must generate a minimum return over a certain period (usually 12 months) defined as a proportion of the average return obtained by the pension fund industry. The management companies (pension societies) are responsible for compensating fund members if the return is insufficient (in Argentina and Chile). If the guaranteed return is applicable to one year, the investment policy becomes short term-oriented. At present they are considering an extension to 3 or 5 years.

When the average investment return is guaranteed, all pension funds are compelled to behave in the same way. In addition, one year is too short a period for calculating returns, as under such conditions volatile funds are penalised, even though they produce better results over a longer term, whereas investments which are close to the permitted level are always profitable but bring lower returns than the average.

5.1.2. Supervision of Pension Funds in Latin American Countries

Generally, supervision institutions in Latin America are devoted entirely to pension funds. This is attributed to the fact that Latin American pension funds were created after or, in some cases, at the same time as the supervision agencies.

Comparing supervisory institutions of Latin American pension funds, one can observe significant differences in financing and the degree of autonomy enjoyed by the agency. In three countries the supervision agency has a significant degree of autonomy – both in administrative and political status. These three agencies are financed directly

Table 5.4. Institutional characteristics of pension-fund supervisory agencies in Latin America

Country	Area of government	Administrative and Political Independence	Funding source
Argentina	Ministry of labour and social security	Autonomous	Supervision fee
Bolivia	Treasury	Dependent	Supervision fee
Chile	Ministry of labour and social security	Dependent	National budget
Colombia	Central Bank	Dependent	Supervision fee
Mexico	Treasury secretary	Autonomous	Supervision fee (partial)
Peru	Ministry of the economy	Autonomous	Supervision fee
Uruguay	Central Bank	Dependent	National budget

Source: Rofman, R. and Demarco, G. (1998)

by supervised pension companies, through the payment of a fee. At the other extreme, the agencies in Colombia and Uruguay are a department of the Central Bank. Chile is a halfway house, since the supervisory agency is separate but with (administrative, political and financial) dependence on the ministry of labour and social security (cf. Table 5.4).

However, not only pension supervisory institutions oversee this industry. As it belongs to the larger financial sector of the economy, it is supervised by other institutions as well. For example, in Chile there are four institutions which have say in the industry: the *Superintendencia de Administradores de Fondos de Pensiones*; the *Superintendencia de Valores y Seguros* or Superintendent of Securities and Insurance; Central Bank of Chile; and the Risk Rating and Classification Commission.

In Uruguay all financial institutions are supervised by the Central Bank. In Argentina the *Superintendencia de Administradores de Fondos de Jubilacion y Pensiones* is joined by the Superintendent of Insurance, the Superintendent of Banking and the Superintendent of Securities at equal levels, along with the Central Bank, the Inland Revenue Bureau and the Department of Social Security.

Performance of supervision institution

Table 5.5 presents several features of currently operating supervisory bodies from the point of view of their effectiveness.

The Mexican supervisory institution is the largest of the seven agencies, at least in terms of the number of employees. But this reflects differences in the number of affiliates to pension funds (see Table 5.1) – over 14 million employees are covered in Mexico, compared with more than 7 million in Argentina, 6 million in Chile, 3 million in Colombia, just over 2 million in Peru and fewer than half a million in Bolivia. Consequently, Mexico's employee-to-fund-member ratio is the second lowest after Colombia. The very high ratios in Bolivia and Uruguay probably result from the relative youth of their systems and the small number of pension-fund members, which may cause problems due to a lack of scale, whereas the high ratio in Peru may indicate inefficiency.

The ratio of the budget to the revenues flowing into funds is less distorted. This measure shows how much of workers' contributions go to finance supervision (in systems where fees pay for supervision). Because the supervision agencies in Colombia and Uruguay are part of the Central Bank, it is unfortunately not possible to isolate their budgets from that of the parent institution. On this measure, the

Table 5.5. Latin America: Performance of Supervisory Institutions in Selected Countries

Country	Employees	Budget	Employees/ fund members	Employees/funds	Budget/ funds' assets	Budget/ funds' revenue
	number	\$ million	per million	number	%	%
Argentina	183	12.5	30.5	10.2	0.14	0.36
Bolivia	21	1.9	63.9	10.5	1.80	1.80
Chile	134	7.0	23.2	10.1	0.02	0.28
Colombia	30	—	11.9	3.3	—	—
Mexico	214	26.3	19.1	12.6	0.42	0.95
Peru	85	5.1	73.9	14.2	0.34	1.23
Uruguay	21	—	45.7	4.2	—	—

Source: Rofman, R. and Demarco, G. (1998)

Note: Bolivia: budget/funds and budget/revenue are equal because the figures cover only one year of operation. The figures exclude the Bonosol/Bolivida programme

cheapest agencies are those in Chile and Argentina, which spend between 0.25% and 0.50% of total revenues. The ratio of employees to the number of operating pension funds appears to be the most consistent indicator. Its value is close to 10 in most cases. The exceptions of Colombia and Uruguay reflect the fact that supervision is a part of the Central Bank, and so support services are part of the larger organisation and outside the supervision agency.

5.2. Experiences of Selected OECD Countries*

Pension funds in the OECD countries were established much earlier than pension funds in the Latin American coun-

5.2.1. Activities of Pension Funds in Selected OECD Countries: the Comparative Perspective

As we have said, pension funds can have one of several legal formulas.

The legal structure of the private pension provision may be:

- Bank or insurance company,
- Management company, or
- Foundation/ trust/ mutual fund.

Pension fund assets may be wholly segregated, or mingled with other investors or asset managers.

Most countries require entire segregation of the assets belonging to pension funds either from the sponsor (employer) or management company. The pension fund can be set as a trust (Anglo-American countries), a foundation/mutual fund (European Countries) or a management

Table 5.6. Pension fund assets and benefits paid in selected countries

Country	Fund assets as % of GDP	Share of pensions from PF as % of all retirement benefits	Working population covered
Belgium	4.0	8.0	31%
Denmark	60.1	18.0	80% [1]
The Netherlands	88.5	32.0	90%
Switzerland	70.0	n.a.	100%
Sweden	74.0	n.a.	90%
United Kingdom	79.4	28.0	50%
Australia	39.0	n.a.	n.a.
United States	66.0	n.a.	46%

Source: European Commission (1997) and OECD (1998 a, b). For working population: Laboul (1999), p. 30

Note: [1] - Regarding to employees only

tries. They developed along very different tracks and no tendency to unify them is visible today. However, one can identify a group of countries where pension funds are widespread or much more popular than elsewhere. These are where occupational pension schemes have been made mandatory. This is the case in Switzerland, Denmark, the Netherlands and Australia. One must also mention Sweden, which in 1998 significantly reformed the public pension system and introduced an obligatory capital segment into it, to which a mandatory premium of 2.5% is paid.

In the other countries, participation in capital pension funds is not obligatory, but they are so popular that they are a significant element of securing income for old age. These countries include the United States and the United Kingdom. Pension funds are also relatively popular in Belgium.

company (Latin American countries). A book reserve system and accounts in financial institutions allows conjunction of assets.

Table 5.7 shows the diverse range of valuation methods used in OECD countries.

In Hungary, book value for assets valuation is used. Unrealised capital gains are not included. Assets value is recalculated quarterly at market prices. In Switzerland there is no insistence on valuing assets at market prices, therefore it is possible to manipulate prices. Artificial sales and purchases of shares occur in order to realise capital gains. Manipulation of returns in order to meet the established minimum is also possible in this way.

Most of the countries have adopted formal accounting standards – FAS 87 in the US, SSAP 24 in the UK, BiRiLiG in Germany – which are also used in pension fund accounting.

The problem of funding arises only for defined benefit (DB) pension plans. They may be fully or partly funded. Some countries impose minimum funding requirements in

* Chapter 5.2 is partly based on materials provided by Audrone Morkuniene, from the Lithuanian Free Market Institute.

Table 5.7. Valuation bases in OECD countries

Country	Equities		Bonds		Loans	Property
	Quoted	Unquoted	High quality	Low quality		
Belgium	market	market	repayment	mkt/purchase	outstanding	market
Denmark	mkt/purchase	mkt/purchase	amortised	amortised	amortised	mkt/purchase
Ireland	market	market	market	market	market	market
Netherlands	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	market
Sweden	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase
Switzerland	adjusted market	adjusted market	amortised	amortised	market	—
United Kingdom	market	adjusted market	market	market	market	Market
Australia	market	market	market	market	market	market
United States	market	market	amortised	mkt/purchase	mkt/purchase	mkt/purchase

Source: Rofman, R. and Demarco, G. (1998)

Note: 'mkt/purchase' means the lower of either the market or purchase price for quoted investments and the lower of the purchase price or written-down book value for unquoted. Belgium: repayment value used for securities issued or guaranteed by the public sector; the lower of the market or the purchase value applies to other high-quality bonds. Finland: mortgages are amortised, while other loans are adjusted to market value. Netherlands: bonds and loans can also be valued on an amortised basis. United States: data apply to New Jersey and Delaware

order to enhance the security of pension promises. Defined contribution (DC) schemes are fully funded by their nature.

In tax privileged DB schemes the problem of overfunding – and not only insufficient funding – may arise. Governments are usually concerned not to allow too high tax subsidies.

Many OECD countries – Australia, Belgium, Germany, Italy, Japan, Sweden and Switzerland – also set portfolio limits. In other countries, such as Canada, Denmark, Ireland,

the Netherlands, the United Kingdom and the United States, there are no quantitative restrictions. However, pension funds are obliged to invest as a 'prudent person' would with his or her own money.

Most of countries have some type of limits on possible pension fund investments.

The actual structure of investments is shown in Table 5.8. It shows there is a significantly varied approach. Beside countries with a large degree of boldness in investing in

Table 5.8. Portfolio distribution of pension funds in selected OECD countries

Country	Equities	Private bonds	Public bonds	Loans	Other	Investments abroad
Australia ⁽¹⁾	27.0	20.0		n.a.	39.0	n.a.
Denmark	7.0	56.0	11.0	7.0	19.0	-
Ireland ⁽²⁾	57.0	n.a.	n.a.	n.a.	7.0	n.a.
Netherlands	30.0	4.0	19.0	43.0	6.0	15.0
Sweden ⁽¹⁾	1.0	84.0		n.a.	14.0	n.a.
Switzerland	16.0	29.0		22.0	33.0	-
United Kingdom	63.0	3.0	11.0	-	23.0	18.0
USA	46.0	16.0	20.0	2.0	16.0	4.0

Source: World Bank (1994) p. 374, Davis (1993)

Notes: (1) For Australia and Sweden Bodie, Michell and Turner (1996). (2) For Ireland: OECD (1998 a, b)

Table 5.9. Simulated rate of return to private pension funds in selected countries: 1970 – 1990

Country	1970 – 75	1975 – 80	1980 – 85	1985 – 90	1970-1990
Denmark	-2.0	0.8	16.9	-	4.1
Netherlands	-1.5	1.9	10.4	6.2	4.2
Switzerland	-1.4	3.7	2.7	-0.2	1.2
United Kingdom	-0.5	5.0	12.4	8.0	6.1
USA	-1.6	-2.0	7.7	9.6	3.3

Source: World Bank (1994), Davis (1993)

more risky instruments (United Kingdom, Ireland), there are many examples of a moderate or even clearly conservative policy.

As regards the profitability, the rate of return of pension funds varied substantially not only between countries, but also in time spans (cf. data in the Table 5.9). The latter demonstrates how much pension funds depended on financial markets. On the other hand, the size of pension funds

requirement. There are "guaranteed investment contracts" at insurance companies and "guaranteed deposit contracts" at commercial banks, promising interest lower by half than one-year government securities.

Contribution holidays are permitted in the event of surplus. Statutory surpluses may be refunded subject to a number of conditions, including indexation of present and future pensions.

Table 5.10. Vested rights in selected countries

Country	Entitlement of vesting rights	Transfer modalities
Belgium	Immediate on employee contribution 1 year on employer contribution	Transferability of vested reserves
Denmark	Immediate	Possibility of transfer of surrender value between occupational pension schemes
Netherlands	1 year	Possibility of transfer, under same conditions, within large network of pensions
Sweden (ATP)	Immediate	Full transferability of national plans
Switzerland	Immediate for minimum contribution	-
United Kingdom	2 years	Transfer to the pension funds
United States	5 years	Possibility of lump sum in case of transfer

Source: Laboul (1999), p. 33

Table 5.11. Indexation in private schemes in selected OECD countries

Country	Existence/ Legal status
Belgium	No indexation but possible adjustments
Denmark	No mandatory indexation, but usual in practice by allotment of bonus
Ireland	Indexation usual in practice
Netherlands	No mandatory indexation, but usual in practice
Sweden	Indexation
Switzerland	Optional indexation
United Kingdom	Benefits indexation
United States	Discretionary indexation

Source: Davis (1995), Laboul (1999)

affected the structure of financial markets. Countries with large funded schemes tend to have developed securities markets, while in countries with small pension fund sector capital markets are relatively less developed [Blommestein, 1998].

Data covering the period 1967–90 seem to support the argument on differences in annual rates of return on pension fund investments between countries with prudent-person rules compared with those with quantitative limits. The first group gained relatively higher returns; more recently, the difference in returns between the two groups widened from 2.6 percentage points in 1984–93, to 4.3 in 1984–96 [Blommestein, 1998].

Despite the fact that most OECD countries have DC schemes, under which all risks are taken on by the employee, they do not impose a guaranteed investment return

Vested rights and portability differs significantly across countries, posing serious obstacles to the portability of pension rights between distinct pension schemes and countries. In certain countries the requirements are very strict. The vesting period is one year of service in Belgium; in Denmark – 5 years or age 30, whichever is the earlier; in Spain – immediate; in Ireland, 5 years; the Netherlands – 1; the UK – 2 years; Switzerland – immediate vesting of minimum benefits; Germany – age 35 or 10 years of service; and Luxembourg – from 5 up to 10 years.

Payments from pension funds may be in the form of annuities, periodical withdrawals or a lump sum. Some countries allow only annuities. Lump sum payments are usually restricted.

The indexation of private pensions is very rare. It can be applied both to pension benefits in payment and deferred

pension rights. The examples of mechanisms applied in this regard in selected OECD countries are presented in the Table 5.11.

5.2.2. Brief Description of Pension Funds' Activities in Selected Countries

Denmark

An obligatory capital segment of securing income for old age (ATP) was introduced in Denmark in 1964. It provides benefits much higher than those from the public segment. Benefits from the first pillar account for a dozen or so percent of total retirement income, while the second pillar accounts for close to 70%. Approximately 90% of working people belong to ATP. Pension funds in the ATP system are managed by bodies representing employees and employers. When pension plans are defined contribution, employee representatives are in the majority.

Companies are required to calculate the current value of the vested benefits and to transfer that sum to the new plan. However, the way this sum is calculated is often left to the discretion of the managers, who tend to favour those who stay in the plan. The sum depends on the premises used in the calculation.

Netherlands

In the Netherlands, pension plans are mandatory through industry-wide agreements. Separate plans may be provided only by companies (usually large ones) that offer conditions not worse than industry plans. Insurance conditions are the same for all members. There are no choices, and therefore administrative costs are very low, about four times lower than those of insurance companies. Boards of management of pension plans consist of equal numbers of employees' and employers' representatives. There are no special rules or responsibilities imposed on the managers of pension arrangements other than in respect of financial safeguards and disclosure practices. Pension scheme assets must be fully segregated from the sponsor's assets.

Approximately 90% of all employed people belong to pension funds. The per capita asset value of these funds is the highest in the world. The investment policy used to be conservative. A significant move towards shares was only effected 10 years ago.

Funding is obligatory not only during the investment period, but also in the phase of annuity. Contribution holidays are permitted in the event of surpluses but not reversions.

Entitlements of vesting rights are applied after one year. Accrued benefits are indexed. There is transferability within pension circuits with the same conditions.

So as to prevent the imposition of age requirements, the law regulates participation conditions: all employees over the age of 21 or with one year of service are to be included in a pension plan if it is applicable for that particular professional group.

The Netherlands put a ceiling on pension benefits provided from tax-privileged plans so that they do not divest all earnings. They therefore establish not only vesting periods, but also benefit-accrual schedules so as to prevent the acquisition of either very extensive or very limited rights to pensions during a minimum obligatory period.

The Netherlands pension fund members must be offered annuities as they reach the retirement age.

Switzerland

In Switzerland since 1985 all employers must provide old-age, survivor's and disability pensions for their employees. DC schemes are mandatory for all employees in a company. Employees have no choice other than to accept labour and pension contracts together. Workers contribute up to 50% of total contributions. Death and disability risks must be insured.

Yet certain groups, such as young employees, employees of retirement age or low-income workers, may be excluded from mandatory schemes. Pension schemes are not obligatory for employees under 25. In Switzerland, people earning less than 40% of the average wage are not required to pay into second-pillar pension funds.

In Switzerland pension funds are established as foundations with full legal separation of the pension fund from the employer-sponsor. Pension fund councils (management) must comprise equal numbers of employers' and employees' representatives.

Maximum investment limits for Swiss pension funds are:

- 100% cash and fixed interest,
- 80% property,
- 50% equities and other securities,
- 30% foreign bonds with a maximum of 5% per debtor,
- 30% foreign currency bonds, equities, securities.

In reality Swiss pension fund investments concentrate 62% in fixed income securities and 38% in equities and real estate. Switzerland is subject to the severest investment restrictions:

- in Switzerland the pension fund must guarantee a nominal 4% investment return annually,
- all plans need approval from an expert that they are properly financed,
- a mandatory minimum pension benefit is set.

Sweden

Since 1998, 2.5% of pensionable earnings have been set aside and transferred into a fully funded pension system.

This part is administered separately from the pay-as-you-go system. The rest of the administration and insurance function of this sub-system is under public responsibility. The scheme has the following characteristics:

- contributions are accumulated in one or several funds which the individual chooses,
- the amount in the funds increases by the investment yield on the savings that are deposited,
- the pension is determined by the conventional private insurance principle.

United Kingdom

In the UK a pension scheme must be established under irrevocable trust managed by trustees who are personally responsible for the investment of the assets in a prudent way. Small companies are generally managed by insurance companies.

The UK recently brought in a requirement under the Pensions Act 1995 giving members a right to nominate trustees.

There are mandatory minimum funding requirements. Funds may not be below actuarial obligations. In cases of more than 10% underfunding the employer is either required to provide securities or to transfer the shortfall to the fund. The 1995 Pensions Act introduced a minimum funding legislation, which requires DB plans to hold sufficient assets to meet their liabilities in the event of immediate wind-up.

In the UK written principles of investment decisions are mandatory.

The management of assets is governed by several broad concepts:

- Investment decisions must be made in a prudent and reasonable manner on the basis of a level of skill, expertise and diligence that would be expected of a person with similar investment responsibilities. This is called the prudence requirement and is the most basic concept that underlines the whole regulation.
- Investment decisions must be made for the exclusive purpose of providing benefits.
- Assets must be diversified so as to minimise the risk of large losses.

There is a compensation scheme for funded plans to provide up to 90 per cent of liabilities in the event of an offence involving dishonesty. Solvency margins are regulated.

Vesting applies after 2 years, as does indexation of accrued benefits. Members have the right to transfer to other pension funds, but there is no obligation on a fund to accept a transfer from another fund.

The maximum increase of the annual pension payment is whichever is the highest: 3% above an increase in the retail price index, or as required by social security. Limited price indexation (retail price increases up to 5%) must apply to all benefits earned from April 1997, with the exception of Additional Voluntary Contributions.

A maximum lump sum payment permitted at normal pension age is 1.5 times the final remuneration after 20 years of service (less for shorter periods of service).

United States

In the USA, private pensions are employer sponsored schemes operating on a purely voluntary basis. Supplementary pensions can be both private and public (from the government as an employer).

The sponsor plays a key role in the system by collecting contributions, holding assets for investment and paying out benefits. The number of private plans has increased from about 300,000 in 1975 to about 700,000 today. The majority are single employer plans. Only 3,000 are sponsored by unions.

Pension plans cover about 50% of the full-time workforce. Of these, one third are in defined benefit, one third are in defined contribution, and one third are in both. Many DC plans (401) operate as supplements to DB plans, allowing employees to make their own contributions.

In the USA, the tax laws can be viewed as a means of establishing a basic structure for the financing and benefits of pension plans. They are very specific in terms of how benefits must be distributed among the workers in an enterprise and the amount of funds that must be set aside each year to pay for these benefits.

Among the most important of these rules are the following general requirements:

- workers have an irrevocable right to benefits after working a maximum of five years,
- at least 70% of workers participate in the plan in most cases,
- highly paid employers and owners of companies cannot receive benefits that are more than their salaries,
- the maximum level of benefits that may receive special tax treatment must be established, and
- the sponsor sets aside in a separate legal account sufficient funds to pay for the benefits promised.

Pension funds in the USA are established as trusts. Even 401 plans, which may be individual DC schemes, should have a trust established with its trustees, even if the whole management is delegated to investment funds. If a pension fund outsources all its activity, the responsibility remains with the trustees appointed by the pension fund founder.

In the USA, the Employee Retirement Income Security Act of 1974 (ERISA) created a system of legal requirements and enforcement to ensure that the assets set aside are adequately safeguarded. The protection of assets is ensured by the application of fiduciary requirements: the assets must be segregated from those of the sponsor of the plan. They have to be held in the custody of a third party (or trust) and managed solely at the discretion of the trustee.

The US tax laws specify minimum standards for the fairness and funding of pension plans that must be met to

obtain special treatment. This is one of the major regulatory mechanisms for employee benefits.

ERISA provides a regulatory framework for the application of investment standards by:

- providing relatively specific definitions of what constitutes the assets of a pension trust,
- establishing a relatively broad functional of who is construed to be responsible for the management of these assets (the fiduciaries),
- imposing significant liabilities on these fiduciaries.

In practice this regime creates a very flexible set of standards. This may be interpreted as its strength because it is continually adaptable to the rapidly changing financial markets. It is also, however, a source of considerable difficulties in implementation due to the degree of uncertainty it may impose on practitioners and the interpretative burdens it places on the regulators.

Another principle of ERISA in governing US private pension funds is that it is essentially a conflict of interest statute. The law specifies parties or individuals that may have interests that are in opposition to those of the trust, and prohibits them from engaging in transactions with the trust.

Pension plans now hold more than one-fifth of the total financial assets in the US economy. About 40% of the assets are invested in pools managed by banks and insurance companies.

The US, like the Netherlands, put a ceiling on pension benefits derived from tax-privileged plans so that they do not divest all earnings. Indexation of benefits is not obligatory, but almost universal in practice. The Pension Benefit Guarantee Corporation was established in 1974 to guarantee pension benefits up to a specific ceiling. All private DB plans must participate.

Australia

Retirement benefit coverage has become mandatory for Australian employees – a policy embodied in the Superannuation Guarantee in 1992. The government legislated that employers should pay into an "approved" superannuation fund a percentage of the earnings of their employees, thus effectively making mandatory what had been, since the mid-eighties, part of a national agreement between employers and employee organisations.

A phase-in schedule was also legislated, with employer contributions rising to 9% of earnings by the year 2002. It is envisaged that, by then, a 3% employee contribution will also be required. As a result of this *mandatory retirement saving* policy, superannuation coverage has increased from 40% of all employees in 1987 to over 90% in 1995.

Australian superannuation funds face few investment restrictions. There are no asset requirements or floors and no minimum rate of return requirements. As a

result, superannuation funds tend to invest in a wide variety of assets with a mix of duration and risk/return characteristics.

Until the 1980s, the Australian superannuation market was largely self-regulated and was therefore subject to much less control than was the practice elsewhere. However, in conjunction with its policy of broadening the coverage of superannuation the government began to play a larger role in the regulation and supervision of the industry.

The first major regulatory initiative was the implementation of in-house asset limits in March 1985. This was followed by the introduction of a comprehensive set of operational standards for superannuation funds under the **Occupational Standards and Supervision Act (OSSA) and Regulations of 1987**. This legislation established an industry supervisory body, the **Insurance and Superannuation Commission (ISC)**, and set out requirements for tax concessions, investments, benefit standards, member participation and reporting and disclosure. As the Australian Government does not have the constitutional power to make laws concerning superannuation per se, the enforcement of OSSA was tied to the tax concessions provided to superannuation funds. Superannuation funds that did not comply with the requirements of OSSA were not eligible for superannuation tax concessions. The main tax concession for compliant funds is the 15% rate on fund income. Non-compliant funds are subject to tax at the top personal marginal rate.

In 1993 OSSA was superseded by the **Superannuation Industry Supervision (SIS)** legislation, which increased the level of prudential supervision and required standards of the industry. The SIS expanded the jurisdiction of the regulatory body, the ISC, providing it with greater enforcement powers. It also clarified the duties and responsibilities of trustees and investment managers, and encouraged greater member participation. Previously the ISC shared the responsibility with other regulators, including the Reserve Bank, The Australian Securities Commission and the State Government.

One of the main innovations of the SIS has been to place the regulation of superannuation funds on a different legal basis under the constitution. Previously, the Australian Government's taxation power was used, and eligibility tax concessions were dependent upon a fund complying with OSSA. A particular problem with this approach, however, was that the only sanction for non-compliance was the withdrawal of a fund's tax concessions, which would hurt fund members rather than the trustees who were responsible for the breach of regulations.

To overcome this problem, the SIS is enacted under the Australian Government's corporations and pension powers, in addition to the taxation power. This strengthens the ability of the Australian Government to legislate in the area of superannuation and, in particular, allows legislation to target

individuals responsible for intentional or reckless non-compliance with the duties and standards contained in the SIS legislation.

The current regulatory framework covers three main areas: industry supervision, contributions and benefit standards, and member rights.

– **Industry standards**

SIS makes trustees solely responsible for the prudent operation of their funds. To enhance this, the SIS codifies the duties of trustees and investment managers. This approach allows them maximum commercial autonomy in their investment decisions.

Trustees are personally liable under both civil and criminal law for breaches of their obligations. Penalties range from disqualification and fines to prison terms. The regulatory framework also extends to other service such as investment managers, custodians, auditors and actuaries.

– **Investment Standards**

In light of the obligations of trustees to formulate and implement an investment strategy, the SIS imposes a number of restrictions on the investment of superannuation fund assets. These include:

- Investment in in-house assets must not exceed a statutory maximum. A reduction in the statutory maximum from 10% of the cost to 5% of the market value of assets is being phased in by 2000/2001.

- Borrowing except on a short-term basis to make benefit payments or to cover settlement of securities transactions is prohibited.

- Funds must be maintained for the "sole purpose" of providing retirement benefits, so they cannot be used as a means of conducting business.

- All investment must be on an arm's length basis.

- Loans or financial assistance to, or acquisitions from, members (or their relatives) are prohibited.

Importantly, however, the investment restrictions extend neither to asset requirements or limitations nor a required rate of return. Neither is there a government guarantee of member benefits. Instead, the security and adequacy of superannuation benefits relies upon compliance with the supervisory regime established under the SIS. Particularly important is the requirement that an investment policy be formulated and that it be implemented according to the prudent person principle.

– **Reporting requirements**

The SIS legislation was introduced essentially to protect the interests of members. One way of enhancing this is to keep members fully informed. As such, the reporting requirements have been designed to facilitate members' understanding of their superannuation entitlements and the investment policy and performance of the superannuation fund. The SIS requires that trustees report regularly to fund

members and, when requested, disclose certain information. This includes both member specific and fund details.

Member specific reports are to be sent to members on at least an annual basis, when they join or leave a fund, and in case of "one-off" special events. They are to include details of contributions, accrued benefits, earnings, fees and charges deducted, and other benefits such as for death or disability. Fund information is generally sent to members in the form of an annual report. This must include details of the trustees and fund managers, the main accounting and financial data and the main investment information. Investment information must include the investment strategy of the fund; details of investments that exceed 5% of assets; the earnings of the fund; and the reserving policy. Members can obtain other relevant information on request.

– **Contribution and benefit standards**

Contribution and benefit standards aim to ensure the superannuation funds are used for genuine retirement income needs and not for other purposes such as the short-term exploitation of tax concessions.

The SIS attempts to address this by establishing rules relating to the contributions made to, and benefits received from, the superannuation funds. These include rules relating to the age limits for acceptance of contributions and payments of benefits, the employment status of fund contributors, access to benefits by members (the preservation of *minimum payment standards*) and the minimum benefits owned by members (vesting or *minimum benefit standards*).

– **Contributions**

A fund may accept contributions or, in the case of a defined benefit scheme, grant benefit accruals in limited circumstances only. The general rule is that contributions can be accepted only until a member is aged 65, and only if the member is or was within the past two years in the paid workforce or is no longer in the workforce because of ill health.

– **Benefits**

Prior to the introduction of mandatory employer contributions, vesting, preservation and portability generally only applied to employee contributions and the earnings thereon. Under O SSA some compulsory vesting, preservation and portability was introduced and this has been extended under the SIS legislation.

The SIS contains minimum benefits standards ensuring full vesting applies to all member and mandatory employer contributions provided under awards or the Superannuation Guarantee, and the investment earnings on these contributions. Vesting is not required for non-mandatory employer contributions.

In Australia vested rights are deferred until retirement age; they are not transferred to another fund. As a conse-

quence, each worker can hold several accounts with only one active (contributions paid in).

The minimum payment standards in the SIS require that superannuation benefits be fully preserved to the statutory preservation age. Since July 1, 1996, this has applied to all superannuation benefits that have been subject to concessional taxation. Generally, it is required that benefits be preserved until the statutory preservation age. This is currently 55, but is being progressively increased to 60 by the year 2025. Earlier withdrawals are available in the event of death, temporary or permanent disability, permanent departure from Australia and, with the discretion of the ISC, the cases of financial hardship.

Preserved benefits are also portable between funds. When a member leaves an employer, preserved benefits can be transferred to a new employer's superannuation fund, to a master trust, an approved deposit fund or an eligible rollover fund. Alternatively, they can be used to buy a *deferred annuity* from a life insurance company.

– **Members' rights**

The SIS provides for considerable member participation in the operation and management of superannuation funds. At least 50% or half of the trustees of superannuation fund should be members. Members of all funds are

nal arrangements and if these fail under the *Superannuation Complaints Tribunal*.

5.2.3. Supervision Over Pension Funds

Status of the supervisory authority

Table 5.12 shows the situation in OECD countries. Pension-fund supervision is usually the responsibility of a separate agency, although ministries are directly involved in Austria, Finland, Greece, Japan, Spain and the USA (first column). In 17 countries the supervision of pension funds is part of the supervision of other insurance markets (second column). Pensions and insurance have a number of common characteristics, such as similar organisation and operation. Insurance companies have a major role in the pension sector in many countries, managing 20–30 per cent of total pension assets across the OECD. They often offer group-insurance plans and act as investment and benefit managers.

The agency responsible for pension-fund supervision also sets regulations in selected countries (third column).

The Australian Prudent Regulation Authority oversees in Australia both the Bank Supervision Department of the Reserve Bank of Australia and the Insurance and Superannu-

Table 5.12. Supervisory authorities in OECD countries

Country	Supervision	Insurance	Regulation
Australia	Insurance and Superannuation Commission	same	same
Belgium	Insurance Supervisory Office	same	Ministry of Economic Affairs/ same
Denmark	Financial Supervisory Authority	same	same
Ireland	Pension Board	Irish insurance federation	Ministry of Enterprise and Employment
Netherlands	Insurance Supervisory Body	same	Ministry of Social affairs and Employment
Sweden	Financial Supervisory Authority	same	same
Switzerland	Federal Office of Social Insurance/Federal Office of supervision of private insurance	same	Federal ministries
United Kingdom	Financial services authority and occupational pensions regulatory authority	same (financial services authority)	Departments of Trade and Industry and Social Security
United States	Department of Labor (Pension and welfare benefits administration)	Department of Commerce and the National Association of Insurance Commissioners	same

Source: Rofman and Demarco (1998), Laboul (1999)

required to receive certain fund and member information on a regular basis; and members have the right to bring civil and criminal action against trustees and investment managers who have failed in their duties. In addition, members have access to a comprehensive mechanism for resolving disputes through compulsory, fund-based, inter-

ation Commission, which in turn oversees superannuation funds, life and general insurance and insurance brokers.

In the Netherlands pension funds are supervised by the Dutch Insurance Chamber, along with life insurance companies. Solvency is top priority. The framework of rules is quite liberal. In Ireland there are the Pension Board and Irish

Revenue Commissioners. In Germany book reserve arrangement and support funds are supervised by the Ministry of Finance. Pension funds and insurance contracts are supervised by the insurance supervision authority, BAV.

In 1997 OPRA – the Occupational Pensions Regulatory Authority – was established in the UK. It can suspend a pension scheme or replace it by other schemes. The Inland Revenue Office also exercises control relating to fiscal matters. There is a Pensions Ombudsman institution and Occupational Pensions Advisory service.

In the US the regulation of pension plans is conducted exclusively by two agencies of the Federal Government: the Internal Revenue Service and the Department of Labour. Pension plans are provided with special tax status in which contributions to plans and earnings from investments are not generally taxed until they are distributed to employees. These tax provisions are extremely complex. They are administered by the Internal Revenue Service of the Treasury Department.

The legal basis for the regulation of pension funds in the US was established by the Employee Retirement Income Security Act of 1974, commonly known as ERISA. ERISA provides a uniform basic structure and requirement for private pension plans, and a system for providing government guarantees of the benefits for DB plans. Enforcement of ERISA is carried out by the Pension and Welfare Benefits Administration of the Department of Labour.

Powers of supervision

The US Department of Labour is provided with broad authority:

- to interpret and apply the general principles embodied in the statute,
- to obtain information and to investigate pension plans that appear to be in violation of standards,
- to refer cases to the Federal courts to recover any losses that may result from the failure of fiduciaries to adhere to ERISA requirements.

Each year the Department of Labour conducts about 2,500 investigations into pension plans. When indications of a violation of the law are found, an attempt is made to reach a voluntary agreement that will correct the violation.

Most of the cases are resolved in this manner, which usually involves the repayment of monies to the pension fund or the sale of assets that represent a conflict of interest. If an agreement can not be reached or there is evidence of criminal activity the case is referred to the appropriate legal authorities in the federal government and ultimately the courts.

The supervisory authority does not have authority to go to the courts on its own. In the United Kingdom the Occupational Pensions Regulatory Authority (OPRA) has wide

powers to ensure that trustees, employers and their advisers comply with their statutory duties, and to impose penalties and disqualification when they do not. Plan auditors and actuaries have "whistle blowing" functions.

In Ireland the Pension Board has powers under the Pensions Act of 1990 to ensure that trustees and others involved with pension plans comply with their statutory duties. There are mandatory "whistle blowing" requirements for all involved with pension plans in relation to fraud or misappropriation and also voluntary "whistle blowing".

Information disclosure

Disclosure requirements, that is one of the main instruments in pension fund supervision, vary enormously in Europe. The United Kingdom and Ireland have the most comprehensive rules. Irish and UK trustees must provide a statement of individual benefits and an audited annual report nine months after the year-end in Ireland and one year after in the United Kingdom. Trust deeds must be made available as well. Members of employer-based schemes must be informed of eligibility rules, the calculation of contributions and the type and level of benefits. In the report trustees must account for the collection of contributions, the number of beneficiaries, asset investments and the payment of benefits. In addition they need to provide an actuarial valuation of assets and liabilities, performance rating and remuneration of managers.

In the US, pension fund members must receive an annual report outlining the plan and the rights to receive a pension. Austria, Denmark, France, Spain and Switzerland also have legal requirements to inform members. In other countries, such as Belgium, Germany, Italy, Luxembourg, the Netherlands, Norway and Sweden, there is no legal requirement to inform members, and there exists the risk that plan members do not have adequate information to assess the performance of their funds.

EU requirements

In 1997 The European Commission issued a Green paper, "Supplementary Pensions in the Single Market", the core elements of which were freedom of investments based on the prudent person principle, freedom to choose asset managers and custodians, and a level playing field between operators (life insurers vs. pension funds).

Assets held by funds of EU member states comprise 20% of the EU GDP. However, it is the only major financial sector without any explicit legal EU framework. Within the EU, there is:

- no transferability of private pension rights,
- no cross-border membership of pension funds,
- a number of investment restrictions.

Equal treatment of men and women is the fundamental EU requirement applicable to pension schemes. The retirement age and contributions may not vary for men and women within the EU countries after the Barber case of 1990 and the Coloroll case of 1994. However, this requirement will be enforced fully only for schemes started after May 17, 1990 so that the existing schemes would not be injured financially. Spouses' pensions have to be equal as well. No distinction of part-time workers is permitted. The retirement age may be increased for any gender so that it is the same for both [Avdel Systems Ltd case, 1994].

After the Barber case the European Court acknowledged that pensions represent deferred wages i.e. salaries, but not remuneration for loyalty. Close attention should therefore be paid as to how employers meet their liabilities and whether pension rights are lost upon job changes.

While the EU treaty sets the goal of free movement of capital within the member countries, many restrictions to invest outside the countries still exist [7].

Conclusion

It is difficult to compare Latin American supervision institutions with those in OECD countries because their design is quite different. Latin American supervision is more proactive. For example, in the US, the Department of Labour reviews just 1% of pension-related documents each year. Supervision institutions in Latin America are devoted entirely to pension funds, which is not always the case in OECD countries. One of the main reasons for these different approaches is historical: in developed countries privately managed pension schemes had existed for some time before the supervisory agency was created. Therefore, the supervision structure had to be adapted to the shape of the pensions industry. In contrast, Latin American pension funds were created after or, in some cases, at the same time as supervision agencies. Although Austria, Ireland, Italy, the Netherlands, the United Kingdom and the USA have comprehensive pension laws as in Latin America, in other OECD countries regulations are found across a range of legal provisions.

[7] For example in the Article 73b.1. of the Treaty: "Within the framework of the provision set out in this chapter, all restrictions on the movement of capital between (EU) Member States and between Member States and third countries shall be prohibited."

Part 6

Development of Pension Funds and Pension Supervision in Central and Eastern Europe

6.1. The Development of Pension Funds in Central and Eastern Europe

Pension funds in Central and Eastern European countries are developing along several paths. Four can be identified at present:

- the spontaneous path, i.e. without a special law on establishing pension funds, but based on general regulations on the freedom of management or operation of financial institutions; funds were established in this way in Russia, Ukraine and Bulgaria,
- the path involving special laws on establishing and operating pension funds: Hungary (1993), the Czech Republic (1994), Poland (1997), Kazakhstan (1998), Latvia (1998), Lithuania (1999), Estonia (1999) and Slovenia (1999),
- the path of evolution from spontaneous establishment of pension funds to the introduction of special resolutions: Ukraine (1998) and Bulgaria (1999); in this case, the main reason for special regulations was the introduction of incentives (tax breaks) for fund participants (including employers) on the one hand, and on the other, regulations safeguarding the funds' operations from threats,
- the path of evolution from voluntary funds (resolution of 1993) to obligatory funds (1997); this happened in Hungary.

A few other countries in the region are preparing to establish pension funds in 2000, based on special laws, e.g. Croatia, Romania and Moldavia.

The above paths of establishing pension funds are different from the classification concept proposed by Michał Rutkowski, who takes into account mainly those that are created as obligatory funds (if not for everyone, then at least for a specified group) and are linked to the reform of the system's basic segment (first pillar) [Rutkowski, 1998 and 1999]. In this report, on the other hand, we take into consideration chiefly experience, or the very fact of a pension fund being established – a new institution that is both financial and social in view of its goals. Actually, in the discussion on social security reform in Poland, many lawyers do not recognise pension funds as social institutions due to their lack of social solidarity.

In identifying the pension funds emerging in the countries of Central and Eastern Europe as presented in this

paper, all cases have been taken into account as far as possible, regardless of whether the pension funds were established on the basis of a special law or not, of how they gain participants (voluntary or obligatory funds), and whether their establishment is accompanied by reforms of the basic pillar or not.

We offer the hypothesis that the gaining of experience in creating new market-type institutions is very important for the popularisation and success of the reforms following which the new institutions will supplement, or even replace, old institutions. That is why we appreciate the importance of establishing voluntary funds, even on a small scale, and recognise them as being worthy of detailed analysis. From this viewpoint, the Hungarian path seems especially interesting. Voluntary pension funds were established first (1994), thanks to which experience was gained in managing them, and society accepted them. After five years, obligatory funds were introduced, combined with a radical change in the basic pay-as-you-go system.

Voluntary pension funds in Hungary were established in the form of mutual funds. This means that their participants became their owners. They formed as small financial organisations. In mid-1999 they numbered approx. 300, had nearly 1 million participants (25% of Hungary's working population) and accumulated nearly 500 million USD. Company funds became the most expansive, grouping more than 25% of all participants. The Hungarian system for motivating people to join voluntary pension funds is described as generous [Ferge, 1998], especially for employers, who regain as much as 40% – in the form of various breaks – of the resources contributed to the funds. These resources are treated as a wage rise for employees. It is interesting that the introduction of obligatory funds (the second pillar) has not decelerated the development of voluntary funds. On the contrary, it has contributed to their continued expansion [Parniczky, 1999].

Relatively little attention is paid to funds established spontaneously, without any special state regulation. In Bulgaria, for example, these funds (grouped in an organisation of pension funds) became a pressure group for the passing of a law regulating the rules for the funds' functioning, which happened in 1999, and also constituted the main section of the community promoting pension reform.

6.2. The Case of Hungary*

Introduction

In 1993 the supplementary system of voluntary and funded pension funds on a special regulation basis was introduced in Hungary – the first country of the former communist bloc to make such changes. Five years later the whole public pension system was reformed and the mandatory second pillar was introduced. Mandatory private pension fund membership has been compulsory for new entrants to the labour force only since July 1, 1998. A resounding 94% of members voluntarily chose the mixed pension system, while for the remaining 6% of new entrants to the labour force entry was mandatory. About 40% of the economically active population chose the reformed (mixed) system. The majority (75%) of fund members consists of people from the 20-40 age group.

Table 6.1. Main features of the pension fund sector

	Funds	1994	1995	1996	1997	1998	1999 [1]
Members of funds	Voluntary	13,211	194,387	464,382	675,019	939,291	986,033
	Mandatory	-	-	-	-	1,346,732	2,072,701
Value of assets (in million USD)	Voluntary	na	na	na	na	na	468
	Mandatory	-	-	-	-	na	217

Source: Parniczky (1999)

Note: [1] Data from the end of August 1999

The assets of the fund sector had grown to almost 700 million USD by the end of 1999. The composition of investments is very much conservative. Assets in government securities make up 86% and the proportion of stocks is 6%. Besides government securities and stocks there are corporate bonds, mutual fund shares, bank accounts and cash in the portfolio of the funds.

6.2.1. The Supervision Concept in Hungary

In the Law of Voluntary Mutual Benefits Funds – XCVI Act of November 16, 1993 – the special tasks and powers of the pension fund supervision agency and its activities were defined. The supervisory agency – the Private Fund Supervisory Board (pension funds) – that was established then also supervises the mandatory private pension funds introduced in 1997 (LXXXII Act on Mandatory Private Pensions of 1997). The tasks of the supervisory board were expanded in the new Act, but the main principles of legal

status and activities are the same as in the previous regulation on voluntary funds.

There is no single model for the best supervision of private pensions. However, in the case of mandatory pension systems, there are arguments in favour of a specialised and autonomous supervisory agency:

- a new specialised agency will help to build people's confidence in the pension system,
- there are implicit and explicit government guarantees,
- conflicts of interest between the objectives of the pension funds and the objectives of other sectors can be settled,
- the pension fund system has unique characteristics (there are no "economies of scale" in the centralised supervision of insurance, banking and pension markets).

In Hungary there already exists a development system of supervision in the pension field. The public pillar is subject to State Insurance Supervision (SIS). The investment activities of private pension funds also belong to the supervision of the capital market, which has one common agency with

banks – the Banking and Capital Market Supervision (BCMS) institution. Other important institutions in this field are the Voluntary and Mandatory Pension Fund Members Register and the Public Information Service. In Hungary the Code of Ethics and Competition has also been formulated. This is aimed at maintaining the high quality of fund management.

To avoid the risk of benefit insolvency for pensioners – that is, members of pension funds – a Guarantee Fund carried out by the Private Fund Supervisory Board was established.

6.2.2. Legal Status of the Supervisory Board

The Private Fund Supervisory Board is a national, administrative institution of first instance operating as an independent central office (as the legal entity) under the supervision of the Minister of Finance. The Supervisory Board is funded by the central budget with semi-independent finances. This means that while the institution is part of the general state budget, it can nevertheless produce some income from undefined origins (for example: fines, dues, prices for

* Chapter 6.2 is based on data and regulations provided by Edward Molendowski, the Polish governmental representative in Hungary.

forms). Additionally, the pension funds pay a 0.2% supervisory fee from members' contributions.

The Minister of Finance appoints the president and vice presidents of the Supervisory Board. Its 70 employees are civil servants, who must have a higher education degree suited to the supervision of pension activities: law, auditing, investments, economics, actuarial studies, etc.

The organisation of the Supervisory Board is based on five main tasks (functions). These are: the supervision of pension funds, operations of benefit fund system, back office operations, services connected with public information, and the register of mandatory pension fund members. The above operations are supported by the following departments:

- Legal and Licensing Department,
- Inspection and Accountancy Department,
- Investment Supervisory Department,
- Development and Economic Department,
- Actuarial Department,
- Co-ordination and Human Resources Department,
- and
- Information and Record-keeping Department.

The salaries of employees of the Supervision Board are set by law. The experiences of the functioning of the supervisory institution has so far shown that salaries on average are lower than those with the same qualifications in the private sector.

6.2.3. Activities of the Private Fund Supervisory Board

– Licensing: The Supervisory Board was established before the pension funds. A licence from the Supervisory Board must be obtained to: a) establish a fund, b) start the fund's operation, c) implement the benefit regulations, and d) start the provision of fund services. The first task of the board is therefore to evaluate applications for licences.

– Defining professional standards, the form and content of the pension fund documents and reports.

– The distribution of information to anyone interested; the following documents and data of the funds should be available, free of charge:

- deed of foundation,
- fund regulations,
- benefit regulations,
- minutes and resolution of General Meetings,
- registered office information,
- tax number,
- fund assets,
- names, addresses and positions of the authorised representatives,
- mode of representation,
- names and addresses of senior officers,

- name and address of the auditor,
- annual reports.

– The Supervisory Board carries out the central record keeping of the pension fund data management. These data include: data of fund members (membership period and contribution payments), employers and their service providers to pension funds, and data of senior officers and employees of pension funds. The basis of the record keeping in the second pillar is the pension fund member, while in the social security (first pillar) it is the employer. The pension fund member has the same social security identification number in both pillars.

– Setting the deadline, if required, for the full implementation of provisions specified in the pension law and other regulations relating to the activities of pension funds.

– Initiating accountability or dismissal proceedings in respect of the manager concerned.

– Initiating the revision of the financial plan and the modification of pension fund regulations.

– Convening the meetings of the Board of Directors and an extraordinary General Meeting.

– Imposing supervision penalties on any members of the Board of Directors of the pension fund or pension funds who violate the fund regulations, are involved in activities contradictory to fund regulations, operate a fund without an operational licence or fail to abide by resolutions passed by the Supervisory Board. The financial penalty may range from 100,000 to 1 million Hungarian Forints (HUF). The payment of the penalty shall not be paid from the assets of the fund, but it should be financed from the assets of the managing body.

– Appointing a Supervising Commissioner if deficiencies appear in the accounting of the pension fund or if the internal control system of the fund is so grave that it is impossible to evaluate the actual financial standing of the fund, or if the pension fund Board of Directors may not fulfil its duties.

– Ordering the suspension of the admission to the pension fund, if any activities appear against the interests of fund members.

– Ordering the suspension of pension fund operations and initiating legal proceedings in court to liquidate the fund if the financial standing of the pension fund does not enable the fund to operate in accordance with the appropriate regulations.

– An additional task is the daily portfolio valuation for the pension fund to be handled by the supervisory agency.

6.2.4. The Private Fund Council as the Consulting Body of the Supervisory Board

Members of the consulting body are nominated first of all by specific ministries: the Ministry of Welfare, the Ministry of Labour and the Ministry of Finance. Then they are

elected from representatives of partner institutions for pension funds: SIS, BCMS, the National Bank of Hungary, The Budapest Stock Exchange, the Pension Insurance Fund Administration, the Guarantee Fund, various chambers in which fund service providers are members, and interest representation bodies whose members include fund service providers. Finally four independent experts are invited by the Minister of Finance who appoints the president and vice-president from among them.

The tasks of the Private Fund Council are to:

- make recommendations concerning the activities of pension funds,
- make recommendations concerning changes in the operational conditions of pension funds and the Guarantee Fund,
- put forward proposals (which should be published in co-operation with the pension funds) in the given field and concerning ethical conduct,
- prepare and publish professional publications.

6.2.5. The Basic Principles of the Code of Ethics and Competition

– All participants of the pension fund "industry" act in order to ensure in the long run the operation of the private pension scheme in relation to social insurance.

– Pension funds and the representatives of their interests (e.g. associations) accept the Code voluntarily and as mandatory for themselves.

– Pension funds commit themselves to encouraging all their partners who are in connection with the private pension scheme.

– The basis of the fund system is not only law but also the trust and close co-operation between pension funds and their members.

– Pension funds are ready to disclose data for the sake of comparison and are ready to operate transparently.

– Pension funds do not provide misleading pieces of information either to the public or members-to-be.

– Pension funds commit themselves to accept the judgement of the independent forum concerning the validity of information provided.

– Pension funds act in keeping with the long term interests of their members, and manage the fund assets for the benefit of their members.

– Pension funds establish a quick and efficient system to handle the complaints and remarks of their members.

– Pension funds do not utilise dishonest methods either with members, amongst each other or in providing media and advertising publicity.

– Pension funds – to ensure the Code is observed – must set up an organisation (ethical committee) that representatives of pension funds participate in and which will determine whether the resolutions of the Code were infringed or

not, and if that is the case, will proceed with the necessary measures.

– Pension funds act always together with the Supervisory Board and with the Private Fund Council.

6.2.6. Responsibilities of the Guarantee Fund

The Guarantee Fund is a central financial institution and a legal entity. It has two main objectives. The first is to complete the fund member's claim in the event of switching from one pension fund to another. If the former pension fund is unable to pay out the total amount from the fund member's personal account, the Guarantee Fund will transfer the missing amount into the new fund and claim it from the old one. In fact, this means, that in case of fraud or negligence, the supervisory institution will also inspect this pension fund.

The other purpose of the Guarantee Fund is to provide a minimum pension for those who have spent at least 15 years in the system and claim to respect normative funding. Also in the event of the level of benefit reserves hampers the fulfilment of service obligations in the period of payment of benefits.

The GF is pre-funded; pension funds pay 0.3 - 0.5% of fund members' contributions into the GF. The government guarantees the commitments of the GF only if its own resources are exhausted. This means that the government's commitment is limited to fraud or negligence cases and to the minimum pension.

The operations of the GF are supervised by Board of Supervisors (3 members) appointed by the Minister of Finance upon recommendation of pension funds. The GF supervisors determine the rules and procedures themselves.

6.3. The Case of Poland

Introduction

The introduction of private pension funds in Poland as additional institutions ensuring income for old age was effected together with the comprehensive reform of the whole pension system. After several years of public debate on the reform, the first group of laws from the reform package was passed in 1997, and the next in 1998, including the "mother law" of the new system. These reforms were implemented as of January 1, 1999. Notably, other social reforms were started on the same date, in particular health care reform and the so-called decentralisation reform. The combination of these reforms is causing some tension in Poland at the moment.

The pension reform is addressed mainly to young people (up to 30 years old), whose participation will be obliga-

tory, which means they will pay part of the [social security] premium (19.52% of pay) to the old, pay-as-you-go segment (first pillar), and part (8%) into pension funds (second pillar). Working people aged 31–50 have the right to choose between either only the reformed pay-as-you-go system (the reformed ZUS system), or a mixed, two-pillar system. People over 50 have been excluded from the reform. In this respect, the Polish reform is similar to that introduced in Argentina in 1994.

Pension funds started being registered in mid-1998, and by the end of 1999 people covered by social security, fulfilling the appropriate age conditions and who had made their choice, moved to the new system, which includes pension funds.

Pension funds in the new system operate as open and obligatory (for the youngest people) funds in the second pillar, while in the third pillar, they are closed and voluntary funds. It is estimated that by the end of December 1999, more than 8 million people had signed up with the open pension funds (second pillar). Thus, we are observing a mass-scale trend of professionally active people joining the new system. The new institutions' tasks are all the more significant since a substantial part of the previous social security premium is now transferred to the pension funds: 9.76% of gross pay, or more than one-fifth of the old public system's revenues.

Pension funds were introduced at the same time as in-depth changes were made to the public system (first pillar), in which the benefits are now calculated on a full-equivalence basis, with many elements of redistribution being given up. A system with a specified benefit has been transformed into a system with a specified premium. The demographic factor has also been taken into account. Thanks to this, the changed pension formula is similar to the solutions used in Sweden and Latvia, where the benefit amount depends on the sum of premiums paid into the system and on the average life expectancy.

Thus, the first and second pillars of the new pension system, though each is managed differently, have a similar logic from the point of view of the benefit recipient. The key issue here is the personal contribution of the insured person [Office of the Government Plenipotentiary for Social Security Reform, 1997].

Pension funds in Poland have a dual form: pension societies (management companies) and the actual funds themselves. They can be established by institutions fulfilling serious capital requirements (4 million Euros). Consequently, the shareholders of pension societies (management companies) are mainly large insurance companies, banks and other financial institutions. The corporate sector also participates in this process, including state-owned enterprises, but its capital is very dispersed.

6.3.1. Instruments Safeguarding the Interests of Insured Persons in the New Pension System

Wanting to ensure greater transparency and effectiveness for the new system, and to protect the interests of its members from potential risks, the reformers envisaged a number of safeguards. The general mechanisms increasing the new system's safety include [Office of the Government Representative for Social Security Reform, 1997, p. 68]:

- complete separation of the pension fund's assets from the assets of the management company,
- required diversification of the funds' investment portfolios,
- the mechanism of a minimum rate of return,
- the participant's right to switch to another fund without any fees,
- the obligation to ensure fund participants access to regular information,
- the establishment of guarantee institutions,
- specialised supervision over the funds' operations.

Separation of the pension fund's assets from the assets of the pension society (management company)

The complete separation of pension fund assets from the assets of the management companies can effectively protect mainly against the risk posed by the pension society's owners. In the law passed, this separation is treated precisely and literally – the society and the pension fund have separate corporate-body status. The pension society establishes the fund, represents it to third parties, and first and foremost, manages its resources. However, both entities are financially separate. In addition, to guarantee the separation of the fund's assets from the resources at the disposal of the pension society, the fund's assets are kept with a financial partner – the depositary bank that carries out the appropriate orders placed by the pension society. The depositary is obligated to ensure that the pension fund's assets are invested in accordance with the law and the fund's statutes. In case of investment decisions incompatible with the law, the depositary is held financially responsible. It also has the obligation to immediately inform the Pension Fund Supervisory Office (UNFE) of any operations of the fund that, according to the depositary, violate the law, the fund's statutes, or do not sufficiently safeguard the interests of the fund members [cf. UNFE, 1999]. Thus, the pension society cannot dispose at will of the fund's resources.

Diversification of the funds' investment portfolios

Diversification of the funds' investment portfolios has two basic goals. The first goal involves ensuring the safety of

the funds' investment policy, which includes specifying a list of allowed financial instruments investing in which will allow for their day-to-day valuation. Secondly, by diversification rules under law, the funds' demand for securities can be given direction. From the public authorities' viewpoint, this means ensuring demand for State Treasury securities. The solutions passed in Poland provide for investing in particular instruments within the limits listed below (Table 6.2).

Minimum rate of return

Opinions on the required minimum rate of return for pension funds vary greatly. Supporters of strong supervision believe that the requirement of covering losses from the assets of the management company, linked to the minimum rate of return requirement, strongly motivates administra-

Table 6.2. Allowed investment limits in particular financial instruments in Poland

Instruments	Max. limit	Total limit
Bank deposits and bank securities	20.0%	-
State Treasury compensation certificates	7.5%	60.0%
Shares in companies listed on the regulated stock-exchange market	40.0%	
Shares in companies listed on the regulated non-exchange market	10.0%	
Shares in National Investment Funds (NIFs)	10.0%	
Certificates of closed-end and mixed investment funds	10.0%	
Units in open-end investment funds	15.0%	
Publicly traded communal bonds and other communal debt securities	15.0%	-
Non-publicly traded communal bonds and other communal debt securities	5.0%	-
Other entities' publicly traded backed bonds	5.0%	-
Other entities' non-publicly traded backed bonds	5.0%	-
Exchange-listed companies' bonds and other debt securities	5.0%	-

Source: Council of Ministers (1998)

Besides limits imposed on the categories of financial instruments, restrictions as to the issuer have also been specified – the total value of investments in securities from one issuer cannot exceed 5%. The permissible share of investments in foreign securities listed on OECD countries' stock markets is also 5%.

All the funds operating in Poland have been complying with the legal investment limits. Initial experience shows that in their first months of operation the funds tended to

tors to search for more effective ways of investing on the market. Thus, if a given fund records a lower rate of return than the permissible minimum – however defined – the fund participant's loss is covered from the management company's funds.

Opponents of this solution, on the other hand, argue that such behaviour does not actually occur in practice. Even more, the required minimum rate of return leads to actions detrimental to the funds' competitive behaviour and to

Table 6.3. Investment structure in private pension funds in Poland, 1999

Instrument	May	June	July	Aug.	Sept.	Oct.	Nov.
Bank deposits and bank securities	26	67	3	6	4	1	2
Shares in exchange-listed companies	3	6	13	11	8	13	22
Treasury bills	38	11	26	19	18	11	10
Bonds listed on the regulated stock market	33	16	58	63	70	75	66
Total	100	100	100	100	100	100	100

Source: Pension Fund Supervisory Office – UNFE (1999)

choose safe instruments and avoided investing resources in exchange-listed stocks. In May 1999 these latter instruments accounted, on average, for just 3% of the funds' portfolios. By the end of the year, despite seasonal fluctuations, especially in the share of Treasury bills, the share of such stocks had grown to nearly one-fifth of invested resources (see Table 6.3).

effective market allocation of resources. As we have mentioned when discussing risks, instead of working towards the most favourable investments, there appears a mechanism of "copying" the investment policy of the leaders [cf. Żytniewski, 1997].

The minimum rate of return required in Poland is defined by two alternative conditions. They refer to the

weighted average rate of return of all the funds, calculated over 24 consecutive months of the funds' operation [8]. The minimum rate of return is defined as the rate lower than:

- 50% of the value of the weighted average rate of return, or
- the weighted average rate of return minus 4 percentage points, depending on which condition gives the lower result [9].

If a given fund's rate of return is lower than the minimum, then there is a deficit in the fund's accounts – one that the management company is committed to cover.

Switching funds

One important mechanism supposed to increase the Polish pension system's safety is a participant's freedom to move to another fund. Every fund member, faced by worsened investment results or unfavourable changes in the terms of membership, has the right to switch to another fund, one that he or she feels better meets his or her requirements.

In Poland, this solution was introduced with certain modifications. They have a dual nature: 1) financial (a specified penalty fee for the transfer); and 2) ordering (transfers can be made only at regular intervals, e.g. every quarter, which is justified on technical grounds).

First of all, in Poland a limit has been imposed on switching funds free of charge. It is possible to move to a different pension fund, but this entails no cost to the participant only if their membership period in a given fund is at least 24 months. The maximum fee is just under 50 USD and is charged by the current fund by way of reducing the balance of transferred funds.

Secondly, there is a restriction for those people who decide to switch funds even though their 24 months with the first fund are not up yet. As has been mentioned, this limitation is bureaucratic – transfers are effected every three months (at the end of February, May, August and November). A person wanting to change funds has to sign an agreement with the new fund by the 25th day of the month preceding the month of the transfer payment, on a special form. The previous fund must be informed of the agreement with the new fund within 14 days of the date of signing. In the month of the transfer payment, the funds prepare a transfer list of persons leaving a given fund. The list is sent to ZUS. In the final phase of making the payment, the fund charges the penalty fee for the transfer if a given person paid premiums to the fund for a period shorter than two years.

Access to information

The obligation to provide regular information to fund participants is another important instrument safeguarding the rights of persons participating in private pension programmes. Materials sent to fund members can contain two kinds of information:

- information on the fund's general economic situation,
- information on the status of the individual pension account.

As to the fund's economic situation, pension funds in Poland are obligated to publish an annual information prospectus that should be available:

- 1) in the nation-wide press,
- 2) at the request of a person submitting an application for fund membership.

Moreover, upon request from a fund member, the fund has to produce the prospectus together with the latest half-year report. The fund should send the prospectus and the half-year and annual financial report to the supervisory body.

At least once a year, the pension fund should inform its members about the status of the funds on their individual pension accounts, together with information on how many settlement units (points) were purchased, what management costs were deducted and what the revenues were from deposit activity.

Guarantee institutions

Regardless of designing the various instruments described above, thus limiting the risk of pension funds' operations, institutions of ultimate guarantees have been introduced in Poland as well. This is proof of a certain over-regulation of the system, but at the time the pension reform laws were being passed there were so many fears that introducing these institutions was the condition of political acceptance of the whole project [Golinowska, Hausner, 1998].

The extensive guarantee mechanism serves to cover deficits on individual pension accounts. In accordance with the law, the first guarantee is a **reserve account** to which every fund pays regular reserves, whose value should be from 1% to 3% of the fund's asset value. The second guarantee consists in the **assets of the pension society** (management company), which announces bankruptcy if it is unable to cover the losses from the reserve account. The next safeguarding element is the **Guarantee Fund**. This is administered by the National Securities Depository. Payments to the Guarantee Fund are made by the pension soci-

[8] That is why we will know the funds' average profitability in Poland in April 2001, when the first years have passed since the pension funds began operating. This is why it is not possible at present to evaluate how this safeguard functions.

[9] Cf. Article 175 of the law on the organisation and operation of pension funds (Dziennik Ustaw 1997, No. 139 item 934).

eties, and the value of resources amassed by the Guarantee Fund cannot exceed 0.1% of the net value of assets of all the private pension funds. The ultimate body in protecting pension fund members is the **State Treasury**, which guarantees the payment of amounts due if claims cannot be covered by the previous institutions.

6.3.2. Supervision Over Pension Funds

In Poland, the supervisory body is the Pension Fund Supervisory Office (UNFE) which began operating in May 1998. This is an institution of specialised supervision, focused exclusively on the new institutions of the pension system, as is the case in Hungary.

The UNFE operates as a central government administration body overseen by the Prime Minister. The Prime Minister appoints the UNFE president, whose term in office is 5 years. The conclusion could be drawn that in a political sense the UNFE is only partly an autonomous and independent institution. The choice of the first UNFE president in May 1999 was determined by political considerations. The fact that there is a term in office and that the president can be recalled by the UNFE Advisory Committee does give the UNFE a degree of independence, however.

In terms of financial management, the UNFE is also partly dependent on the public authorities. Each year, resources for the UNFE are included in the state budget law. The monthly payments made by the pension societies are an additional source of financing for the UNFE's operation. Half the revenues from the pension societies' payments are earmarked for the so-called UNFE special resource, which is meant to finance improvements in the UNFE's efficiency and upgrading of employee qualifications. The rest of the payments go to the state budget.

The UNFE's general task involves stimulating actions aimed at ensuring the development of pension funds in Poland. The UNFE's basic goal as defined by the law, on the other hand, is protection of the interests of fund members and participants in employee pension programmes. To this aim, the UNFE exerts supervision over the funds' operations. The supervision includes both the licensing process (analysing applications for the establishment of pension societies and pension funds and issuing decisions on starting up those organisations) and their day-to-day operations.

If any irregularities occur in the day-to-day operation of the funds, the UNFE can impose cash penalties and revoke the licence for a given fund's operation.

The UNFE also has an important educational role to fulfil – increasing the public's knowledge about the goals and

principles of the funds' operation, and in particular the rights to which fund members are entitled.

The UNFE co-operates with other organs of administration, including the National Bank of Poland, the Securities and Exchanges Commission, and the Social Insurance Company (ZUS) by providing them with the necessary information.

The UNFE's legal status and the prerogatives it has been vested with limit the role of supervision in Poland to reactive supervision. This is conditioned by the fact that being a central government administration body, the UNFE can neither issue its own legal regulations nor officially submit a legislative initiative on the operation of pension funds. This deprives it of the possibility of rapid reaction by way of adaptations of the law.

6.3.3. Experiences in Pension Fund Supervision in Poland in 1999*

In the first period of operation, the supervisory body was engaged mainly in the process of reviewing applications for licences for operating the funds. In the second stage, when the funds began operations, the UNFE focused on monitoring four main areas of the funds' operations:

- providing information on the pension funds to the media,
- registering the funds' agents,
- protecting clients' rights in the context of marketing activity,
- the transfer of members between pension funds.

Advertising

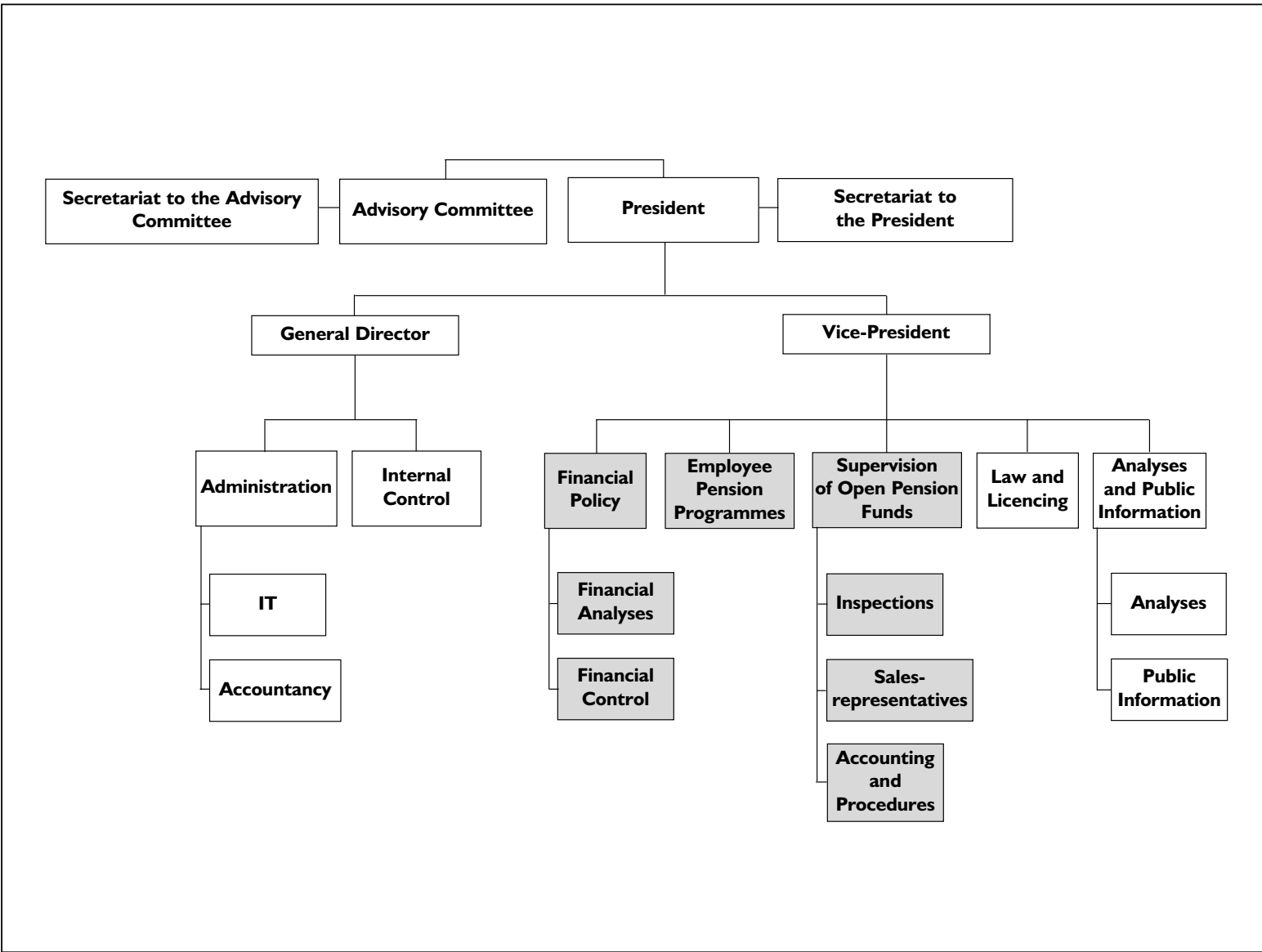
Advertising is the first plane on which an insured person comes in contact with a pension fund and it often has the greatest influence on a person's decision. Supervising the funds' and societies' advertising is based on monitoring published advertising information.

The aim of the UNFE in supervising advertising information is the development of standards ensuring honest competition between the funds and allowing the decisions of people joining the funds to be based on rational grounds with the maximum possible elimination of external factors. It is worth noting that such standards, though they are very general, were created by the funds themselves in January 1999. Even so, despite the funds' declarations, which were widely publicised in the press, the funds' activities have prompted the UNFE to react.

The UNFE has questioned advertising information that could mislead potential fund members. The advertising

* In Part 6.3.3 we have referred mainly to the paper written by Leszek Bucior (1999).

Graph 1. Poland: The internal structure of autonomous Pension Fund Supervision Institution (UNFE)



Source: UNFE (1999)

information most often questioned by the UNFE, published or broadcast by the funds, includes:

- information which underlines only the fee on the premium – neither the fee for managing fund assets nor the fee for switching funds were given; information was lacking on the existence of any other costs covered directly from a fund's assets and ultimately having an impact on the value of the future pension, such as the depositary's fee or transaction costs;

- information suggesting that the value of the future pension will depend on the fee collected on the premium, while in fact the future pension depends on two factors: the costs (fees) covered by fund members and the results of the funds' investment activity; thus, information on the factors influencing the future pension's amount should be complete and include both the above elements;

- information highlighting the decreasing fee on the premium, thus suggesting decreasing and in future even zero-level costs of fund membership, without specifying the period over which the fee on the premium decreases;

- information on the rate of return from a fund's investment activity for a period of 2–3 months, which suggests the funds' future large returns in the long term; the UNFE's position is that the rate of return for a several-month period cannot be the basis for projections of the funds' future profits; moreover, there is no possibility of comparing the published rate of return from a fund's investments with the weighted average rate of return of all the funds, which will be made public by the president of the UNFE 24 months after the private pension funds began accepting premiums, i.e. in 2001;

- information on the amount of the management company's capital in a situation where the amount of capital was set without taking into account the losses recorded in a given accounting period;

- information containing marks (logos, advertising slogans, graphic symbols) used in advertisements by the shareholders of a pension society suggesting the existence of a direct link between the society's shareholders and their reputation, and the fund managed by that society. The practice described above was used in order to circumvent the legal ban on advertising the funds before February 16, 1999.

Registering agents

An individual obtains the right to act as an agent upon being registered in the agents' register. In Poland, the agents' register is with the UNFE – similarly to Mexico, Argentina and Peru. Obviously, in the early period of the system's implementation, the registering of agents has to take place on a mass scale and be as little bureaucratized as possible. The solution accepted in Poland, however, did not provide for the sending of information via electronic media. Applications from all the prospective agents had to be submitted to the UNFE on paper.

The liberal legal criteria that allow persons to act as agents in Poland – no criminal record, being of age, registering with the UNFE (for a fee of approximately \$25) – without any significant barriers in terms of qualifications or financial costs, have led to a number of problems with the quality of the agents' operations.

When the reform started to be implemented (August 1, 1998 – the UNFE started accepting applications for licences), the potential number of agents was estimated at 100,000. The "worst-case" scenario prepared by the UNFE in late 1998 envisaged the necessity to register approx. 200,000. Meanwhile, by December 2, 1999, more than 450,000 people had been registered. Being aware of the impossibility of registering such a huge number "manually," the pension societies had an informal agreement with the UNFE on submitting agents' data for registration via electronic media.

The client recruitment process

The large number of agents in Poland suggests two things.

First of all, it is a sign that the funds treat the agents like seasonal workers, often employing them for several months or weeks, without the necessity of carrying out any kind of operations. In order to woo the greatest number of members by the end of 1999, the funds showed little or no interest in thoroughly training the agents and binding them permanently to the company. Neither are they interested in passing on to the agents any standards in terms of business ethics that are widespread in the companies that are pension-society shareholders.

Secondly, it means that due to the scale of the project, the process of recruiting members for the pension funds has to be chaotic. The issue here is the existence of a state of affairs, permanent and inherent for the system's logic, so to speak, whereby both agents and funds violate the interests of insured persons, and dishonest agents violate the interests of the pension societies (through agreements with fictitious persons).

The most frequent symptoms of violations include:

- forging the signatures of persons "joining" a fund on the agreement form,

- canvassing among persons who will lose their pension privileges from the first pillar if they join the capital system (e.g. the right to early retirement,

- canvassing among under-age persons without the consent of their legal representatives.

The number of people who have "joined" a fund by having their signature forged is hard to estimate. It is highly probable that the number of people signed up with private pension funds without their consent is greater than 100,000 (a cautious estimate). Most probably, many cases of forged signatures will come to light when the funds start sending out account statements.

In this situation, the supervisory body carried out its duties indirectly, focusing mainly on ensuring the proper protection of fund members' interests by strict and maximally restrictive inspections of the members' complaints concerning canvassing that had been submitted to the funds. In this area, the supervisory body counted on extensive co-operation from most of the funds, who realised that the way a fund reviews complaints about agents is part of the comprehensive service package offered by the fund, and that it allows the fund to build up a proper market reputation, which is of great importance for achieving market success in the long term.

Supervision over transfers between funds

The aim of the regulations concerning transfers should be to enable the will of an insured person to switch funds to be fulfilled, assuming that such a decision was made in a rational way. At the same time, barriers are introduced in relation to those who want to change to a different fund but made the decision out of an irrational impulse caused by an agent or under the influence of an offer of extra material benefits.

It is in the interest of pension societies to reduce the number of transfers within the system. The higher the transfer index, the lower the stability of the pension society's revenues from pension fund management and the higher the costs of its operation, and also the higher the investment risk for the pension society's shareholders.

The most important factors that influence the number of switchovers is the number of agents, the structure of commission paid to the agents, and the state of public awareness of the funds' operations. The first factor requires no comment. The structure of the commission is extremely important. If an agent receives his or her whole commission upon the signing of the membership agreement or at the moment when the first premium reaches the client's account, they will not be interested – contrary to the fund itself – in having the new client stay on with the fund. On the contrary, if the agent changes to a different fund, they will be sure to want to bring over their clients from the previous fund to the new one. Striving to reduce the number of transfers, the funds should pay the agents part of the commission for signing up a new member, and the rest for keeping that person in the fund for a specified period of time. Appropriate changes made by the pension funds in Chile helped greatly in reducing the number of transfers within the system. This drop was made possible also by the government's mass-scale information campaign that explained the principles of the funds' operations.

Supervision over pension funds' operations in the area of transfers should chiefly consist in detailed inspections of

transfer lists in terms of correctness and setting individual transfer amounts (including collecting the penalty fees for a transfer). Inspections carried out by the UNFE to date have shown that most of the scrutinised funds are extremely determined not to place persons wishing to switch funds on a transfer list.

6.3.4. Association of Pension Funds – a Defensive Reaction to Supervision?

Pension funds are not the passive object of supervisory activity. On January 14, 1999, thirteen pension societies that had obtained licences to operate private pension funds, drew up their first statement, which among other things set rules for avoiding negative campaigns in relation to one another, as well as the basic rules for the good treatment of clients. In May 1999, the pension societies established the Pension Societies Chamber of Commerce (IGTE), which represents their interests before state institutions, including the parliament.

The IGTE's primary statutory goal is to consolidate participants' trust in the new pension system's institutions, and especially to create an image of the pension societies as an institution of public trust. Although this is a grassroots initiative and membership in the chamber is not obligatory, most of the funds are IGTE members – 18 out of 21 currently in operation.

The chamber is becoming a natural partner in the public dialogue on further directions of the new pension system. This is expressed, for instance, in the effort put into holding annual conferences, which are an opportunity to summarise achievements to date and draw conclusions for the future [IGTE, 1999].

However, the activities undertaken by the IGTE so far have constituted typically defensive behaviour in relation to the UNFE. There are a number of differences where the UNFE's officials and the chamber's representatives take on the role of supervision and in their assessment of the funds' operations so far. The disputable issues concern those areas of the pension funds' operations discussed above – inaccurate media statements, the large number of agents, the large scale of legally invalid agreements, and restrictions on transfers.

The topic that aroused the most discussion in 1999, also in the media, was the nature of the funds' responsibility for their agents. The UNFE imposed high cash penalties for gross violations in the canvassing process. The IGTE opposed this, arguing that the agents should be penalised (civil liability) and not the funds (administrative accountability).

Thus, at this stage it seems that the chamber which groups the pension funds and societies together is more of an element of defence against the state's institutions than an active subject of uncritical co-operation.

Table 6.4. Poland: Analysis of instruments used to counteract potential risks of pension funds (PFs)

Instruments	Risks	Notes and explanations
I. External risks (typical)		
Creation of procedures facilitating (through consulting and bargaining) social and the political consensus	Political risk. Postponement of the law. Risk of passing flawed laws	Polish experience suggests that until social and political support is reached, the appropriate laws will not be passed.
Education of politicians, journalists, members of parliament and trade union members	Political risk. Passing of flawed laws (defective PF regulation) Poor interaction between separate state regulations	This type of educational solution was and is necessary to make policy-makers aware of strong arguments for pension reform. It is also crucial to provide information on solutions in other countries for convincing social and political decision-makers.
Education of the general public, including the civil service	Political risk Poor information disclosure	Both experts and journalists are responsible for informing people about possible solutions. By providing information on other countries' experiences on PFs (e.g. in the press), trust in private financial institutions was built.
Establishment of an inter-ministerial government task force responsible for preparing a competent draft law	Passing of imperfect law (defective PF regulation) Changes and flaws in the legal system Poor interaction between separate state regulations	Such a task force (in Poland: the Office of Governmental Plenipotentiary for Social security Reform) has distinct areas of competence for law preparation and supposition of changes in other laws.
Systematic and consistent privatisation	Underdeveloped domestic capital market	-
Development of financial instruments for the capital market	Underdeveloped domestic capital market	-
Development of financial market institutions	Banking risk Unstable and underdeveloped financial sector Lack of market liquidity	-
Consistent realisation of anti-inflationary policies	Unstable national currency Mismanagement of exchange risk	-

Instruments	Risks	Notes and explanations
II. External risks (associated with establishing the supervisory institution)		
Establishing of supervisory institution (UNFE)	Lack of enforcement of regulations Vague regulating procedures Extensive and inflexible regulations	The idea of creating a special supervisory institution was a controversial one in Polish discussions. A choice of already existing institutions of supervision and regulation was also considered (e.g. the Committee for Securities and the Stock Exchange).
Provision of the Statute with precision defined tasks, areas for supervision, instruments for operation and means for activities of the supervisory institution	Vague regulating procedures Extensive and inflexible regulations Mismanagement and a lack of division of responsibility Appointment of incompetent managers Manipulation of pension rules	The UNFE Statute was given by the Prime Minister of Poland (Regulation of June 2, 1998). Apart from solutions in the law, the Statute states precise tasks, tools, organisation, co-operation with other external institutions and financing of UNFE.
Definition of rights and power of the supervision authority (UNFE) and of supervising procedure	Vague regulating procedures Simulation or falsification of pension fund activities	Having clearly defined rights, power and procedures, it is possible for the UNFE to control and influence the activities of potential or real PFs and depositories, but only within the framework of the law.
Definition of clear principles for the creation and functioning of PFs and the establishment of the UNFE by law	A lack of formal decision-making procedures Lack of enforcement of regulations Vague regulating procedures Engagement in other activities by PFs	Lack of precision in the law on the role and tasks of PFs may lead to the danger of private institutions mismanaging the funds or engaging in activities that contradict the functions of PFs (intentionally or not).
Setting the rules and activities of dissemination of information by the UNFE	Political risks Poor information disclosure	The supervision authority creates and develops public awareness of the purposes and operating principles of open pension funds with particular regard to rights vested in their members and, in the case of employee programmes, in their participants. The UNFE also provides necessary information for the National Bank of Poland, the Stock Exchange and the Securities Commission. The President of UNFE shall submit annual reports on supervision activities to the Prime Minister.

Instruments	Risks	Notes and explanations
II. External risks (associated with licensing PFs)		
<p>Establishment of the licence procedure for pension fund institution candidates</p> <ul style="list-style-type: none"> – Documents required to be submitted to the UNFE by potential managing societies – Documents required to be submitted to UNFE for the establishment the pension fund – Registration procedure 	<p>Unfair competition between PF creators</p> <p>Create a weak institutions with shortcomings</p>	<p>A licence is required for the establishment of both the management company – the Pension Society – and the PF. A licence for the Society is granted on the request of the founders, if the specified documents are submitted. They include among other things:</p> <ol style="list-style-type: none"> 1. The draft statute of the Society 2. A draft agreement with a custodian bank 3. A 3-year organisational and financial plan 4. List of founders 5. List of candidates for membership of statutory governing bodies 6. List of persons to be appointed by the custodian bank to perform the draft agreement 7. A certificate confirming no criminal record of members of governing bodies 8. Documents presenting the financial standing of the founders. <p>Documents that are required for the establishment of a PF include:</p> <ol style="list-style-type: none"> 1. Statute of the fund 2. Agreement with a depositary 3. List of persons (information on skills and professional experience) that will be employed in issues connected with financial decisions in the PF and depositary. <p>Any amendment to the articles of association of a Society or its depositary, as well as any amendment to the agreement with depositary, requires UNFE approval.</p> <p>The register of managerial companies and the funds shall be held by the registry court (only by Provincial Court in Warsaw). The register shall be available for inspection by third parties. The Minister of Justice issues an ordinance defining the manner of keeping the register of pension institutions, its form and the detailed procedure used for registration in the PF register.</p>

Instruments	Risks	Notes and explanations
II. External risks (associated with licensing PFs)		
Decision to withdraw the licence for establishing managerial companies (UPS and EP)	Mismanagement Insolvency of the Society	The UNFE may impose on a Society a penalty of up to PLN 500,000.
Decision to take over or merge the management of a PF with limited conditions	Mismanagement Insolvency of the Society Lack of competition between PF management companies	This decision should be co-ordinated with the anti-monopoly agencies. The combined value of the assets which come into existence as a result of the take-over or merger of a pension society (management company) can not exceed 33% of the total value of all net assets of open PFs in any month of the year preceding the year of notification.
Definition of guidelines for the supervisory authority (UNFE) for refusing licensing, take-over and merging requests	Excessive supervisory activities	Significantly, already established management companies claim there is excessive supervision by UNFE. To defend against them they have created common umbrella organisations of pension societies.
Control of supervisory decisions and behaviour	Political risk	The Supervision Authority shall be supervised by the Prime Minister, which has for this purpose a special body – the Advisory Committee (AC). The AC consists of 15 members. 6 of the members are selected by the Trilateral Commission for Social and Economic Affairs. The state budget covers the costs of AC operations.
IV. External risks (connected with the creation of institutions related to PFs)		
Assignment of management of PFs to private management institutions (Universal Pension Society – UPS and the Employee Society – ES)	Inefficient activities Mismanagement and squandering Weak self-regulating practices	This issue was discussed for a very long time in Poland. It revealed two extreme opinions: opponents of privately managed PFs described examples of money misuse (e.g. Robert Maxwell's case in the UK), while supporters of private institutions highlighted their efficiency and competition (high rate of return e.g. in Chile).
Defined requirements by law for private institutions managing the PFs: (sufficient capital of founders, organisational form, internal structure)	Lack of formal decision-making procedures Mismanagement and squandering Inefficient management fees	1. Requirements to be met by managing company of UPS: – Organisation form: stock company, equal treatment of each share-holder, – Minimum equity capital of ECU 4 million (ca. PLN 16 million) acquired solely in cash form. 2. An employee society may not be a profit-making society. Shareholders of employee societies shall not have the right to share in the annual profit.

Instruments	Risks	Notes and explanations
IV. External risks (connected with the creation of institutions related to PFs)		
Separation of managerial body (pension societies) and PF of accumulated assets (the fund)	Temporary misuse of money Mismanagement and squandering Lack of or inadequate segregation of assets Lack of formal decision-making procedures	This instrument makes clear the distinction between managerial (administration) issues and the stock of collected assets.
Appointment of custodian depository bank for PF	Temporary misuse of money Mismanagement and squandering Lack or inadequate segregation of assets Engagement in other activities by PFs	Conditions for custodian bank: – To be a domestic bank in the meaning of the Banking Law – To have minimum capital of ECU 100 million in the case of holding the assets of an open fund, or ECU 30 million in case of an employee fund – Not to hold shares in the Society managing the PF whose assets it holds – Not to lend money to or borrow from the PF whose assets it holds, or the relevant Pension Society, unless the amount of the loan or advance does not exceed 1% of the value of the assets of the PF.
Institutional separation of annuity firm and PF	Fictitious payments Manipulation of pension rules Inadequate benefit payment rules Engagement in other activities by PFs Insolvency risk	This instrument, separating the functions of annuity firms, which pay pensions, and PFs, which invest collected contributions, is sometimes used to clarify the aims of institutions concerned, especially when they seem to compete.
Appointment of institution responsible for contributions' collection	Mismanagement	In Poland the Social Security Institution (ZUS) is responsible for collection of contributions. The contributions, therefore, do not go directly from employers to the PFs. This set-up is linked to the relatively strong state control on the mandatory second pillar of the pension system. In the case of employee funds – the voluntary third pillar – the contributions go directly from employers to PFs.

Instruments	Risks	Notes and explanations
V. Administration issues		
Application of essential requirements (professional and by reputation) to managers of PF and supervisory institution members	Appointment of incompetent managers	Management board members should meet the following criteria: <ol style="list-style-type: none"> 1. Possess full legal capacity 2. No convictions for offences against property, document credibility, economic trading, trading in money and securities 3. Have a higher education degree 4. Have at least 7 years professional experience 5. Guarantee the performance of their functions as a member of the management board.
Introduction of competitive level of remuneration for PF managers	Misuse of money Appointment of incompetent managers	-
Assignment of civil responsibility to managers	Lack of formal decision-making procedures, other PF management procedures, and division of responsibility, combined with weak self-regulating practices Misuse of money	-
Cost limits for operation of pension society – in relation to total costs, the remuneration of managers, and acquisition and marketing costs	Mismanagement and squandering Insufficient management fees	The amount used to cover costs of managing the PF (by the Society) may not exceed 0.05% of the value of the net assets per month.
Punishments for management for exceeding cost levels	Mismanagement and squandering	-
PFs must provide information to fund members, shareholders, sponsors, and supervisory body (special governmental regulation of May 12, 1998)	Poor information disclosure	Open PF should address information about its activities to four types of partners: <ol style="list-style-type: none"> 1. Any person who applies for membership – the information prospectus 2. The UNFE supervisory body – on the proportion of the assets invested in classes of assets in the form of monthly, semi-annual and annual reports 3. A daily newspaper with nation-wide circulation (such as <i>Rzeczpospolita</i>), which puts the proportion of the assets invested in classes of assets 4. PF members should receive regularly, at least once a year, details of PF activities, and detailed information on the assets standing to the member's account. At the request of a member, the PF is required to provide him or her with a statement of the monetary value of his account.

Instruments	Risks	Notes and explanations
I. External risks (typical)		
V. Administration issues		
Adjustment to the requirements of Civil Code	Misuse of money Lack of formal decision-making procedures	-
Adjustment to the requirements of accountancy regime	Lack of proper rules of financial accounting Improper asset valuation Inadequate planning of financial activity Fictitious payments	-
External audit	Inadequate planning of financial activity Fictitious payments Lack of decision-making procedures	-
VI. Pension rules		
Free choice and equal access to the PF even in option for obligatory memberships	Sanctions for termination of pension agreements Arbitrary discrimination towards PF members Lack of competition of PFs	An open pension fund may not refuse to conclude a contract unless the person applying for membership of the fund fails to meet the eligibility requirements specified in separate regulations. An individual may be a member of only one pension fund. In the case of employee PFs a contract is concluded with the employees' representation. The employee participates voluntarily in the pension programme after making a declaration. A fund shall keep a register of its members. The keeping of this register may be entrusted to a third party.
Clearly defined levels of provisions (commissions) and methods of payment by insured persons	Mismanagement and squandering	PF may charge fees in only two ways: – By deducting a given part of contributions, before they are converted into accounting units; – By deducting the given amount from the amount of a member if he or she decides to change the PF, but earlier than 24 months from the date when he/she became a Member of the Fund. In the case of a 24-month period it is impossible to impose such a deduction).
Clear definition of the pension formulae that will be the base for the future payments of benefits	Inadequate benefit payment rules Manipulations of pension rules Disadvantageous modification of contribution and benefit payment conditions	In Hungary the PF was not defined, which caused massive criticism of the reform The PF is based on the main principle of the new system, which means a defined contribution system. New pension formula can be simplified as $P = C/E$ with $P =$ old-age pension from pension funds, $C =$ virtual retirement capital of the insured person and $E =$ average life expectancy at the time of retirement.

Instruments	Risks	Notes and explanations
VI. Pension rules		
Unambiguous determining of entitlements for inheritance of accumulated contributions	Manipulations of pension rules Inadequate benefit payment rules	The amounts standing to the account of a deceased PF member shall be transferred to the persons nominated by the deceased to the members of the immediate family (spouse, children, parents and grandchildren) in equal proportion if the separate law regulates this issue differently.
Free change of PF by the participant (with reasonable limitations)	Sanctions for termination of pension agreements Arbitrary discrimination of PF members Lack of competition of PFs	Reasonable limitation would be e.g. the minimum collection period for free PF shifting without any costs (in Poland: 24 months).
Provision of at least minimum rate of return from sources invested in by contributions	Disadvantageous distribution of investment income Insolvency risk	The return rate of the PF is compared to the average weighted return of all PFs for the last 24 months (weight is the market share of PFs). The minimum required return is: 1. a return 50% lower than the average return of all PFs, or 2. 4% points below the average return of all PFs, <i>whichever is the lower</i> .
Introduction of individual accumulation and investment accounts	Apportionment of investment income contrary to the interest of PF members Disadvantageous distribution of investment income	This instrument ensures that investment income will be distributed according to the adequate share of input for each participant.
Guarantee of payment of benefits by creation of a Guarantee Fund	Pensions insolvency risk	A Guarantee Fund is established on the basis of contributions of UPS and ES from their own means and any investment returns on the contributions. The Guarantee Fund shall be administered by the National Depository. In Poland means from the state budget are used as a final guarantor.
VII. Investment of pension fund assets		
Defined structure of investment (portfolio diversification rule – legal special requirements – Regulation from May 12, 1998)	Lack of liquidity due to improper investments Investments into own projects Investments into related persons Disadvantageous distribution of investment income Mismanagement of investment portfolio Improper diversification	General provisions: 1. Investments in: – Bonds, other securities issued by the State Treasury or the National Bank of Poland – Bank deposits and bank securities – Shares listed on the regulated stock market or quoted on the regulated OTC market – Shares in National Investment Funds (NIFs) – Investment certificates and participation units in investment funds, and – publicly traded bonds and other debt securities issued by communes and by other entities – shall in total represent at least 95% of the value of the assets of a PF. 2. The total value of assets invested by the PF in any securities issued by one issuer may not exceed 5% of the total value of assets.

Instruments	Risks	Notes and explanations
VII. Investment of pension fund assets		
		3. No part of the assets of an open PF may be invested in shares of the pension society governing that open fund, shares of a shareholder of the Society, or shares of connected companies.
Legal restriction to invest in instruments that are not prepared or well regulated	Misuse of money Inadequate planning of financial activity Improper diversification	PFs must not invest in items that can not meet the conditions of stability or day-to-day valuation. If a PF does not comply with the regulation provision concerning principles for investing or fails to perform its obligation, UNFE shall impose on the managerial society a penalty of up to PLN 500,000.
The legal obligation of general information about investment income	Poor information disclosure	This aims to ensure good conditions for rational choice of individuals.
Financial responsibility of the managerial institution for ineffective investments; covering the losses from the capital of managerial institution	Investments into own projects Investments into related persons Misuse of money Mismanagement and squandering	A deficiency – this occurs when the PF return is lower than the minimum one – is calculated as the ratio of the number of accounting units of the PF and the difference between the value of an accounting unit to ensure the minimum return, and the actual value of the unit. Deficit should be covered from the following sources: 1. The assets of the special <i>reserve account</i> of the given PF 2. If that is not sufficient, the pension society (management company) shall meet the deficiency from its <i>own assets</i> 3. The Guarantee Fund, or 4. <i>The State Treasury</i> shall guarantee to make good a deficiency in the event that a deficiency cannot be met using the resources of the Guarantee Fund.
Regulations of assets valuation by special law – disposal of government (from June 23, 1998)	Inaccurate assets valuations	Asset and obligations valuation of PFs shall be done on the basis of market prices, taking into account the principle of prudent valuation.

6.4. The Case of Croatia*

Introduction

Some key characteristics of the legislation pertaining to the Pension Fund industry in Croatia are outlined below. Those characteristics may be used to compile the different foreign countries' approaches (instruments) in addressing the concrete risks we have identified (prioritised and generalised) in our report so far.

6.4.1. General Remarks: the Fund and the Company

Mandatory and voluntary supplementary pension insurance are both based upon individual capitalised savings. An Agency for Supervision of Pension Funds and Pension Insurance is established – the Agency grants licenses and supervises Pension Investment Funds and their governing Pension Management Companies.

The Pension Management Companies are joint-stock or limited-liability companies. Those are actually the Investment Fund Management Companies as defined in the Law on Investment Funds.

A Pension Fund is the open-end investment fund as defined in the Law on Investment Funds. A Fund is comprised of amounts of contributions made by Fund members plus amounts of the returns on investing the contributions. A Fund is owned by its members. A minimum number of members is required (80 thousand for mandatory, 2 thousand for voluntary funds in the third year of operation): if the number of members falls below the statutory minimum for three months, authorisation is to be revoked.

The only object of activity of the Companies must be the administration of Funds, their representation before third parties and activities related to carrying out pension management business. A Pension Company may establish and manage one Fund only.

The registered name of the Companies shall contain the name 'Pension Management Company': only licensed Companies may use such words in their registered names.

Each Pension Company shall be liable to Fund members for damages resulting from any failure to perform its obligations pertaining to the administration of the Fund.

6.4.2. Managers' Qualifications

A member of the Board of Management or Supervisory

Board of a Pension Company must satisfy the requirement of the Company Law, as well as the following special requirements:

- must have a degree,
- must have professional work experience in the field of banking, accountancy, insurance or financial services for at least five years.

6.4.3. Information Disclosure

A Fund shall no later than 31 March each year publish an information prospectus about the previous year. The information prospectus shall be made available for inspection by anyone who applies for membership in the Fund, as well as by the current Fund members.

The Pension Company shall at least once in every six months provide each Fund member with information about the assets standing to the member's account. Such information is to be provided upon request by the members too, a fee for that may be imposed which cannot exceed the cost of providing the statement.

At least once a year a Pension Company shall disclose information on the value and proportion of the Fund's assets invested in particular securities, including details of the issuers.

The Pension Companies also submit various kind of information to the Regulator: annually or at other intervals specified by the Regulator.

A Pension Company shall keep an archive of all documents and other records related to the Fund it manages.

6.4.4. Selling Practices

No one may offer any collateral benefits (cash incentives, gifts, etc.) to a person for the purpose of persuading him to become or remain a Fund member. No one may offer such benefits to a trade union or other collective entity for the purpose of inducing or rewarding that entity to persuade its members to join a particular Fund.

No one may make any claims or predictions relating to the future investment performance of a Fund.

6.4.5. The Licensing Stage

'Authorisation' by the Regulator is needed prior to establishing a Pension Company. A separate 'license' is needed by the Regulator prior to undertaking the administration of a Fund. The register of trade cannot register a Pension Company until it has been granted that separate license. Once

* Chapter 6.4 was based mainly on material provided by Ivaylo Nikolov, the Center for the Study of Democracy.

authorisation is granted, incorporating the Pension Company is obligatory within six months. Authorisation to incorporate a Pension Company does not guarantee a license to carry on Fund management.

While reviewing the authorisation application procedure, the Regulator may cooperate with other competent regulatory authorities.

Within thirty days after incorporation, the Pension Company must submit an application for a license. If a license is granted, the Pension Company may commence the business of managing a Fund no earlier than the date of the issue of the license.

Any subsequent changes in the documents or the information submitted when applying for a license, require a prior approval by the Regulator.

An authorisation of functioning of a Pension Fund is also required: application for it should be made by the managing Pension Company at the same time as the Company itself applies for a license. The Regulator co-operates with other competent authorities while reviewing the application.

The Fund may contract a custodian or an external asset manager, and may start accepting contributions, only after authorisation for the functioning of the Fund and a license for the governing Company are granted.

6.4.6. Investing the Company's and the Fund's Assets

A Pension Company may not grant loans or provide guarantees. It may not borrow or take credits, including the issue of bonds, with a total value in excess of a percentage of the value of its own capital, as determined by the Regulator.

A Pension Company may acquire part or all of the share capital of another Pension Company with the prior consent of the Regulator.

The assets of the Fund are invested according to the principles of security, diversity and liquidity. A 'statement of investment principles' is drawn up in advance by the Supervisory Board of the Company. That statement is regularly reviewed and amended, as well as disclosed.

Fund's assets may only be invested in particularly specified by law classes of securities. Amongst those are: shares and securities registered with the Securities Commission on account of having been placed through a public offering and provided that they are traded on the Zagreb Stock Exchange or other organised markets; foreign securities as set out in the regulations of the Securities Commission; foreign and domestic mutual and investment funds investing primarily in quoted equities in OECD countries.

The Securities Commission may impose maximum, but not minimum (with the exception of requiring a minimum of 50% investment in central government long-term bonds),

proportions of the Fund's assets being invested in particular instruments.

The Fund's assets may not be invested in: securities unlisted or not publicly traded; physical assets which are not frequently quoted on organised markets or for which valuation is uncertain (antiques, works of art, motor vehicles); real estate or any interest in real estate.

Asset valuation and accounting

The value of the assets of a Fund shall be determined in accordance with the valuation principles. The Regulator shall issue regulations detailing principles for valuing the assets and liabilities of Funds.

Net assets of the Fund are valued on 'valuation dates' as determined by the Regulator, but not less often than once a month. The return for the last 24 months is determined by the Company governing the Fund at the end of each quarter: the investment return is based on the valuation of the net assets.

All internal bookkeeping and accounting of the Pension Companies and the Funds shall be done in accordance with international accounting standards.

Conflicts of interest

The same legal or natural person may not be a shareholder of more than three Pension Companies.

A member of the Board of Management or Supervisory Board of a Pension Company cannot be a person who is a member of a Board of Management or Supervisory Board of:

- any other Pension Company,
- any external asset manager, if appointed,
- the custodian holding the assets of the Fund,
- any person related to the Fund or the Company itself.

The Fund's assets may not be invested in securities issued by: shareholders of the governing Pension Company; the asset manager if appointed; the custodian; any related persons.

The custodian

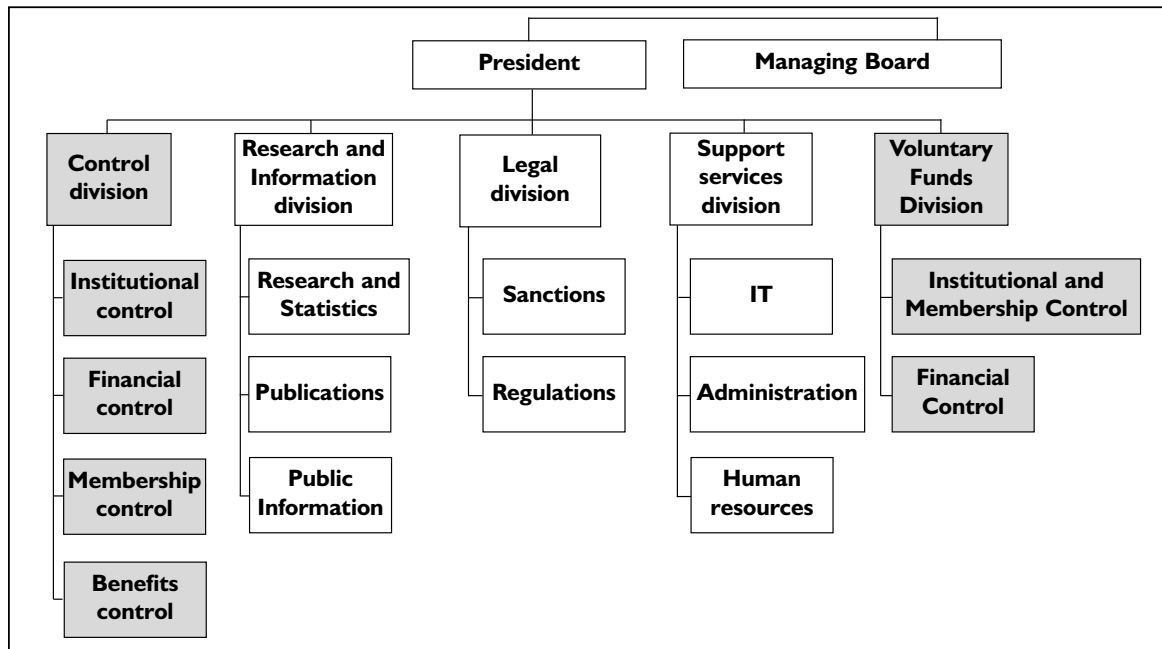
The Pension Company must appoint a custodian to keep the Fund's assets. A Company must appoint a single custodian for all the assets of the Fund managed. A custodian may act as such in relation to more than one Fund, but it must keep the assets and records of each Fund strictly segregated from each other and from those of the custodian.

Bankruptcy aspects

A Fund may not be declared bankrupt.

Fund's assets deposited and kept with a custodian may not be subject to execution against the custodian and may not be included in the bankruptcy estate of the custodian.

Graph 2. Croatia: The internal structure of an independent pension fund supervisory agency



Source: Taken from Rafael Rofman report on Croatia

6.5. The Case of Bulgaria*

Introduction

The currently operating pension system in Bulgaria is of a Pay-As You-Go (PAYG) type. This means that the financing of the old age pensions, disability and industrial accidents pensions, as well as survivor pensions, is done on the basis of the insurance contributions made by the current workers. The conditions for access to the pension system in Bulgaria are not very strict – the retirement age is comparatively low, there are early retirement schemes and the length of service required for retirement is already achieved in the middle of one's working career. At the same time, the pension benefits are rather low – the average pension constitutes about 1/3 of the average salary for the country. The recently established private pension funds still cannot fulfill their role of an alternative due to the fact that their functioning is not yet regulated in a special law, while the low incomes and the fear of financial pyramids refrain people from joining them.

Over the recent years a huge amount of social, political and expert energy has been spent (including international technical assistance) to prepare the White Book of Social Security Reform, develop a new Pension Act and make

amendments in the existing pension legislation. The major flaw of these attempted reforms was that the solution of the pension problem was sought only within the context of the current pension system. There was no political will and courage to undertake more radical reforms, incorporating a change in the conditions for access to the pension system. While looking for ways to adjust the pension benefits of the retirees, the new pensioners, who relied only on the public pension system, found themselves in the same miserable condition.

For the first time the *Bulgaria the 2001 Program* of the UDF proposed a new way for getting out of the wicked circle. The government of Bulgaria realised the need of radical reforms and adopted the idea of establishing a three pillar system based on the principle of security through diversity.

It is the purpose of the reform to establish a three pillar system:

- **Public mandatory pension insurance system of a PAYG type (first pillar).** This pillar of the pension system shall secure incomes to cover the larger part of the basic needs of pensioners like food, housing, medication. The PAYG system shall ensure a pension benefit equal to 40–45 per cent of the net salary prior to retirement.

- **Supplementary mandatory pension insurance (second pillar),** based on mandatory defined contributions accumulated into an individual account. Each working person shall have his own individual account where the

* Chapter 6.5 was based on materials provided by Ivaylo Nikolov, the Center for the Study of Democracy.

employer and himself shall make mandatory contributions that shall be exempt from taxes (respectively recognised as operational expenditures). The means shall be kept with a pension fund and invested by licensed private pension insurance companies. The amount of the pension benefit shall depend on the sum total of contributions, as increased with the revenues from investment, and reduced with fees and charges for the management of the pension fund. This pillar of the pension system shall ensure a pension benefit equal to 15–20 per cent of the net salary prior to the moment of retirement. Naturally, the longer the worker has contributed and the better the funds have been invested, the higher the benefit shall be. The state regulation here is extremely strict and includes also guarantees for a minimum investment earning.

– **Supplementary voluntary pension insurance** (third pillar), based on voluntary pension contributions, made by the worker or the employer in a voluntary pension fund. One can participate in voluntary pension insurance also with investment vouchers, and separate pension funds are set up to this end. The amount of the pension benefit is determined in the same way as with the second pillar. It is expected that about 1/3rd of the economically active population will participate in this option and their pension incomes will depend on their individual contributions and the social initiatives of their employers. This pillar is of an investment savings type with the ultimate objective of entitlement to a pension. The difference with the normal type of saving schemes or individual investment is to be found in the fact that part of the savings in the form of insurance contributions are tax exempt or recognised as operational expenditures. On the other hand, there is a strong government regulation of the pension insurance companies' activities, though at a more liberal regime than with the second pillar. There are no guarantees here for minimum investment earnings and the risk is shared between the insured persons and the pension insurance companies [10].

6.5.1. Key Issues of Pension Reform

Although most of the politicians support the establishment of a three pillar system, there is still no consensus and clarity as to the sequence and content of the reform. The key issues that are still the subject of debate include:

- How to achieve a better differentiation in legal terms between the pension insurance company and the pension funds administered by in the Bulgarian legislative context?
- Should the pension insurance companies be given the chance to administer more pension funds or restrict their activities to the management of one cash pension fund and one investment vouchers pension fund?

– What should be the structure of the pension funds from the second pillar – should they be occupational funds only, universal funds only or both types should exist side by side?

– What should be the level of the mandatory contributions for supplementary mandatory pension insurance?

– How to avoid the problem of double taxation of the current workers whereas they contribute first for the benefits of the present pensioners, and second – for their own pension benefits, in the conditions of a high insurance burden?

6.5.2. Main features of the Supplementary Voluntary Pension Insurance Act

The proposed Bill will settle social relations in supplementary voluntary pensions insurance through the introduction of legal regulation of the activities of the existing companies in the field of supplementary voluntary pension insurance and the provision of conditions for its development.

The main objective of the Bill is to provide conditions and opportunities for enhancement of the social protection of the population through supplementary voluntary pension insurance.

The additional objectives of the Bill are:

- to encourage the savings of the population,
- to stimulate employers' social initiatives,
- to promote the development of the securities markets in the country,
- to intensify the social drive of privatisation,
- to integrate the Republic of Bulgaria in social Europe.

The Bill was developed on the basis of the following **major principles**:

- 1) Voluntary participation,
- 2) Defined insurance contributions,
- 3) Insurance contribution sources: personal funds, employer funds and investment bonds,
- 4) Capitalisation of insurance contributions,
- 5) Keeping an individual account for each participant,
- 6) Differentiating the participant from the shareholder funds, including legal separation of the voluntary pension fund from the pension insurance company,
- 7) Clear and easily understandable formulation of the principal rights and obligations of the participants in SVPI, including:
 - their entitlement to old age, disability and survivor pensions,
 - their entitlement to a free choice among the "products" being offered: life pension benefits, pension benefits for a certain period of time (in years), lump or rescheduled

[10] This is also the principle difference between defined contributions voluntary pension insurance and life insurance, where the risk is taken by the insurance company offering defined pension benefits.

withdrawal of the moneys accrued in the accounts under the terms and conditions regulated by the law,

– their entitlement to transfer the funds accrued in their individual accounts from one SVPI Fund to another under the terms and conditions regulated by the law,

8) Functional and effective government regulation and oversight aimed at protecting the interests of the participants in SVPI,

9) A regime of licensing the administrative, actuarial and investment services available to the voluntary pension funds to pension insurance companies,

10) Government preferences and incentives for the development of SVPI,

11) Regulation of the capital adequacy and liquidity of the funds in the pension insurance companies,

12) Fair competition between SVPI companies,

13) Transparency in the pension insurance companies' activities, and

14) Mandatory regular accountability before the participants concerning the activities of the Fund and the cash flows in their personal accounts.

The following aspects of the Bill deserve **special attention**:

1) Primary focus on the protection of the interested of the insured persons through clearly defined and legally regulated rules governing the activities in the field of SVPI; stronger governmental control, separation of borrowed from equity funds, requirements for professionalism in the management of borrowed funds, transparency in the activities of the pension insurance companies.

2) Freedom of the insured to choose a pension insurance company, pension scheme and mode of participation, their entitlement to dispose of their own money. The Bill envisages some constraints upon these entitlements, especially for the cases when the insurance contributions are made by the employer or are in the form of investment vouchers.

3) Some specific rules are introduced for competent borrowed funds management and achievement of higher yields: a contract with an investment broker and depository or independent management provided by the pension insurance company on the ground of a special license. The right to participation of foreign investors and the investment of a limited part of borrowed funds outside the country guarantee yields in the conditions of underdeveloped capital markets in the country.

4) A special regime of participation is regulated for SVPI participation with investment vouchers and for their management through their differentiation in a separate pension fund of investment vouchers. Owing to the dynamics of the process of mass privatisation it is suggested that the specific forms and rules of participation of the pension insurance

companies in mass privatisation should be settled by decree of the Council of Ministers.

5) A combination of fees and yield appropriations are introduced towards the support of the pension insurance companies. The proposed fees in the form of % of the contributions are aimed to guarantee fixed revenues for the support of the activities of pension insurance companies regardless of the investment climate in the country. The second source of revenues to support their operations will be appropriations of up to 10% of the yields obtained from the investment of the moneys of the pension fund with a view to the more efficient management of investments ensuring uniformity in the interests of the parties to the insurance contract. The envisaged options for additional fees in connection with funds withdrawal and transfer in the order prescribed by the law or the requirement for information outside the legal prescriptions seek greater stability in the system and coverage of the extraordinary expenditures of the pension insurance companies.

6) The tax preferences indicated in the Bill are aimed at stimulating the participation in SVPI. Their specific amount will be defined in the relevant tax laws.

7) Special status and larger powers of the government supervisory agency combined with high professional performance requirements for its staff members; universal scope and uniform government supervision (through a unified agency) over the different forms of supplementary social insurance - pension, health and unemployment. Co-ordination of its operations with the competent government authorities: the Ministry of Labour and Social Policy, the Commission for Securities and Stock Exchange, the Bulgarian National Bank and the Insurance Supervision Directorate.

In the drafting of this Bill account has been taken of the principal ideas of the reform in the field of social insurance: transformation of mandatory social security (the first pillar); development of mandatory supplementary insurance (second pillar) and development of supplementary voluntary insurance (third pillar) in Bulgaria.

6.6. The case of Lithuania*

Introduction

In Lithuania, as in other post-Soviet countries, the creation of an independent state was associated with the rapid formation of new national institutions, including social security system institutions. Initially, pensions were treated like other social benefits paid from the state budget. As early as 1991, the social insurance fund was separated; later on pen-

* Chapter 6.6 was based on material provided by Audrone Morkuniene, from the Lithuanian Free Market Institute.

sion benefits became more actuarial in character, related to both the length and amount of contributions.

Pension reform in Lithuania was implemented in three main phases:

1) **Separation of the social insurance fund from the national budget in 1991.** The previous system, inherited from the Soviet regime, was not operating as financially independent. The separation from the budget made it possible to create the fund, which is administered by a tripartite council, representing employers' organisations, trade unions and the government.

2) **Arrangement of the public pension system in 1995, enacted through the Law on State Social Insurance Pensions.** Before this reform Lithuania operated virtually a flat pension system. The new law replaced pension eligibility criteria and pension formulae and raised the retirement age. This regulation resembles reforms applied in other countries Central and Eastern Europe, that put their public systems in order.

3) **Introduction of the supplementary pension pillar through the Pension Funds Act in 1999.** The law enables people to join the private pension fund on a voluntary basis.

In this section the main supervisory instruments relating to pension fund activities are presented. Since it is too early to study the results of pension funds, the analysis is based on solutions that were prescribed in the Law on Pension Funds.

6.6.1. Licensing of Pension Funds

Pension funds may be established as joint stock companies in a closed manner. This means that the first issue of a pension fund's shares may not be distributed publicly. Only the founders of a pension fund have a right to acquire them. This measure is intended to facilitate the examination of founders-shareholders' reputation and readiness to start pension fund activity before a license is issued.

A pension fund must obtain an official permit to start activity. Pension contributions may not be collected until such a permit has been obtained and a pension programme has been co-ordinated and registered with relevant regulatory institutions.

A permit to start a pension fund may be granted only to entities operating or established in accordance with the Law on Pension Funds. The main requirements are:

- equity capital of no less than four million litas (one million US dollars),
- readiness to start a pension fund in terms of facilities and qualifications (also founders' reputation),
- appropriate by-laws,
- a pension programme approved by supervisory institutions (the Securities Commission and the Ministry of Social Welfare and Labour),

- a three-year business plan,
- an appropriate depository, and
- an appropriate management company in case of outsourcing.

If pension fund activity is launched by an operating company, the Securities Commission also examines the last year's audited financial statements. Applicants are required to submit information about their selected depository and management company, if any. The Securities Commission has a right to require the submission of additional documents if such are necessary to adopt a decision regarding the issue of a permit.

A permit to start a pension fund must be issued during three months. A permit is not issued if the applicant fails to meet established requirements concerning documents and authorised capital. Borrowed funds may not be used to pay for authorised capital. In-kind contributions may not comprise more than 20 percent of authorised capital.

The supervisory authority may use licensing procedures to influence activity of pension funds at later stages of operation. If a pension fund violates the law or the interests of the insured, the supervisory institution may restrict the pension fund's activity or assign an administrator to oversee its operation for a period of no more than three months. During this period, a decision must be made whether to lift the restrictions or revoke the licence. There is a belief that a three-month period may be too short for a pension fund to ameliorate its situation. There is a danger that a licence may be revoked, and a pension fund liquidated, to the disadvantage of its members.

A permit to perform pension fund activity is revoked if a pension fund violates the law or fails to discharge liabilities towards its members, to rectify identified defects or to launch activity during a period of one year.

New licensing procedures are applied after a pension fund has been reorganised.

6.6.2. Regulation of Documents Related to Pension Funds

The law regulates the content of pension funds' by-laws. In addition to general requirements applicable to all joint stock companies, specific requirements are imposed on the formulation of pension programmes, distribution of investment income, and information disclosure to members of pension funds. Internal by-laws may be replaced only with the consent of the supervisory authority. Pension funds must obtain a permit from the Securities Commission to establish subsidiaries.

The Law on Pension Funds allows the establishment of both open-end and closed-end pension funds. The latter must stipulate certain participation restrictions in their pension programmes.

Pension fund activity is organised based on pension programmes. Pension programmes may vary by investment strategies, payment of contributions, and other participation conditions. The content of pension programmes is regulated by law. Pension programmes must be approved by the Securities Commission and the Ministry of Social Welfare and Labour plus registered with the former. Changes to pension programmes enter into force upon the approval of the Securities Commission.

A pension fund must conclude pension agreements with each payer of contributions. Payers of contributions may be members of the fund or other persons who will contribute on behalf of them. The Securities Commission, together with the Ministry of Social Welfare and Labour, establishes necessary terms of pension contracts. Pension funds have no right to terminate a pension agreement without the consent of the member, but members are allowed to do so. Breaches of the terms of payments of pension contributions may not serve as a basis for terminating a pension contract. Concurrent payment of contribution and receipt of benefits under the same pension programme are prohibited.

If contributions are to be paid by the employer on behalf of the employee, the employee may indicate a pension fund with which to conclude a pension contract. The employer may not shift onto the employee his obligation to pay pension contributions. An employee may volunteer to pay contributions under a contract signed by the employer.

A pension fund must keep a register of all members in accordance with rules prescribed by the Securities Commission.

Members of the pension funds may switch to another programme or another fund without incurring any sanctions a year. In case of repeated transfers, the pension fund to be quitted may charge a fee. If a member withdraws his savings before the retirement age without transferring them to another pension fund, sanctions are imposed: the pension fund must deduct either investment income accrued over the past three years or five percent of the sum withdrawn, whichever is bigger. The money received from sanctions is apportioned between other pension fund members.

The retirement age is defined in pension programmes. It may not be lower than the official retirement age by more than five years. Exemptions are applied to disabled individuals who may receive benefits as of the date when the disability was recognised. When a person reaches the retirement age, he is under no obligation to terminate accrual of funds or to withdraw his benefits.

The law defines possible types of benefits. These are benefits payable from personal accounts or a benefit payable for the purchase of an annuity in an insurance company. Pension funds are not allowed to pay annuities. Certain limits are imposed on the size of pension instalments payable from personal accounts for members who are not eligible for pensions provided by the state. A member who

did not purchase an annuity instantly has a right to do so for the sum remaining later on.

6.6.3. Regulation of Financial Activity and Investment

Pension funds are not allowed to carry out any activity unrelated to pension fund activity.

Pension accounts belong to pension fund members by the right of ownership. Pension accounts may be inherited. Pension contributions made by a third party on behalf of a pension fund member become the member's sole property as of the moment these contributions are received by the fund. Pension accounts may not be used to make disbursements not defined by the law.

The assets of members are financially segregated from the pension fund's own assets. Given that accrual of pension funds is administered under distinct programmes, the assets of these programmes are segregated as well.

To prevent creditors' claims to pension assets, pension funds are not allowed to extend loans, to guarantee with, or to mortgage, its assets, except when a pension fund takes a short-term loan guaranteed with its assets to maintain liquidity. Pension funds may not borrow for any other purposes. Pension funds are not allowed to be founders of companies or to issue bonds.

Pension funds must assume an obligation in their pension programmes to provide a certain level of investment return for their members. Pension funds are allowed to set the minimum level of investment return themselves. This level may not be lowered later on. To be able to discharge its liabilities, a pension fund must form a guarantee reserve fund. The procedures of forming the fund are defined by the Securities Commission. If investment income and guarantee reserves are lacking for a pension fund to discharge all its liabilities, equity capital must be used.

The law stipulates requirements for the apportionment of investment income. Investment income is used in the first place to discharge liabilities arising from pension programmes. The remaining funds are apportioned as follows: 80 percent is distributed among pension fund members, and 20 percent goes for the pension fund.

Each pension programme must define the procedures for covering administrative costs. No limits are imposed on administrative expenses. Profits generated by pension funds may not be used to pay bonuses and dividends if capital adequacy, equity capital and reserves appear to be lower than required by law or the Securities Commission.

Pension funds are subject to a capital adequacy requirement which is intended to ensure sufficient reserves calculated based on investment risk for a pension fund to discharge all its liabilities (first of all, profitability of pension programmes). Yet, this requirement does not secure an

adequate ratio of equity capital to assets managed. It may be acceptable to replace the capital adequacy requirement with a certain ratio of equity capital and assets under management.

Other requirements applicable to pension funds include liquidity ratio and the maximum open position in foreign currency. The usefulness of the liquidity requirement is questionable given that pension funds will not pay pensions themselves. The maximum open position in foreign currencies will restrict investments abroad. The latter may not prove the best way to protect members' interests given that investments abroad may accommodate better diversification and investment safety.

Pension funds are allowed to hire management companies to administer their investments or the whole of their activity. The general meeting of shareholders must approve agreements with management companies. Management companies may not be replaced without the Securities Commission's consent. Management companies must compensate for the harm incurred by pension funds through their fault.

Special requirements are applied to management companies. Management companies must obtain a permit from the Securities Commission. Only specialised institutions can act as management companies, because in order to comply with EU requirements they are prohibited from performing any other activity. This may partly be explained by the fact that performance of pension fund management by operating financial institutions (banks, insurance companies) would complicate their supervision.

A management company may be related to the pension fund, but the depository must be independent. A pension fund may not be related to its management company and depository through employees. The same people may not hold top positions in a pension fund and its management company or depository.

Investment restrictions

Investment regulations follow the listing rather than the "prudent man" rule. They define allowable investments and investment limits. Investment portfolios may comprise securities, real estate, deposits in commercial banks, and deposit certificates issued by banks.

The requirements for investment portfolio diversification comply with international standards: pension funds may not acquire more than 10 percent of securities of one issuer and investments into one issuer or one property item may not exceed 5 percent of pension assets. These restrictions are not applied to government securities. Here, no mandatory minimum levels are prescribed.

The law defines types of securities into which pension funds may invest. These are treasury bills, issues quoted on the Official List of the National Stock Exchange of Lithuania, plus other liquid securities recognised by the Securities

Commission. The same diversification requirements are applicable to investments abroad. No limitations are imposed on the amount of investments abroad. Yet, the law prescribes the maximum open position in foreign currencies. The concept of sponsorship? is not stipulated in the law.

Pension funds are prohibited from investing into their own securities or securities issued by other pension funds.

Investments into real estate may not exceed 20 percent of pension assets. Not more than 25 percent of pension assets may be invested into related persons. The Securities Commission has a right to impose additional restrictions on investments into securities or deposits in commercial banks.

Given that the assets of each pension programme are administered separately, each pension programme is subject to distinct diversification and other requirements. The equity capital must be invested into a diversified portfolio, which is subject to the same investment requirements as members' assets.

6.6.4. Regulation of the Safekeeping of Assets

All assets belonging to pension fund members must be transferred to a depository for safekeeping. A depository must be an independent institution not related to the pension fund or its management company. The Securities Commission may impose requirements on a pension fund's depository in addition to those stipulated by the law governing depositories. The assets transferred to a depository for safekeeping must be segregated from the depository's own assets. The assets of distinct pension programmes must be administered separately.

The depository not only safeguards pension assets, but also examines whether transactions with the pension fund comply with the law, the pension fund's by-laws, and programme requirements. The depository is liable for damages to the pension fund.

A pension fund may make the decision to be liquidated provided it has transferred all its liabilities to other pension funds and provided the latter does not worsen programme conditions. If the license has been revoked, a decision to liquidate a pension fund may also be adopted by the Securities Commission. In such cases the Securities Commission assigns a liquidator. If a pension fund is liquidated by the decision of the Securities Commission, all assets of pension fund members must be taken over by other pension funds. The remaining assets are sold and apportioned between shareholders.

If a pension fund is to be reorganised, it must obtain approval for the reorganisation project from the Securities Commission and the Ministry of Social Welfare and Labour.

If a pension fund is being liquidated or reorganised, or a pension programme is terminated, the pension fund may

transfer its liabilities without members' consent provided participation conditions are not worsened and the supervisory authority has granted its consent. Members who are dissatisfied with such decisions have a right to switch the new programme free of charge.

Since the pension fund's and members' assets are segregated and the money held in pension accounts belongs to the members by the right of ownership, this money, in the event of the pension fund's bankruptcy, is returned to the members before creditors' claims are satisfied. If money is lacking to discharge all liabilities, the pension fund covers the shortfall with its equity capital. As soon as bankruptcy proceedings are instituted, all operations of the pension fund are suspended, except for accrual of investment income and other operations necessary to proceed with liquidation.

6.6.5. Management and Responsibility

Since the Law on Pension Funds is based on the Law on Joint Stock Companies, the establishment of a council and board of pension funds, as well as the definition of their powers and responsibilities, is regulated by the Law on Joint Stock Companies. Definition of the establishment and competence of managing bodies is also required in pension fund by-laws.

The Securities Commission has a right to require a pension fund to convene an extraordinary meeting of shareholders.

Pension funds as well as their management companies and depositories must act in the best interest of the pension fund members. Members of the council and board as well as top managers have a joint liability for compliance with statutory provisions and performance of the duty to act in the best interest of the members of pension fund. They must compensate the pension fund for damages incurred through failure to perform the said duties. This may also be a basis for the supervisory authority to intervene and impose sanctions.

An independent audit of a pension fund is mandatory after each business year. The terms of an audit contract must be co-ordinated with the Securities Commission. Pension funds may also set up temporary controlling commissions.

6.6.6. Information Disclosure

Only a company established under the Law on Pension Funds and conducting pension fund activity has a right to use the words "pension fund" in its name.

A pension programme is the main document regulating participation conditions. Before signing a pension contract,

each member must be familiarised with the pension programme, which constitutes part of the contract. If a programme is being replaced, each member and payer of contributions must be notified in writing about the changes no later than 30 days before these changes come into effect.

The pension fund must notify its members about non-compliance with the payment of pension contributions if these are paid by third parties.

The Securities Commission must announce information about reorganisation or liquidation of pension funds according to established rules so that this information would reach every member and payer of pension contributions. In addition, every interested person has a right to receive from the pension fund information about the process of reorganisation. Members of the pension fund and the Securities Commission must be notified about the pension fund's decision to terminate a pension programme within five working days.

The law provides for periodic financial accountability: each year's audited reports plus semi-annual reports must be submitted to the Securities Commission and announced publicly. Members of pension funds are allowed to receive copies of these documents on demand. Pension funds are required to notify their members in writing at least once a year about their account statements, about changes to legal acts relating to pension funds, depositories and management companies, and about changes regarding depositories and management companies. Pension programmes define the content of such notices. It is our opinion that the periodicity of reports about account statements should be increased over time.

Management companies are also required to submit financial reports to the Securities Commission according to its established procedures.

6.6.7. The Powers of the Supervisory Authority

Lithuania has opted for an operating non-specialised supervisory institution of pension funds. Pension supervision will be delegated to the Securities Commission, which supervises the capital market. This option has been prompted by the fact that pension funds will be savings institutions similar to investment funds and will represent a voluntary supplement to the existing public pension system. The Securities Commission will have a right to inspect pension funds, to issue mandatory instructions and to impose sanctions.

The Ministry of Social Welfare and Labour will oversee the formulation of pension programmes, their compliance with collective agreements, the discharging of employers' liabilities to pay pension contributions, and the application of restrictions on the payment of benefits from pension accounts.

Conclusions and Recommendations

The development of pension funds as private financial institutions that invest savings for future pensions is being effected by a great variety of means. This is apparent not only in Western countries with a rich tradition of market solutions in many areas of the economy and social relations, but also in Central and Eastern European countries that started from the same position, one might think, when they gave up a centrally planned economy and started to build a market economy.

The varied paths leading to the development of pension funds means that supervision over them takes different forms as well. Experience shows there is no universal recipe for proper supervision.

One must ask why supervision is necessary at all, and what proper supervision entails. As has been mentioned previously (see Chapter 2), the development of pension funds during the first historical period of their establishment took place more or less without any outside supervision. Today, though, both newly established institutions and old ones are under supervision. Why is this so?

It seems there are two basic causes that combine to strengthen the arguments in favour of supervision.

Firstly, the share of the pensioner population's income from saving in pension funds is growing, regardless of whether participation in the funds is compulsory or not. This population will grow because Western societies are ageing dynamically. A pension from a pension fund will not be (and in many countries already is not) just a marginal solution for the wealthier group of the senior population, but an increasingly widespread way of securing income for old age. The safe and effective functioning of the funds will thus be an important criterion of trust in the State, the economic system and its institutions.

Secondly, contemporary market economies are not free of crises, especially financial ones. Many individual institutions and whole groups fall victim to weak (short-sighted) regulations and bad management, as well as fraud. The economies of countries who practised central planning until recently, possessing little market experience and a huge

deficit of regulations adapted to the new system's logic, are especially susceptible to crisis. At the same time, the crisis of any market institution in any country can cause a great loss of trust among society in general. Change, meanwhile, requires motivation and positive examples to stimulate people to private activity and participation in market solutions. That is why financial institutions, thanks to which the average citizen gains market experience, should be extremely solid.

To decide what proper supervision means, one has to understand that the financial risk linked to pension funds is an element of the overall risk found in the financial system. The existence of risk, as a "natural" component of that system, has to be calculated into both regulation and supervision [11]. This paper has attempted to provide a detailed analysis of risks and, furthermore, even to rank them. However, it is impossible to say unequivocally what kind of supervision is proper. Let us try, nevertheless, based on an analysis of different countries' experiences, to show certain conditions and qualities for the proper supervision of pension funds.

– The first condition involves the necessity of complying simultaneously with safety criteria and effectiveness criteria. Due to the great importance of this for pension funds, a separate supervisory body is created for them. When the supervisory body is common for different types of financial activity and covers an excessively large part of the financial market (e.g. the banking or insurance system, or the whole financial market as in the United Kingdom), the trend to disregard the interests of fund members can occur more frequently. Where this happens, supervision identifies with the interests of the pension fund industry as a part of the sector undergoing supervision rather than defending future pensioners against excessive financial risk (this is called "supervisory capture"). Common supervision leads to a situation where, in the course of time, specialist analytical institutions are separated out, and this reduces the danger of domination of the sector's interests over its clients. Thus, institutional unity is not maintained. Admittedly, establishing a sep-

[11] Sometimes the difference is emphasised between regulation and supervision for the purpose of order; regulation means creating laws, and supervision means putting those laws into practice in accordance with the letter of the law while eliminating deviations and irregularities.

arate supervisory body just for pension funds does not solve the problems involved with balancing the criteria. What is needed is a supervisory body that would have extensive competence in both financial supervision and legal supervision. In practice, achieving such harmony of competence is not simple. Supervision employees would have to have the same financial qualifications as those who manage the funds. Since supervisory bodies are usually government agencies that are unable to compete with commercial (private) companies for employees highly qualified in finance, supervision over pension funds is entrusted to bodies that supervise the stock exchange, banks or insurance companies. However, if there is a separate supervisory body, as is the practice in the model-creating countries of South America (Chile, Argentina) and subsequently adopted by Hungary and Poland, the problem arises of obtaining and paying the best experts for such a body. They would have to earn about the same as members of the pension fund management board – and these are high salaries, far higher than government administration salaries. In supervisory bodies that are government agencies, drastic salary differences between government administration employees are very hard to accept, and practically impossible to implement, though the example of Argentina seems to show that this is in fact possible (salaries in supervision are 50% higher than in the management boards of the best funds). Let us not forget, however, that Argentina's *Superintendencia* is a largely autonomous institution.

– The second condition relates to the independence of the supervisory body. The issue here is independence in a broad sense, both from political influences and the influence of the funds themselves, as well as other pressure groups. Due to the growing share of assets in the funds, which is turning them into a serious financial force, they are increasingly becoming the object of pressure and political coquetry that occasionally has serious consequences on their effectiveness. Independence from political influences can be achieved by the proper placement of the supervisory body and well-defined methods for choosing its head, with the participation of parliament to ensure its functional stability in the longer term. One important element of such a body's independence is to ensure it has independent financing. The source of funding should be commission from the funds rather than an annual state budget subsidy. Budget financing makes it difficult to use aggressive salary motivation for

employees of the supervisory body (see above), which in turn is a condition for attracting highly qualified people in the financial field to supervise pension funds.

– Independent supervisory bodies should have the right to submit drafts of changes in the regulations or of additional regulations on the operation of pension funds. They should also provide opinions on draft regulations proposed by others. This right is especially important in countries with little experience in regulating the financial sector – in the countries undergoing transition. The supervisory body is quickly becoming one of the most competent institutions in the sector, and while it should maintain its independence, its voice should be ensured the proper rank in initiating new regulations. This does not mean, though, that the supervisory body should be created as the fundamental regulatory institution (in accordance with the active supervision model). Its initial assets in improving the regulation of the pension fund sector could be transformed into the defects of a leading decelerating force, weakening the market adaptation of the funds themselves and their capacity for self-regulation.

– With supervisory bodies in countries where participation in pension funds is obligatory for a certain group or for the whole population, and where the pension from the fund de facto becomes a component of social security, supervision should be developed along stricter and more draconian lines. It needs to be exercised exceptionally scrupulously, even though there are other safeguards in such cases (e.g. a defined investment structure and investment limits, a minimum rate of return, a guarantee fund). In the case of pension funds operating on the basis of voluntary participation and greater freedom of choice regarding not just the fund but also the investment options, a distanced form of supervision (within reactive supervision) is permissible. The "prudent man" concept forms the basis for this type of supervision.

– Institutions exercising supervision of pension funds should be legally obligated to co-operate with other supervisory bodies and regulatory bodies. The obligation of co-operation should also concern the public part of the pension sector. In the countries undergoing transition, it is as yet difficult to achieve this kind of co-operation. Had it existed, it would have allowed several risks that became apparent at the start of the pension funds' functioning to be avoided.

Appendix

Legal Provisions Regarding the Supervision of Pension Funds in Selected Countries of Central and Eastern Europe

A-I. The case of Hungary: Act on Private Pensions and Private Pension Funds (Act LXXXII of 1997) [fragments]

Chapter XI. State Guarantees, State Supervision of Funds

Section 100.

The State shall secure the operation of the private pension system by enforcing the rules of institutional protection, by maintaining state supervision and by assuming financial guarantees from the central budget for the solvency of the Guarantee Fund, which guarantees the payment of the fund members' claims.

Section 101.

Legal supervision of the funds shall be carried out by the General Prosecutor's office in compliance with the relevant governing rules, and state supervision shall be carried out by the Minister of Finance through the Private Fund Supervisory Board.

Legal Status and Scope of Responsibility of the Private Fund Supervisory Board

Section 102.

1. The Private Fund Supervisory Board is a national, administrative organisation in the first instance operating as an independent central office under the supervision of the Minister of Finance.

2. The Private Fund Supervisory Board is a legal entity and operates as an organisation funded by the central budget, with semi-independent finances. The Fund Regulations of the Private Fund Supervisory Board shall be approved by the Minister of Finance. The registered office of the Private Fund Supervisory Board is in Budapest.

3. The authority of the Private Fund Supervisory Board includes the supervision of the activities of organisations specified in Section 2 of this Act, as well as tasks and authority specified by VMIFA.

4. The Private Fund Supervisory Board shall act in compliance with SAPR with due regard to the provisions listed in this Act.

5. Appeals against the resolution of the Private Fund Supervisory Board may be submitted to the Minister of Finance.

6. The Private Fund Supervisory Board has the right in the preparation phase to examine legal regulations related to the system of social security, mandatory and voluntary pension funds, and to make recommendations on the formulation of relevant legal regulations and the amendments thereof.

7. The Private Fund Supervisory Board may sign agreements of co-operation, may exchange information which is not classified as personal data with foreign supervisory authorities or international organisations established by such authorities, and may join such organisations as a member. The Private Fund Supervisory Board may utilise data and information received from foreign supervisory authorities to improve its performance, as well as to have a better basis to judge applications, pass resolutions, take measures or impose sanctions. The Private Fund Supervisory Board may disclose data and other information to the above mentioned organisations for the same purposes, within the framework of international co-operation.

8. The Private Fund Supervisory Board shall officially publish its resolutions and opinions in the "Financial Gazette".

Section 103.

1. Any person who serves or served in a civil service capacity, other work-related, or commissioned legal relationship with the Private Fund Supervisory Board, shall maintain business and fund secrets related to the activities of the funds which are/were disclosed to him while carrying out supervisory tasks. Secrecy shall be maintained without any limitation in time, even after the termination of the legal relationship with the Private Fund Supervisory Board.

2. Any such person as referred to in Subsection 1. shall not use business or fund secrets disclosed to him to gain advantage for himself or for any other person directly or

indirectly through such secrets, nor to cause any detriment to the fund or fund members.

Power of Appointment President of the Private Fund Supervisory Board

Section 104.

1. The President of the Private Fund Supervisory Board shall be appointed for a term of six years, and the vice-president(s) for an indefinite period, by the Minister of Finance, who shall also exercise the employer's rights over the President and the vice-president(s).

2. The status of the President, vice-president(s) and employees of the Private Fund Supervisory Board shall be governed by the provisions of CSA, with respect to the provisions of this Act, with the exception that the rates set out in Subsection 3. of Section 30/A, Paragraph b) of Subsection 5. of Section 42 and Subsection 1. of Section 44 of CSA may be increased to the extent specified by legal regulations pertaining to the ministries.

3. The President and the vice-president(s) of the Private Fund Supervisory Board shall be Hungarian citizens with no prior criminal record, a higher education in the field, and at least five years of management experience in the field of finance, business, or public administration. The Minister of Finance may grant a two year exemption from the five-year experience requirement; furthermore, the Minister of finance may also grant an exemption from the requirement that the higher education degree be in the field, provided that the candidate has had five years experience in the field.

4. As regards the appointment of the actuary of the Private Fund Supervisory Board, the provisions of Subsections 2-4 of Section 47 of this Act shall apply.

5. The appointment of the President and the vice-president of the Private Fund Supervisory Board shall be terminated through discharge if:

a) according to a final judgement of the court they have committed a crime, or have become unworthy of their positions in any other way,

b) they have permanently become unable to fulfil their functions,

c) they have not eliminated conflicts of interest with their functions.

6. The President of the Private Fund Supervisory Board shall

a) represent the Private Fund Supervisory Board in Hungary and abroad;

b) manage the activities of the Private Fund Supervisory Board;

c) exercise the employer's rights over the employees of the Private Fund Supervisory Board, and make recommendations on exercising employer's rights related to the vice-president(s);

d) exercise rights related to the financial management of the Private Fund Supervisory Board;

e) order measures and impose penalties;

f) exercise all rights vested in him by the Fund Regulations of Private Fund Supervisory Board pursuant to this Act.

7. The President of the Private Fund Supervisory Board may transfer his powers specified in Paragraphs c)-e) of Subsection 6. with the exception of the right to make recommendations on exercising employers rights related to the vice-president(s).

Conflict of Interest

Section 105.

1. The President, vice-president(s) and civil servants of the Private Fund Supervisory Board shall not be in an employment relationship, in any legal relationship with the purpose of work, in a membership relationship in terms of a corporation or partnership involving personal contribution, or ownership relationship with any fund, legal entity in contractual relationship with that fund, the Guarantee Fund, or any organisation involved in social security activities. The said persons may not be senior officers of or members of any organisation entrusted with the supervision thereof.

2. The President, the vice-president(s) and the civil servants of the Private Fund Supervisory Board, and the persons listed in the Subsection 1 shall not be close relatives of each other, and shall not act in issues in which they or their close relatives have interest.

3. Persons specified in Subsection 1 shall immediately notify the person exercising the employer's right of the existence of conflicts of interest specified in Subsections 1 and 2 and eliminate any conflict of interest as specified in Subsection 1 with immediate effect. The party exercising employer's rights may require the person concerned to eliminate such conflict of interest, even if he fails to fulfill the requirement of notification. If the persons concerned fail to eliminate such a conflict of interest, the civil servant status of such persons shall be terminated by the Private Fund Supervisory Board. In the event of conflicts of interest specified in Subsection 2, the party exercising employer's rights shall decide whether or not the cause of conflict of interest shall be eliminated, and whether the person notifying the Board is entitled to act in the given circumstance.

Responsibilities of the Private Fund Supervisory Board

Section 106.

1. The Private Fund Supervisory Board shall:

a) supervise compliance with the provisions of the law and the legal regulations issued on the basis of authorisation conferred by the law;

b) evaluate applications for licenses, and ensure that the funds operate in compliance with such licenses;

c) appoint a Supervising Commissioner in the events specified in this Act;

d) co-operate in discovering and eliminating obstacles which hamper the development of the funds and the Guarantee Fund, in co-ordinating the co-operation of the above with the social security bodies;

e) operate an auditing and information system;

f) determine, in advance, on an annual basis, the expected and minimum return requirement on the funds' investments with a method of calculation specified by law;

g) approve the regulations of the funds.

2. The Private Fund Supervisory Board shall permanently make the following documents and data of the funds available to anyone interested, free of charge:

a) deed of foundation,

b) Fund Regulations,

c) benefit regulations,

d) minutes and resolutions of the General Meetings,

e) registered office, site(s), branch(es), affiliate(s),

f) tax number,

g) the assets of the fund,

h) names, addresses and positions of the authorised representatives,

i) mode of representation,

j) names and addresses of senior officers,

k) name and address of the auditor,

l) annual reports.

3. The Private Fund Supervisory Board shall fulfill its tasks related to the voluntary mutual interest funds in compliance with a separate law.

Section 107.

1. In fulfilling its tasks, the Private Fund Supervisory Board shall have the right to issue licenses, exercise control, take measures and impose penalties.

2. While exercising its rights, the Private Fund Supervisory Board shall not compel the fund to carry out financial management other than approved in the Fund Regulations and in the financial plan, unless the fund is temporarily insolvent.

Licensing Authority

Section 108.

The license of the Private Fund Supervisory Board shall be obtained:

a) to establish a fund;

b) to start the fund's operation;

c) to implement the benefit regulations, and to start the provision of fund services.

Right of the Private Fund Supervisory Board to Control, Take Measures and Impose Penalties.

Section 109.

1. The Private Fund Supervisory Board shall have the right at all times and an obligation to monitor every second year whether the activities performed by the fund are in

compliance with the law and other legal regulations related to the fund activities, the licenses granted by the Private Fund Supervisory Board and the safety of the fund members. To this effect, the Private Fund Supervisory Board shall have the right to require the production of data, reports, statements and inspection materials related to the performance of the fund, or which are necessary to carry out the audit, and to examine these documents on site, even without prior notice, as well as to request reports.

2. The Private Fund Supervisory Board shall operate an information system through which it can be connected directly to the information system of the funds and the Guarantee Fund. The detailed rules pertaining to the common information database shall be determined by the Government in the form of a decree.

3. In order to carry out the supervisory tasks specified in Subsection (1), the Private Fund Supervisory Board may send an employee, an independent auditor or other experts to the fund to carry out a general or specific audit, as well as to enforce the fund's reporting and accounting obligations.

Section 110.

1. For the purpose of the fulfillment of the obligations of the fund, the protection of fund members' interests, as well as the implementation of the relevant legal regulations, the Private Fund Supervisory Board may take the following measures:

a) it may issue a notice, and set the deadline, if required, for the full implementation of provisions specified in this Act and in other legal regulations relating to the activities of funds;

b) it may require the submission of an action plan by a given deadline, and may also set a deadline for the implementation of such an action plan;

c) it may initiate accountability or discharge proceedings in respect of the manager concerned;

d) it may convene the meeting of the Board of Directors;

e) it may convene an extraordinary General Meeting;

f) it may impose a supervision penalty;

g) it may withdraw the operational license granted for fund activities and, in this case or in the case of voluntary dissolution, it may temporarily order that the fund members pay their membership contributions to the Guarantee Fund; it shall ensure, by the designation of the appropriate fund, that fund members may become members of the designated fund within sixty days at the latest;

h) it may initiate the revision of the financial plan, and the modification of the Fund Regulations;

i) it may initiate legal proceedings in court to liquidate the fund;

j) it may appoint a Supervising Commissioner;

k) it may suspend the admission of fund members;

l) it may suspend the operation of the fund while concurrently appointing a Supervising Commissioner, and may suspend the admission of fund members.

2. The operational license may be withdrawn if:
- a) the fund fails to start operating within 180 days of the date the license takes effect, or if it suspends operation without the approval of the Private Fund Supervisory Board;
 - b) the fund has disclosed false information or statements in the application for license, and, upon notice, fails to modify the information or statements accordingly within thirty days;
 - c) the fund fails to meet the requirements specified in the license;
 - d) the fund seriously breaches the provisions of legal regulations related to fund activities, or does not comply with the resolutions of the Private Fund Supervisory Board, and therefore seriously jeopardises the interests of fund members;
 - e) the fund is involved in activities other than those for which it is licensed;
 - f) the conditions for the issuance of the license are no longer fulfilled, and remedy of this situation is not possible within an appropriate period of time.

Section 111.

1. The Private Fund Supervisory Board may impose penalties on any members of the Board of Directors or the Private Fund Supervisory Board who violate the Fund Regulations, are involved in activities which are contradictory to the Fund Regulations, operate a fund without an operational license, or fail to abide by measures taken or resolutions passed by the Private Fund Supervisory Board. The amount of the penalty may range from HUF 100,000 to HUF 1,000,000. The payment of the penalty shall not be assumed by the fund.

2. The Private Fund Supervisory Board may impose penalties on the fund if the fund does not change any unlawful practices or practices violating the Fund Regulations, or violates the relevant accounting and financial requirements. The upper limit of the penalty shall be 0.3 per cent of the annual membership contributions, and may be imposed repeatedly. If the fund deviates from the rules and general regulations on investments, and repeatedly violates the rules relating to conflict of interest, the upper limit of aggravated penalty shall be one per cent of the annual membership contributions.

3. The penalty imposed by the Private Fund Supervisory Board shall be paid within fifteen days of the receipt of the legally final judgement, to the account specified in such judgement.

Section 112.

The Private Fund Supervisory Board shall not impose any penalty beyond six months after the default or the violation of obligations becomes known to the Private Fund Supervisory Board, or beyond two years after the default or the violation of obligations.

Supervising Commissioner

Section 113.

1. The Private Fund Supervisory Board may recommend that the fund prepare an action plan if it is assumed that the fund will not be able to meet its obligations.

2. If the fund fails to comply with the provisions of the action plan, or the action plan fails to promote safe operation of the fund, the Private Fund Supervisory Board may appoint a Supervising Commissioner. The Private Fund Supervisory Board may also appoint a Supervising Commissioner if the deficiencies discovered in the accounting or internal control system of the fund are so grave that it is impossible to evaluate the actual financial standing of the fund, or if the Board or Directors of the fund may not fulfill its duties, and thus jeopardises the fund members' interests.

3. The Supervising Commissioner may only be a person who has no business relations with the fund and is not a member thereof.

4. The Commissioner shall investigate the financial standing and financial assets of the fund, and prepare the fund for the production of a report. The Supervising Commissioner shall convene a General Meeting within fifteen days of the completion of his inspection.

5. The activity of the Supervising Commissioner shall aim to restore the fund's operability. In this period the fund shall act in compliance with the directives of the Supervising Commissioner appointed by the Private Fund Supervisory Board, and the Supervising Commissioner shall exercise the rights of the Board of Directors and the Managing Director.

6. The Supervising Commissioner may be appointed for a period of maximum 180 days; this period, however, may be extended pending the appointment of a liquidator. In the event of liquidation proceedings, the appointment of the Supervising Commissioner shall end upon appointment of a liquidator.

Section 114.

1. The commission of the Supervising Commissioner shall specify his duties and scope of authority, which shall exclusively include compliance with and enforcement of the rules specified in this Act, and legal regulations implementing this Act.

2. The Board of Directors of the fund shall be notified of the appointment of a Supervising Commissioner.

3. Upon request, the Supervising Commissioner shall notify the Board of Directors of the fund of the measures taken by him in writing within three days.

4. The Supervising Commissioner shall be eligible for remuneration, the amount to be determined by the President of the Private Fund Supervisory Board and payable by the fund concerned.

Section 115.

If the financial standing of the fund does not enable the fund to operate in accordance with the Fund Regulations,

the Private Fund Supervisory Board may order the suspension of the fund's operation, and may initiate legal proceedings to liquidate the fund.

Revenues of the Private Fund Supervisory Board

Section 116.

Revenues of the Private Fund Supervisory Board are as follows:

- a) supervision fee,
- b) other revenues.

Section 117.

1. The funds shall pay the supervision fee to the Private Fund Supervisory Board from their operational reserves.

2. The supervision fee shall total 0.2% of the membership contributions paid.

Section 118.

1. The supervision fee shall be transferred by the funds to the account of the Private Fund Supervisory Board on a quarterly basis, by the thirtieth day of the month following the quarter under review, on the basis of the fund's actual membership revenues in the quarter under review.

2. The supervision fee shall be utilised to cover the operational expenses of the Private Fund Supervisory Board. Calculation, accounting and utilisation of residual funds at the end of the year shall be governed by legal regulations applicable to financial planning, financial management and the reporting systems of state-funded organisations.

Data Management by the Private Fund Supervisory Board

Section 119.

1. In order to fulfill its tasks as specified in this Act, the Private Fund Supervisory Board may manage, i. e., store and use data, including personal data specified in this Act.

2. In order to fulfill its tasks, the Private Fund Supervisory Board may store and use the data, specified in Schedule No. 2 to this Act, of fund members and the senior officers of the funds, as well as data pertaining to the conflict of interest and qualification requirements of the fund's officers and employees.

Section 120.

The central record keeping of the funds shall be carried out by the Private Fund Supervisory Board within its own organisation. If the Private Fund Supervisory Board judges from the available data that in any fund the safety of benefits is jeopardised due to some malfunction, or the performance-related data of the funds show remarkable disproportion, or it is presumed that the law or legal regulation has been violated, the Private Fund Supervisory Board shall take the necessary measures.

Chapter XII. The Private Fund Council

Section 121.

1. The Private Fund Council is the consulting body of the Private Fund Supervisory Board.

2. Members of the Private Fund Council are as follows:

a) the representatives of the Ministry of Finance, the Ministry of Welfare and the Ministry of Labour (one representative each);

b) the representative(s) of the Alliance(s) of Funds;

c) four independent experts invited by the Minister of Finance upon the recommendation of the president of the Private Fund Supervisory Board;

d) the representatives of the State Insurance Supervisory Board, the State Supervisory Board of Money and Capital Markets, the National Bank of Hungary and the Budapest Stock Exchange (one representative each);

e) the representative of the Guarantee Fund;

f) a representative delegated by the Pension Insurance Fund Administration,

g) the representative of chambers in which fund service providers are members,

h) interest representation bodies in which fund service providers are members.

3. Members of the Private Fund Council shall be elected from among Hungarian citizens with no prior criminal records, who have a higher education degree and a high-level of expertise in the field of pension systems, investment or insurance.

4. The President and vice-president of the Private Fund Council shall be appointed by the Minister of Finance from among the persons referred to in Paragraph c) of Subsection (2).

5. The members of the Private Fund Council, with the exception of the President and the vice-president, shall not be eligible for any remuneration for carrying out the tasks assigned to them. The operational conditions of the Private Fund Council shall be ensured by the Private Fund Supervisory Board.

6. The Private Fund Council shall

a) make recommendations concerning the activities of the funds and the Guarantee Fund, as well as concerning changes in their operational conditions, their roles in the money and capital markets, concerning experience with regard to the implementation of legal regulations related to the funds, concerning the bills and drafts of legal regulations related to the scope of responsibilities of the funds, the practice of consistent asset evaluation and performance assessment techniques of the funds, the regulations on investment diversification and concerning the minimum return requirements of the funds,

b) put forward proposals in the given field and in terms of ethical conduct, and shall publish these proposals in cooperation with the Private Fund Supervisory Board,

c) prepare, have others prepare, and publish professional publications related to the funds.

A-2. The case of Poland: Act on the Organisation and Operation of Pension Funds, passed on 28 August 1997 [fragments]

Chapter 21: Supervision of the Operation of Funds

Article 199

1. The Supervision Authority is established under this Act as a central public administration body.

2. The Supervision Authority shall be supervised by the President of the Council of Ministers.

Article 200

1. The task of the Supervision Authority shall be to protect the interests of Members of Funds and participants of the employee pension schemes.

2. The task of the Supervision Authority shall be carried out by:

- 1) supervising the operation of Funds;
- 2) inspiring, organising and enhancing the development of the pension fund system in Poland;
- 3) supervising the operation of employee pension schemes;
- 4) creating and developing public awareness of the purposes and operating principles of the Funds, with particular regard to rights vested in their Members;
- 5) creating and developing public awareness of the purposes and operating principles of employee pension schemes, with particular regard to rights vested in their participants;
- 6) co-operating with state administrative authorities, the National Bank of Poland, the Social Insurance Office (ZUS), Societies, entities providing services to Funds as well as employers' associations, trade unions and other social organisations, within the scope of developing state policy and aiming to ensure the secure development of Funds and employee pension schemes;
- 7) providing the National Bank of Poland with information necessary for carrying out supervision of banks acting as depository banks and banks which are shareholders in Societies;
- 8) providing the Securities and Stock Exchange Commission with information necessary for carrying out supervision over the operations of the National Depository;
- 9) undertaking other activities provided for in this Act.

Article 201

1. There shall be a president of the Supervision Authority who shall be appointed by the President of the Council of Ministers for five year terms.

2. The President of the Council of Ministers may remove the President of Supervision Authority before the end of his term of office, after obtaining the consent of the Supervision Authority Advisory Committee referred to in Article 211 par. 1, expressed in the form of a resolution passed by an absolute majority of votes in the presence of at least two-thirds of the Committee members.

3. There shall be Deputy Presidents of the Supervision Authority who shall be appointed and removed by the President of the Council of Ministers at the motion of the Supervision Authority President. Deputy Presidents of the Supervision Authority may also be removed on the independent initiative of the President of the Council of Ministers.

4. The amount of funds to be used as remuneration of the President, Vice-Presidents, Director General and employees of the Supervision Authority shall be determined each year in a Budgetary Law, in relation to the salaries paid in Universal Societies, including bonuses and other benefits.

5. The Council of Ministers shall by ordinance confer a charter upon the Supervision Authority which shall specify its organisation and tasks.

Article 202

1. Proceedings before the Supervision Authority shall be conducted in accordance with the Code of Administrative Procedure, unless otherwise provided herein.

2. A decision of the Supervision Authority may be appealed against in the Supreme Administrative Court.

3. A request for re-examination of a case by the Supervision Authority shall not impede the execution of the Supervision Authority's decision to cancel a permit for the establishment of a Society, if the permit is cancelled due to reasons other than those defined in Article 61.

Article 203

1. The expenses of the Supervision Authority shall be borne from the State Budget in an amount specified annually in the Budgetary Law.

2. Universal Societies shall be charged with monthly fees representing no more than 0.02% of the contributions paid in a given month to the Open Funds governed by those societies.

3. Employee Societies shall be charged with quarterly fees representing no more than 0.2% of the contributions paid in a given quarter to the Employee Funds governed by those societies.

4. The employers operating employee pension schemes shall be charged with quarterly fees representing no more than 0.1% of the contributions paid in a given quarter in favour of participants of employee pension schemes.

5. Half of the proceeds from the fees referred to in par. 2-4 charged by the Supervision Authority shall constitute revenue of the special purpose fund of the Supervision Authority which shall be allocated for improving the work of the Supervision Authority, upgrading the professional qualifications of its employees and for paying bonuses to the President, Vice-Presidents, Director General and employees of the Supervision Authority. The remaining part of the proceeds shall constitute revenue of the state budget.

6. The detailed manner of allocating the proceeds constituting revenue of the special purpose fund and the principles for granting bonuses to employees of the Supervision Authority shall be determined by the President of the Supervision Authority in by-laws approved by the Supervision Authority Advisory Committee.

7. The principles for granting bonuses to the President, Vice-presidents and Director General of the Supervision Authority shall be determined in the statute referred to in Article 201 par. 5.

8. The Council of Ministers shall issue an ordinance defining the amount of, and procedure and dates for, paying the fees referred to in par. 2-4.

Article 204

1. Within the scope of its supervision over the activities of the Funds, the Supervision Authority shall in particular have the following rights and powers:

1) to request from the Society copies of all documents relating to the activities of the Fund and to become acquainted with their content,

2) to request any information or interview any members of the Board of Management, the Supervisory Board or any Employees of the Society regarding the activities of the Fund.

2. A person authorised by the Supervision Authority President shall have the right to enter the premises of:

1) a Society - for the purpose of verifying whether the activities of the Society conform with the law and its statute;

2) a Depositary - for the purpose of verifying whether its activities relating to the keeping of the Fund Assets conform with the law and the agreement on keeping the Fund Assets;

3) an entity entrusted with the keeping of the register of the Fund Members - for the purpose of verifying whether its activities relating to the keeping of the register conform with the law.

3. The person who conducts the inspection is entitled to:

1) inspect any books, documents and other records,

2) request copies of such documents and records to be made and released,

3) request any information from members of the statutory governing bodies and employees of the inspected entities.

4. A Society is under an obligation to ensure that the person who conducts the inspection is given access to all the

books, documents and other records relating to the activities of the Fund which are kept by third parties entrusted with some of the activities under separate agreements.

5. The scope of inspection shall be specified in the authorisation issued by the Supervision Authority President.

6. After the person conducting the inspection prepares an inspection protocol, the Supervision Authority shall notify the inspected entity of any irregularities discovered and fix the deadline for amending them.

7. Where irregularities have not been rectified within a deadline the Supervision Authority may impose on the inspected entity a penalty of up to PLN 500,000. Where there have been gross irregularities the Supervision Authority may impose the penalty immediately on them being discovered.

Article 205

1. A Member may make a complaint to the Supervision Authority against a Fund if the Member believes that the Fund's activity is not complying with applicable laws or provisions of the Fund's Statute.

2. A complaint may also be made by a person who has been a Member of the Fund during the six months preceding the making of the complaint.

3. A complaint may also be made to the Supervision Authority on behalf of a group of Members by a social organisation whose scope of tasks does not include the conducting of commercial activity.

Article 206

1. The Supervision Authority may demand the convening of statutory meetings of the Supervisory Board or Board of Management or a General Meeting of a Society and include such matters in the agendas of such bodies, as it feels are necessary in order to exercise proper supervision over the Fund.

2. In the cases referred to in para. 1 above, the Supervision Authority shall delegate its representative to participate in the meeting of the Supervisory Board or the Board of Management, or in the General Meeting of Shareholders, and such a representative shall be entitled to speak at the meeting in all matters included in the agenda.

Article 207

In civil matters relating to the establishment and operation of Funds, the Supervision Authority President shall have the rights of the Public Prosecutor, ensuing from the relevant provisions of the Code of Civil Procedure.

Article 208

The Supervision Authority President shall submit annual reports of the Supervision Authority activities to the President of the Council of Ministers.

Article 209

1. The Supervision Authority President, its Vice-presidents, Director General and employees may not hold shares in or be members of the Board of Management or Supervisory Board of a Society, or be bound to a Society by an employment or service contract or a similar legal relationship. This prohibition relates also to service contracts or similar legal relations between a Fund and the above specified persons.

2. The provisions of par. 1 above do not prejudice the provisions on restricting the possibilities of conducting commercial activities by persons occupying public positions.

Article 210

The provisions of Article 49 shall apply as appropriate to the Supervision Authority President, its Vice-Presidents, Director General and employees and to the persons who are bound with the Supervision Authority by a service contract or a similar legal relationship.

Article 211

1. The Supervision Authority Advisory Committee is hereby established as an advisory and consulting body of the Supervision Authority in matters relating to the operation of Funds and employee pension schemes.

2. The tasks of the Supervision Authority Advisory Committee will be to:

- 1) express opinions on draft normative acts regarding the operation of Funds and employee pension schemes,
- 2) express opinions on the reports on the Supervision Authority activities prepared by the Supervision Authority President,
- 3) present to the Supervision Authority opinions in matters relating to the operation of Funds and employee pension schemes,
- 4) give consent to the removal of the Supervision Authority President,
- 5) approve the by-laws referred to in Article 203 para. 6.

Article 212

1. The Advisory Committee shall consist of 15 members.

2. Members of the Supervision Authority Advisory Committee, including its Chairman and Vice-Chairman, shall be appointed by the President of the Council of Ministers from among individuals having the necessary knowledge and experience of matters relating to the activities of the Supervision Authority.

3. At least 6 members of the Supervision Authority Advisory Committee shall be appointed by the President of the Council of Ministers from among candidates proposed by the Trilateral Commission for Social and Economic Affairs.

4. The term of office of the Supervision Authority Advisory Committee members shall be six years from the date of appointment, with one-third of the Committee members being replaced every two years. Members of the Supervi-

sion Authority Advisory Committee shall perform their duties until the time their successors are appointed.

5. The Chairman and Vice-Chairman of the Supervision Authority Advisory Committee shall be nominated for two-year terms.

6. The provisions of Article 49 shall apply as appropriate to the Members of the Supervision Authority Advisory Committee.

7. The Supervision Authority President shall issue an ordinance specifying the principles for remunerating Members of the Supervision Authority Advisory Committee and the amount of their remuneration.

Article 213

The operating costs of the Supervision Authority Advisory Committee shall be covered from the State Budget.

Article 214

The working procedures of the Supervision Authority Advisory Committee shall be included in the by-laws adopted by the Supervision Authority Advisory Committee and approved by the President of the Council of Ministers.

A-3. The case of Bulgaria: Supplementary Voluntary Pension Insurance Act, passed on 7 July 1999 [fragments]

Chapter Three: Supervision and Licensing

Article 30.

1. For the purposes of licensing and supervision of the pension insurance companies involved in supplementary social security activities, including pension, health and unemployment insurance, the State Insurance Supervision Agency shall be established under the Council of Ministers.

2. The State Insurance Supervision Agency, hereinafter referred to as the Agency, shall be a legal entity funded by the budget and with head office in Sofia.

Article 31.

1. The budget of the Agency shall be approved on annual basis by the Council of Ministers, acting on proposal of the chairman of the Agency.

2. The revenue of the budget under para 1 shall include amounts which the agency collects for:

- 1) fees for license issuance;
- 2) fees for approval of amendments to the statute of the pension insurance company;
- 3) fines and property sanctions under Chapter Thirteen.

3. The fees, fines and property sanctions as referred to in paragraph 2 shall be determined by an act of the Council of Ministers.

Article 32.

The Council of Ministers shall adopt regulations for the application of this law and the Rules of Operation regulating the structure and functions of the Agency.

Article 33.

1. The management of the Agency shall be performed by its Chairman.

2. The chairman of the agency shall meet the requirements under Article 19.

3. A Supplementary Social Insurance Council shall be established under the Agency.

4. The Supplementary Social Insurance Council shall consist of seven members: the Minister of Labour and Social Policy, the Minister of Health Care, the Minister of Finance, the Minister of Justice and Legal Eurointegration, the Minister of the Interior, the Chairman of the Security and Stock Exchange Commission, and the chairman of the Agency. A representative of the Association of Supplementary Pension Insurance Companies shall also participate in the work of the Council with a deliberative vote.

5. Chairman of the Supplementary Social Insurance Council shall be the Minister of Labor and Social Policy who shall convene the Council and chair its meetings.

6. The members of the Council shall not be compensated for their activity as such.

7. The Supplementary Social Insurance Council shall make decisions on:

1) issuance and suspension of supplementary social insurance license within two months following the submission of the proposal by the Agency;

2) permission for merging, joining, separation, and division of supplementary pension insurance companies after submission of a permission for merging or joining by the Competition Protection Commission, when its issuance is mandatory;

3) initiation of bankruptcy proceedings for a supplementary pension insurance company;

4) approval of the list of depository banks in co-ordination with the Bulgarian National Bank, in accordance with this law.

8. The Council of Ministers shall adopt rules for the activity of the Supplementary Social Insurance Council.

9. The Council of Ministers shall appoint the chairman of the Agency and shall determine the number of staff for the agency.

Article 34.

The chairman of the Agency may not hold another salaried office nor is he/she entitled to a remuneration pursuant to a private contract except in cases of research or lecturing activities.

Article 35.

The Agency shall:

1) Issue and suspend licenses for supplementary social insurance activities;

2) Supervise the activity of the supplementary social insurance companies;

3) Register the Articles of Association and the Rules of Operation of the supplementary social insurance companies and their amendments;

4) Issue mandatory instructions for the elimination of violations of the Law and regulations related to supplementary pension insurance as well as for changes required in the Rules of Operation of the pension insurance companies;

5) Develop regulations on supplementary social insurance;

6) Impose measures for the financial rehabilitation of supplementary social insurance companies;

7) Submit to the court proposals for termination and liquidation of the supplementary social insurance companies in case of circumstances stipulated in this Act or other laws and regulations;

8) Prohibit the conclusion of new insurance contracts for a certain period of time;

9) Approve the list of the depository banks in co-ordination with the Bulgarian National Bank;

10) Approve upon co-ordination with the Institute of Certified Public Accountants the list of certified public accountants that are entitled to audit supplementary social insurance companies and voluntary pension funds;

11) Approve the biometric tables that may be used by supplementary social insurance companies and voluntary pension funds;

12) Establish and maintain its own information system and a register of the supplementary social insurance companies and voluntary pension funds;

13) Issue a periodic bulletin and other publications related to the performed activities.

Article 36.

1. For performance of its activities the Agency shall be entitled to:

1) require information, explanations and reports;

2) assign its officials to attend the meetings of the bodies of the supplementary social insurance companies when issues put forward by the Agency shall be discussed;

3) perform inspections of the depository banks jointly with the Bulgarian National Bank concerning deposits of the supplementary social insurance companies and funds.

2. In the execution of its activities the Agency shall be obliged:

1) To study in detail each complaint submitted by an insured person in a supplementary social insurance fund;

2) To issue mandatory prescriptions in case of justified complaints to the supplementary social insurance company for the purpose of elimination of the respective violation;

3) In case of occurrence of justified suspicions for a criminal offense during the investigation, to notify the prosecutor's office;

4) To keep the confidentiality of the information of supplementary social insurance companies and depository banks.

3. When performing its supervisory functions the Agency and the persons authorised by it shall be liable for caused damages.

Article 37.

1. The authorised officials of the Agency when performing their official duties shall be entitled to free access to all business premises and to the documentation of the supplementary pension insurance companies and funds.

2. The Agency officials shall be obliged to keep the confidentiality of all information and data to which they have had access while performing their duties. Disclosure of such information shall only be done in the manner determined by the Agency.

Article 38.

1. The pension insurance company shall submit to the Agency a written application to obtain a license to engage in supplementary pension insurance activities, attaching the following documents:

1) A certified copy of the court decision on company registration;

2) The Articles of Association of the pension insurance company and all other documents related to the establishment of the company;

3) A bank certificate from the depository banks or a court decision for the fully deposited capital under Article 14, para 3;

4) Estimates for the activity of the pension insurance company and the voluntary pension fund for the first three years, including income and expenditure estimates;

5) Actuarial projections for all offered pension schemes;

6) The full name and passport number of the actuary;

7) Documents, including declarations, proving compliance with the provisions of Article 19;

8) A list of the shareholders being in possession, directly or through related persons, of over 10% of the shares, or who are in a position to exercise control over the pension insurance company;

9) Samples of the insurance contracts;

10) Rules of the pension insurance company;

11) A report according to an approved model with respect to persons having inscribed for 1 per cent and over 1 per cent of the capital.

2. All entities under para 1, item 11 shall submit written declarations according to an approved model with respect

to the origin of the funds used to make contributions against inscribed shares and to the effect that the funds have not been borrowed and concerning the taxes paid by them in the last 5 years.

3. The Regional Court for the head office of the pension insurance company shall enter in the Commercial Register the company with sole activity pension insurance after submission of a license issued by the Agency.

Article 39.

1. The Agency shall declare its position on the application for a license as referred to in Article 17 not later than three months after the submission of the documents as referred to in Article 38.

2. The Agency shall notify the applicant in writing about its decision not later than 7 days after making the decision.

3. The license is issued for an unlimited period of time.

4. The decision for license issuance shall come into force upon its issuance and shall be promulgated in the State Gazette.

Article 40.

1. The Agency shall refuse to issue a license in case of non-compliance with the provisions of the Law.

2. In the cases described in paragraph 1 the Agency shall notify the applicant and shall determine a certain period of time, not less than two months, to eliminate discrepancies.

3. If the applicant fails to eliminate the discrepancies within the time limit determined in paragraph 2, the Agency shall refuse to issue a license by a motivated decision.

4. In case of refusal, the applicant may reapply for a license not earlier than 6 months since the date of coming into effect of the decision for refusal.

Article 41.

1. The Agency shall suspend the issued license on the basis of a substantiated decision when:

1) the information and data submitted for the purpose of a license issuance are false;

2) the pension insurance company fails to make or delays payments under the insurance contracts;

3) the mandatory provisions of the Agency are not being complied with;

4) the interests of the persons insured in the voluntary pension fund are exposed to a real and immediate threat;

5) the persons insured in the voluntary pension fund are less than 10,000 after the first two years from the date of licensing.

2. The Agency may provide an additional period for the cases as referred to in para 1, item 5, but not longer than for 6 months.

Article 42.

1. After suspension of the pension license, the pension insurance company may not enter into new contracts for

voluntary pension insurance and amend the conditions, including the period and amount of the contributions under contracts already concluded.

2. The Agency shall notify the court of registration of the company regarding the license suspension in order to cause the termination and commencement of liquidation procedure of the pension insurance company and shall promulgate the notice in the State Gazette.

3. Upon suspension of the license the Agency shall appoint a questor to control the pension insurance company's activities until the moment of appointment of a liquidator.

4. Suspension of a license shall not relieve the pension insurance company from its obligations under signed contracts.

5. The pension insurance company shall dispose with its property and with the assets of the voluntary pension fund after a written consent of the questor.

Article 43.

The resolutions of the Agency shall be subject to appeal to the Supreme Administrative Court in accordance with the provisions of the Administrative Proceedings Act.

A-4. The case of Lithuania: Pension Funds Act, passed in May 1999 [fragments]

Article 41. State Supervision of the Operations of Pension Funds

1. State supervision of the operations of pension funds shall be carried out by the Securities Commission. In pursuit of implementation of this Law the Securities Commission shall be entitled to issue legal acts within its terms of reference.

2. When issuing permits for pension funds and exercising supervision over their operations the Securities Commission shall carry out the following functions:

1) draft, approve changes of and acknowledge as invalid the rules that regulate issuing of permits for pension funds, management enterprises and depositories; as well as the establishing, restructuring, operations, reorganisation and liquidation of the pension funds;

2) draft, approve, change and acknowledge as invalid the formats of periodical reports of pension funds to the pension scheme participants, and establish procedures of submitting and publication of said documents;

3) provide official explanations and recommendations on all the issues of the pension fund activities;

4) issue and revoke operation permits for the pension funds and their management enterprises and restrict their operations;

5) monitor, analyse, inspect and supervise in other ways the operations of pension funds and pension fund management bodies;

6) set the rules for managing pension accounts;

7) apply the sanctions stipulated in the Republic of Lithuania Administrative Code to the heads of pension funds, management enterprises, depositories and auditors of said enterprises for violations of this law and other legal acts;

8) apply sanctions provided for in this and other laws to the persons who violate this law and the rules and instructions approved by the Securities Commission;

9) organise and carry out the inspections of the management enterprises and depositories;

10) carry out other functions established by this Law.

3. During the inspection officials of the Securities Commission have a right to:

1) receive explanations from the persons under investigation in relation to violations;

2) temporarily (up to 30 days) take with them documents of the inspected pension funds, their management enterprises and depositories that may be used as evidence of violations. When taking documents they must leave the motivated resolution regarding taking the documents and the description of taken documents;

3) request to make copies of the accounting documents, agreements and other documents which are considered by the Securities Commission as important for the inspection:

4) freely enter the premises of the pension funds, their management enterprises, and depositories; check accounting books, documents and other information sources needed for the check, provided they produce the service certificate and the resolution of the Securities Commission or its chairman;

5) to receive the data, certificates and copies of the documents about financial operations related with the object of investigation, if they provide the motivated resolution of the Securities Commission or its chairman.

4. The Securities Commission shall be entitled to appeal in court against persons who impede the implementation of the rights of the Securities Commission provided for in part 3 of this Article which are necessary to investigate the violations of the law. These cases are investigated by the District Court of Vilnius. Upon receipt of the request by the Securities Commission, within 24 hours the court must analyse it and issue a resolution obligating the person to perform actions requested by the Commission, abstain from actions impeding the investigation, or from rejecting the request of the Securities Commission. The Securities Commission shall not be charged the stamp duty for submitting the corresponding request. In the event the term allotted for investigating the case expires on a day-off the term shall be counted starting with the first working day following the day-off. Upon receiving the request, the copy thereof shall not be sent to the applicant, and the request to the court to submit

its opinion on the request is not submitted. The applicant shall be notified on the course of the case investigation. The request may also be expressed verbally. Participation of third persons, their representatives and other interested persons in the court session is not obligatory, and summons to them shall not be sent. The verdict arrived at by the District Court of Vilnius shall not be appealed and is effected from the moment the decision is passed.

5. Instructions of the Securities Commission to the pension funds, management enterprises, depositories or their managers regarding elimination of violations of the laws and other legal acts shall be binding.

6. Employees of the Securities Commission must ensure confidentiality of all the commercial secrets of which they had become aware when performing their duties. Employees shall be held responsible in accordance with the laws for using information not for the targeted purposes, or for other illegitimate actions.

7. The Ministry of Social Security and Labour shall monitor the compliance of pension schemes with requirements stipulated in this Law, control payment of benefits, protection of the rights of pension scheme participants when modifying the programs, and supervise the compliance of the pension agreements with collective and employment agreements.

8. Supervisory institutions envisaged in this law may request to carry out their orders, and shall be entitled to inspect, control or carry out investigations in order to ensure that pension funds, management enterprises or depositories comply with this Law and other legal acts and regulations related to it.

9. The Securities Commission shall have the right, following the procedure laid down in the Law on Legal Protection of Personal Data, to get access to the data of persons who are or intend to become managers of pension funds, management enterprises or depositories in order to make sure that the reputation of these persons is impeccable and that they are entitled to take such positions.

10. Pension funds may appeal in court against the decisions of the supervisory institutions stipulated in this Law.

Article 42. Consequences of Violating the Law

1. Economic entities that had violated this Law must:

1) fulfill the orders of the Securities Commission to terminate operations, restore the original situation, terminate or change agreements, fulfill other commitments;

2) compensate the damage;

3) implement the sanctions imposed by the Securities Commission.

2. The Securities Commission shall be entitled to impose monetary fines on:

1) economic entities operating as pension funds without the permit, stipulated in part 1 of Article 5. The size of the

fine may be as high as double the amount of illegitimately received income;

2) economic entities operating as pension fund management enterprises without the permit stipulated in part 1 of Article 7. The size of the fine may be as high as double the size of illegitimately received income;

3) pension funds that enter into pension agreements within the scope of pension schemes not registered with the Securities Commission. The size of the fine may be as high as 100,000 Lit.

3. Application of the sanctions stipulated in part 2 of this Article should not release the managers of economic entities from the civil, administrative and criminal responsibility provided by law.

4. The decision of the Securities Commission regarding imposing administrative fines may be appealed against in court following procedures set out in the laws of the Republic of Lithuania. Decisions of the Securities Commission regarding application of sanctions stipulated in part 2 of this Article may be appealed against in court within one month. The appeal shall not suspend the implementation of the orders or resolutions of the Securities Commission to eliminate violations of the laws or other legal acts, unless the court states otherwise.

5. Fines shall be paid to the budget no later than within one month of the date of receipt of the resolution to impose the fine upon the pension fund, management enterprise, depository or their managers.

6. In the event that within the period stipulated in the 5 of this Article the economic entity fails to pay the imposed fine and does not provide to the Securities Commission the verdict of the court to suspend or terminate the resolution on the fine, the fine shall be exacted from the income of the economic entity without the need to bring a case.

7. Within one month from the date of receipt of the resolution of the Securities Commission the economic entities may appeal in court regarding revocation or amendment of the said resolution.

8. The court appeal shall not suspend the implementation of the orders and resolutions of the Securities Commission, unless the court advises otherwise.

A-5. The case of Estonia: Pension Funds Act, passed on 10 June 1998 (RT * I 1998, 61,979) [fragments]

Introductory remarks

The reform of the current pay-as-you-go pension system in Estonia, which started in 1997, is part of a wide programme of structural reforms. The goal of the reform is to create a new three-tier pension system by the year 2002 (Ministry of Finance, 1999).

The first pillar is the state pension, operating as a compulsory system, based on current financing from social security contributions (pay-as-you-go system). The second pillar, similar to the Hungarian and Polish models, is planned as the mandatory funded pension, managed by the private sector. Employees will make mandatory contributions of a defined sum into the pension funds created. The third pillar is a completely voluntary pension, administered either by life insurance companies with a special licence or managing companies (OECD 1999).

Pension funds, operating as voluntary institutions, exist in Estonia since 1992. However, they were only regularised from the legal point of view at a later date, by the Act regarding Voluntary Pension Funds. In order to stimulate voluntary savings for old age, the government introduced tax allowances for those who participate in such programmes. Employees are entitled to deduct voluntary contributions up to 15% of their income. Within this tier, insurance companies dominate, constituting more than 70% of the contracts.

The Pension Funds Act, which regulates the functioning of pension funds within the second pillar, came into effect 1 August 1998. This act functions under the Act on Investment Funds. In July of 1999, the government made the first decisions regarding the principles of implementing the second pillar. In March 1999, at the proposal of the Finance Ministry's licensing commission, the first licence for the management of pension fund was issued.

According to the Pension Funds Act, the role of the supervisory institution is assigned to the Ministry of Finance. In this regard, the case of Estonian pension reform resembles the model applied in Lithuania, where similarly a separate, independent supervisory institution has not been chosen.

Chapter 2

§ 5. Activity licence

1. Activity licences for the management of pension funds (hereinafter activity licences) are issued and revoked by a directive of the Minister of Finance. Upon refusal to issue an activity licence or revocation of a licence, the justification shall be indicated in the directive.

2. The committee provided for in subsection 19 (4) of the Investment Funds Act shall make proposals to the Minister of Finance regarding the issue and revocation of activity licences, the grant of the deadline specified in subsection 10 (2) of this Act, and the request for additional information from applicants pursuant to subsection 8 (2) of this Act.

3. Activity licences are issued for an unspecified term.

4. An activity licence is not transferable, and its acquisition or use by other persons is prohibited.

§ 6. Application for activity licence

1. An activity licence for management of a pension fund may only be applied for by a management company which, at the time of application, has been operating as a management company for at least eighteen months and which has managed a contractual investment fund during the last twelve months.

2. In order to apply for an activity licence, the management board of a management company shall submit the following documents and information to the Securities Inspectorate:

1) an application to obtain a pension management company activity licence and to register the pension fund rules;

2) the resolution of the general meeting on amendment of the articles of association;

3) an extract from the registry card of the commercial register;

4) the last approved annual report;

5) the balance sheet and income statement as at the end of the month prior to submission of the application if, upon submission of the application, more than seven months have passed since the end of the financial year;

6) an activity report which contains all material information and an analysis of the activities and development of the management company to date as at the last day of the month prior to submission of the application;

7) the last approved annual or half-yearly reports of the investment funds managed, and a statement of investments which is compiled as at the end of the last working day of the month prior to submission;

8) statements, which upon submission of the application shall not be more than ten days old, from the local Tax Board Office certifying the absence of tax arrears

of the management company and the legal persons specified in clause 13) of this subsection;

9) information on the members of the management board and supervisory board of the management company which sets out each member's given name and surname, personal identification code or date of birth in the absence of a personal identification code, residence, educational background, and a complete list of places of employment and positions held during the last five years;

10) the information specified in clause 9) of this subsection on other members of the management of the management company (managing director, chief accountant etc.) and the persons who conduct the internal audits;

11) information on the procurator and auditor of the management company which sets out the given name and surname, residence and personal identification code or date of birth in the absence of a personal identification code of each;

12) information on the shareholders of the management company which sets out the name, registry code, or personal identification code or date of birth in the absence of a

personal identification code, and the number of shares and votes of each shareholder;

13) information on shareholders who directly or indirectly or together with undertakings belonging to the same group of companies hold more than 10 per cent of the share capital or of the votes represented by shares of the management company; in the case of a legal person, the name, registry code, and annual accounts for the previous financial year, and the given names, surnames and personal identification codes or dates of birth in the absence of a personal identification code of the members of the management board or of the body substituting for the management board, and of the supervisory board upon the existence of a supervisory board; in the case of a natural person, the information specified in clause 9) of this subsection;

14) information on companies in which the holding of the management company, a member of its management board or supervisory board, the procurator, the fund manager specified in clause 17) of this subsection, or of the above-mentioned persons combined, is greater than 10 per cent; this information shall also include the amount of share capital, a list of the areas of activity and the percentage of holding of the above-mentioned persons;

15) the resolution to establish the pension fund;

16) a three-year business plan;

17) information on the fund manager of the pension fund which sets out the information specified in clause 9) of this subsection, and a detailed overview of the investment funds managed by him or her (including the value of the assets, the rate of return, the dynamics of the structure of investments, and a complete overview of precepts issued, of compliance with such precepts and of cases specified in §§ 45 and 49 of the Investment Funds Act);

18) the pension fund rules;

19) the pension fund prospectus;

20) a depositary contract specified in § 86 of the Investment Funds Act;

21) the annual accounts of the depositary for the previous financial year;

22) the given names, surnames and personal identification codes or dates of birth in the absence of a personal identification code of the members of the supervisory board and management board, and of the procurator and auditor of the depositary;

23) information on the shareholders of the depositary who hold more than 5 per cent of the votes represented by shares; the information shall set out the name, registry code, or personal identification code or date of birth in the absence of a personal identification code, and the number of shares and votes of each shareholder;

24) an overview of the activities of the depositary to date as a depositary for investment funds;

25) proof of payment of the state fee.

3. The report specified in clause (2) 6) of this section shall, among other matters, set out a description and analy-

sis of the following information:

1) the amount of share capital and shareholders' equity;

2) changes in the investment policy of the investment funds managed;

3) the market value, net asset value, rate of return of the assets and structure of investments of the investment funds managed;

4) the number of units which have been issued and the number of units which have been redeemed;

5) the number of unit-holders who are natural persons and their proportion in the investment funds managed by the applicant;

6) the amount of management fees, depositary's charges and other expenses incurred on behalf of the investment funds;

7) the management structure of the management company, the organisational and technical administration of its activities, and the rights, obligations and liability of persons involved in the management of investment funds.

4. The business plan specified in clause (2) 16) of this section (hereinafter business plan) shall set out a forecast and analysis of all the important economic indicators of the pension fund and the pension management company, and the rights, obligations and liability of persons involved in the management structure of the management company and in the management of the pension fund, and also a description, forecast and analysis of the following factors:

1) the number of units to be issued and the number of units to be redeemed;

2) the organisation of the issue of units;

3) the number of unit-holders;

4) the market value, net asset value and rate of return of the assets of the pension fund;

5) the investment policy and structure of investments of the pension fund (divided by different asset classes - shares, debt instruments, immovable property, etc.,

issued by issuers of different countries, by different sectors of the economy, etc.);

6) risks and rate of return by the different types of investment;

7) the share capital, balance sheet total and profit of the pension management company;

8) the rates for and amount of proceeds from management fees, depositary's charges, and the issue and redemption fees of units;

9) the amount and structure of the management expenses of the pension fund;

10) the development of the organisational structure and technical administration of the pension management company.

5. At the request of the Securities Inspectorate, a management company is required to submit more specific information and documents concerning information subject to submission.

6. The Minister of Finance may establish the procedure

for submission of the information specified in subsection (2) of this section.

7. If a management company fails to submit all the information and documents specified in subsection 2 if this section, or if the information or documents are incorrect, incomplete or incorrectly prepared, or do not comply with the requirements established by legislation, the Securities Inspectorate shall inform the applicant thereof in writing. The applicant shall eliminate the deficiencies within twenty calendar days after receipt of such notice.

§ 7. Refusal to issue activity licence

1. Issue of an activity licence shall be refused if:

1) the applicant for an activity licence fails to submit all the information and documents specified in § 6 of this Act, or such information or documents are incorrect, incomplete or incorrectly prepared, or do not comply with the requirements provided by legislation;

2) the applicant does not comply with the requirements established for pension management companies by legislation;

3) the applicant has violated provisions of legislation, the rules or articles of association of the investment fund, or the management contract specified in § 72 of the Investment Funds Act, or has provided misleading information to the public or violated good business practices in some other way;

4) the applicant does not have the necessary funds or experience to operate as a pension management company with success and continuity;

5) the persons specified in clauses 6 (2) 9), 10), 13) and 17) of this Act do not comply with the requirements provided by legislation;

6) the knowledge, skills, experience and other capabilities and characteristics of the persons referred to in clause 5) of this subsection are not adequate to ensure sufficient protection of the interests of the unit-holders of the pension fund;

7) the pension fund rules do not reflect all the essential rules of the operation of a pension fund in full, clearly and unambiguously, or contain provisions which are misleading or contradictory, or the pension fund rules do not ensure promotion of the best interests of the unit-holders of the pension fund;

8) the investment policy proposed in the rules and business plan of the pension fund does not ensure adequate risk-spreading, or the necessary reliability and sustainable growth of the assets of the pension fund;

9) the business plan submitted is incomplete, contains contradicting and inadequate information or assessments, or upon implementation would not be adequate to ensure protection of the interests of the unit-holders of the pension fund;

10) the depositary does not comply with the requirements established for depositaries of pension funds pursuant to law;

11) the depositary has violated provisions of Acts, other legislation, the rules or articles of association of the investment fund, or the depositary contract;

12) the depositary contract contains provisions which are contradictory, ambiguous, or which prevent the depositary or pension management company from performing their duties in full, or which for some other reason do not enable promotion of the best interests of the unit-holders of the pension fund;

13) the applicant or the persons specified in clause 5) of this subsection are not sufficiently reliable nor capable to the necessary extent of ensuring promotion of the interests of the unit-holders of the pension fund.

2. Among other matters, the following shall be considered upon assessment of the provisions of clause (1) 4) of this section:

1) the level of the organisational and technical administration of the activities of the applicant;

2) the professional qualifications and experience of persons engaged in the management of investment funds, and transparency of their rights, obligations and liability;

3) the value, rate of return and sustainability of growth of the assets of the investment funds managed by the applicant;

4) the number of unit-holders who are natural persons and their proportion in the investment funds managed by the applicant;

5) the level of risk-spreading, and experience in making different types of investments (shares, debt instruments, immovables, derivative instruments, issuers from different countries, different sectors of the economy).

§ 8. Decision to issue activity licence

1. The Minister of Finance shall decide to issue or refuse to issue an activity licence within ninety days after submission of an application and the information specified in subsection 6 (2) of this Act to the Securities Inspectorate by an applicant.

2. In order that a decision be made, the management company, depositary and Securities Inspectorate are required to submit additional documents and information at the request of the Minister of Finance. The Minister of Finance shall issue a directive to request additional documents and information.

3. The following shall be indicated on an activity licence:

1) the number of the activity licence;

2) the name and commercial registry code of the pension management company;

3) the area of activity permitted by the activity licence;

4) the date of issue of the activity licence;

5) the issuer of the activity licence.

4. An activity licence, a copy of the directive of the Minister of Finance to issue or refuse to issue the activity licence, and a copy of directives specified in subsection (2)

of this section and subsection 20 (3) of this Act shall be sent to the applicant within three working days after the issue of such directive.

§ 9. Termination of activity licence

An activity licence terminates:

- 1) upon expiry of the term of validity of the activity licence issued to a pension management company for the management of investment funds;
- 2) four months after issue of the activity licence if the management company has not commenced issue of the units of the pension fund;
- 3) upon transfer of the management of a pension fund, if as a result the pension management company no longer manages any pension funds;
- 4) upon revocation of the activity licence.

§ 10. Revocation of activity licence

1. An activity licence shall be revoked if:

- 1) it becomes evident that information submitted upon application for the activity licence which was of material importance in the decision to issue the activity licence is false; also in cases where false information has been submitted to the Minister of Finance or the Securities Inspectorate, or upon repeated failure to submit information on time;
- 2) the pension management company or the persons specified in clauses 6 (2) 9), 10), 13) and 17) of this Act do not comply with the requirements provided by legislation;
- 3) the pension management company has in the course of its activities violated provisions of legislation or the pension fund rules, or if the interests of the unit-holders of the pension fund have been harmed by the violation;
- 4) the pension management company provided materially incorrect or misleading information or advertising concerning its activities, the members of its directing bodies, or its shareholders to the public;
- 5) the pension management company has failed to implement a precept of the Securities Inspectorate for the specified term or to the extent prescribed;
- 6) the circumstances specified in clauses 7 (1) 3), 4), 6) or 13) of this Act become evident.

2. Prior to a decision to revoke an activity licence, the Minister of Finance, by a directive, may grant a pension

management company a term for elimination of deficiencies which are the basis for revocation.

3. A copy of the directive of the Minister of Finance by which an activity licence is revoked or the term specified in subsection (2) of this section is determined shall be promptly sent to the person specified in the directive and to the depositary of the pension fund managed by the person.

§ 20. Amendment of pension fund rules

1. The permission of the Minister of Finance is required for amendment of pension fund rules.

2. In addition to the provisions of subsection 36 (3) of the Investment Funds Act, a justification and analysis of the effects of the amendments on the further development of the pension fund and on the interests of the unit-holders of the pension fund, and the position of the management board of the depositary concerning the amendments to the pension fund rules, shall be submitted in order to amend pension fund rules. Upon entry into a new depositary contract, the information specified in clauses 6 (2) 21)-24) of this Act shall also be submitted.

3. The Minister of Finance shall decide to grant or refuse to grant the permission specified in subsection 1 of this section by issuing a directive within forty days after submission of a corresponding application and the prescribed information to the Securities Inspectorate by the applicant.

4. The permission specified in subsection (1) of this section shall be refused if the amendments to the pension fund rules would harm the interests of the unit-holders of the pension fund or if other circumstances specified in subsection 7 (1) of this Act become evident.

§ 38. Investment in deposits

1. Assets of a pension fund may only be invested in the deposits of credit institutions located in Estonia, the European Union or states entered on a list approved by the Minister of Finance.

2. The assets of a pension fund invested in the deposits of a credit institution shall total not more than 20 per cent of the market value of the assets of the pension fund.

3. The assets of a pension fund deposited in a single credit institution shall total not more than 5 per cent of the market value of the assets of the pension fund.

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