



INTERNATIONAL PENSION NEWSLETTER



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INTERNATIONAL TRENDS: EVALUATING THE CONSEQUENCES OF THE CRISIS ON PAYG PENSION PROVISION

Solidarity pension schemes are already under demographic pressure due to an ageing population. The PAYG system will also suffer from long - term effects of the present economic crisis: increased unemployment, stagnant tax income, straining state budgets... In a recent report commissioned by the European Commission on the consequences of the economic crisis on public finances, the pension aspect is covered in detail, concluding that while the crisis does create additional financing difficulties, population ageing remains a prime concern.

The most immediate reactions by many Governments is to bring forward plans to increase retirement age to relieve some of the financial pressure by increasing the contribution period and shortening the pay-out period.

European Commission report: "Long-Term Sustainability of Public Finances for a Recovering Economy"- Age-Related Costs to Dwarf Cost of Financial Crisis

The European Commission (which acts as the cabinet government of the EU) prepared this sustainability report and a communication for the EU Parliament, outlining public finance sustainability issues.

This October 2009 report is an update from the 2006 sustainability report requested by the Economic and Financial Affairs Council (The Economic and Financial Affairs Council - ECOFIN – is composed of the Economics and Finance Ministers of all 27 EU member states). ECOFIN asked the Commission to prepare a new sustainability report when the age-related expenditure projections became available in 2009. The report also takes into account the economic and financial crisis. In its communication to the EU Parliament based on the report, the Commission warns that "in the absence of ambitious efforts to implement structural reforms and consolidate government accounts there would be very large increases on debt interest and public pensions, as well as on health care and long-term care during the coming decades."

The report looks at the sustainability of public finances overall and points out that "the projected impact on public finances of ageing populations is anticipated to dwarf the effect of the crisis many times over".

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It says that fiscal sustainability is an acute challenge in most countries because the “fiscal costs of the crisis and of the projected demographic development compound each other.” It predicts “very large increases” in expenditures on debt interest and public pensions (as well as on health care and long-term care).

In the assessment made by the authors of the report, some countries cut out relatively well. For instance in Bulgaria, Denmark, Estonia and Sweden the increase in age-related expenditures is estimated to be below the EU average thanks to pension reforms that helped support their fiscal positions.

At the other end, the “sustainability gaps” of Ireland, Greece, Spain, Slovenia and the United Kingdom are above 12% of GDP - more than double the EU average. Those of Czech Republic, Cyprus, Latvia, Lithuania, Malta, the Netherlands, Slovakia are above 6% of GDP. In nearly all of these countries the sustainability gaps are the result of a very large projected increase in age-related expenditure, compounded in most cases by large initial imbalances.

As for recommendations to resolve the financing gaps, the report insists that the “main policy to ensure sustainability is through reform of pension and healthcare systems.”

In relation to pensions, several “reforming avenues are possible and have been implemented or are being contemplated by several countries.”

Pension reform measures:

- changes in the rules on the accumulation of pension rights
- establishing a better link between contributions paid during working life and pensions
- increasing statutory retirement age
- tightening eligibility requirements

The report underlines the wider impact of increasing retirement age. On top of savings to Government expenditure in a medium to long-term horizon, an increase in the statutory and effective retirement ages contributes to increase the working population and stem the deceleration in potential output. Moreover, the extension in working life and the respective accumulation of pension rights will have a favorable impact on pensioners’ income.”

The EU report also urges governments to use crises as “windows of opportunity” because by illustrating the need and urgency for structural reforms, they allow governments to make “decisive breakthroughs in structural reforms.”

Romania: Social Security Pensions Unsustainable

Romania may have to spend up to half of its state budget on pensions, if the system is not reformed, the Association for Privately Held Pensions (APAPR) warned, quoting the EU report. While Romania did introduce pension reform with a mandatory Pillar II and voluntary Pillar III, contributions are very low. Contributions in the mandatory private pension system are 2% of income which experts believe is too low to ensure adequate pension accumulation.

Denmark: Fund Participants Stops Believing in State Pensions

50% of younger working women (35-40 age group) do not believe that the state pension will exist when they retire,

according to a poll by PKA, one of the country’s largest pension administrators which surveyed about 1000 members. While one third of respondents believe that their pension will still be worth the same or more when they retire, pessimism was palpable: about 60% believe that it would be less, and the younger age group was particularly disillusioned. (IPE.com)

Mannheim Research Institute for the Economics of Ageing (MEA): “The Effect of the Financial Crisis on Pension Insurance, its Contributors and Pensioners”

The report studies the effect of the financial crisis on the German state pension system, its contributors and its pensioners. MEA is a mostly publicly funded research institute and part of the Faculty of Law and Economics, Department of Economics of Mannheim University. The mission of MEA is to “evaluate, anticipate and accompany the micro- and macroeconomic aspects of demographic change.” According to the MEA mission statement, “gradually accelerating demographic change is the background of [the institute’s] mission and belongs to the most important social developments of the next decades.”

The report observes that before the crisis the long-term financing of the state pension system was standing in the foreground due to population ageing. But the financial and economic crisis “has moved that focus to short- and mid-term financial stability of the state pension system and its ability to absorb situational shocks.” It also points out that none of the pension schemes (whether the state pension solidarity scheme or the funded schemes) can be immune to financial – and economic crisis. It concludes, however, that the critics of the funded schemes are wrong when they claim that the solidarity system is more crisis-resistant than the funded system that reacts to market variations.

Though the second and third pillars are affected by market values, the solidarity system suffers because the “crisis “reduces the [total] income base which is the foundation on which the first pillar is built”.

Other effects of the crisis are: “the spread of part-time employment, growing unemployment, the tendency of slower salary increase”. As a result, the end pensions will be lower due to lower “pensionable” income.

For the rest, this symmetry is not surprising, since the first, second and third pillars all rest in one way or another on the highly supplementary factors of work and capital. (http://www.mea.uni-mannheim.de/mea_neu/pages/files/polstudies/egiti5udjt0001rn_MEASTudy09.pdf)

Policy Effects: Retirement Age Increase

U.K. Conservatives Pledge to Raise Pension Age if Elected

The Conservative Party says it will increase the retirement age for men from 2016 to 66 years of age (and for women also, though not in the same time frame), if they are elected. At the moment men can claim their pension when they are 65, while women can claim at 60. Under current government plans the pension age for men and women will increase to 66 in 2026 and to 68 in 2046; retirement age for women is set to increase to 65 between 2010 and 2020. (Timesonline.com, IPE.com)



Netherlands: Government Goes Forward on Retirement Age Increase

Coalition parties have agreed on increasing state retirement age from 65 to 67 by 2025, a step they described in a statement as being “sensible and future-oriented” but are fiercely opposed by trade unions. “It is an important step in the process of modernizing the retirement system,” Dutch Prime Minister Jan-Peter Balkenende said. The Cabinet argues that the present system is under pressure due to worsening government finances and a growing lack of workers. Beginning 2010, all workers 55 years and older will have to work longer. A first increase to 66 will take place in 2020 to allow for workers to prepare for the change. From 2020, employees will still have the option to retire at 65 but will receive discounted benefits. The plan also addresses the issue of income for the unemployed who reach retirement age without finding a new job and whose unemployment benefits have run out. The plan agreed by the coalition is significantly watered down compared to the initial cabinet proposal to increase retirement age by one month over the next 24 years to 67. Workers’ unions had fiercely opposed the plan and the FNV, the country’s largest trade union confederation still opposes any raise in retirement age. (IPE.com, Reuters)

GOVERNMENT POLICIES:

U.K.: Pension Industry in Favor of Independent Pension Commission to Provide Long-Term Strategy

The British pensions publication Professional Pensions surveyed 14 well-known industry figures about which key reforms the next government should initiate in the pension sector, the mistakes it should avoid, and whether there should be an independent pensions commission. 10 out of 14 respondents said that the next government should establish a permanent independent pensions commission to recommend changes to pension legislation, provide long-term continuity over pensions policy and help form a consensus around long-term goals. In support for the need of such a commission, Pensions management Institute President Mike Sullivan said: “Pensions is a long-term issue that will not be adequately dealt within a five-year election cycle.” (globalpensions.com)

Hungary: International Loan Package Approved in Exchange for Reforms

On September 23, the World Bank announced its executive board had approved a one-billion-euro (US\$ 1.40 billion) loan to Hungary, as part of a 20-billion-euro international support package financed jointly by the International Monetary Fund, the European Commission, and the World Bank. The loan is aimed at helping Hungary weather the global economic and financial crisis by supporting the government’s fiscal reforms and financial stability programs”, the Bank said in a statement. Part of the money would go to supporting pension reform in order to improve the funding sustainability of the pension system and the payout design of the private pillar. (World Bank website)

China: Asian Development Bank Provides Grant to Establish a Rural Pension System

The Asian Development Bank (ADB), a bank that finances development projects in Asia, is providing a technical assistance grant of 500,000 U.S. dollars to the People’s

Republic of China to establish an effective pension system for peasants, reducing the inequalities between rural and urban older citizens. In China, 70% of the population lives in villages. The grant will be used to lay the groundwork for a government-run pilot rural pension scheme that will be carried out this year in 200 rural counties across the country, before being replicated elsewhere. The Chinese government will contribute an additional \$200,000 to develop this pilot scheme. “The PRC has well developed urban pension schemes, but most of those trialed in the rural sector have been largely unsuccessful as they lacked government fiscal support”, the ADB says in a press-release. “However, a new formula that combines a basic government-funded ‘subsistence’ pension with individual account contributions has shown signs of promise, and a variation on this model will be used for the pilot scheme”. China is targeting 100% participation in urban and rural pension systems by 2020. According to the ADB, the country has a well established urban system, but the rural schemes have lacked government support. (Asian Development Bank website)

Philippines: New Rules to Incite Pillar III Investments

The Philippines adopted new rules and regulations to implement the Personal Equity and Retirement Account (PERA), a framework for the investment of pension funds. Under PERA, individuals can make investment decisions regarding their pension account, with the hope to boost their retirement savings above the official state pension. Experts say that funds will flow into the domestic debt and stock markets. Under PERA, a maximum annual contribution to tax-free savings accounts of 100,000 pesos (17,000 UAH) per individual and double that amount for Filipinos working overseas. Contributions up to those limits will be granted a tax credit of 5%, and income from the investments will be tax-free. Investments in excess of the maximum contribution will not be allowed the tax credit, nor can investments cease or be withdrawn within a minimum 5-year period. Contributors will normally be allowed to tap their PERA funds when reaching the age of 55. Funds invested into PERA may be placed in a host of local financial instruments, including stocks, bonds and mutual funds. (nasdaq.com)

MARKETS:

Canada: Domestic Stock Market Rebound Good for Pension Funds

Canadian pension funds showed returns of 7.2% in the third quarter of this year, according to research from RBC Dexia investor services, a large investment fund. It was the second straight quarter of strong growth for pension plans spurring total returns over the year-to-date to amount 14.3%, according to the survey. (globalpensions, Reuters)

Macedonia: Country’s Budding Funds Show Modest Positive Returns

Macedonian two funds of the mandatory pensions system - the “Otvoren zadolžitelen penziski fond” (NLB) and the “KB Prv otvoren zadolžitelen penziski fond” (KBP) – have generated returns of 3.7% and 4.3% respectively over the first six months.

When setting up the mandatory system in 2005, the Macedonian government granted only two pension fund



licenses to operate in the first ten years. Since then, workers aged between 25 and 40 at the time of the system's inception have paid 6.65% of wages as pension insurance contributions into the private pension funds. Total assets in the mandatory pension sector at the end of July were MKD6.9bn (110 million euros). (IPE.com)

Romania: Pension Funds Show Solid Performance

According to the Romanian Pension Funds Association (APAPR), mandatory second pillar funds enjoyed an average return of 13.6% while voluntary third pillar funds delivered 12.97% in the first nine months. The mandatory pillar now has over 4.8 million participants while the third pillar amounts to 179,000 participants, but contributions remain low. "The system's only problem [is] the low level of contributions, mainly because of Romanian authorities' decision to freeze contributions directed towards the second pillar at 2% of gross participants' income," said Crinu Andanut, APAPR's Chairman. (IPE.com)

Estonia: Swedbank Promises Compensation for Pillar II Losses

Swedbank announced together with the Estonian regulator that in order to restore the trust in the pension system, the bank will compensate its pension fund clients the difference in net value of the shares of Private Debt Fund that emerged during the third quarter of this year. At the end of September, Swedbank devalued its Private Debt Fund, writing off 120 million kroons – about one fifth of its value, affecting the savings of more than 300,000 people, many of whom are mandatory pension fund investors. The funds held conservative portfolios with the lowest return on investments. Swedbank's Estonian asset management arm Swedbank Investeerismisfondid AS, may have breached its obligations to avoid and mitigate risk and had a conflict of interest the Estonian regulator announced. The regulator said that further steps would be determined after the company's response. Swedbank also said it will reduce fees and make less risky investments in its Estonian pension funds, which have 7.9 bn krooni (US748 million) under management. Participants were also allowed to change the pension fund receiving their mandatory contributions. (The Baltic Course, balticbusinessnews.com)

FUND STRATEGIES:

OECD: Pension Funds Should Be Measured by Long-Term Benchmarks

The Organization for Economic Co-Operation and Development (OECD) published a report in which they underline that private pension funds did not use long-term benchmarks to measure returns. Currently market instruments are focusing on short-term incomes. The findings reveal that private pension funds are treated in the same way as investments that are placed to generate the wealth.

The OECD/IOPS Global Forum on Private Pensions was held in Rio de Janeiro where the key goal was set as finding a proper balance between the role of the market and the role of government in improving the performance of pension funds and thus, reducing the risk of individuals' retirement.

The OECD stated that instead of nationalizing pension assets, governments were forcing reforms in the private pensions

sector. The final results of the project will be ready in December. (OECD, globalpensions.com)

Italy: Funds Drop Custodian over Conflict of Interest Issues

Two Italian pension funds - Previmoda and Byblos - decided to replace Monte dei Paschi di Siena (MPS) with Société Générale Securities Services (SGSS).

This happened after Intesa San Paolo's (ISP), one of Italy's largest banks, acquisition of the MPS's custodian business led to conflicts of interests in their manager line-ups. According to SGSS data, Previmoda allocated €350m (US\$511m) to SGSS in June, and Byblos - €300m in March. SGSS purchased UniCredit's securities services business 3 years ago and is maintaining strong position in the Italian market. It now looks as if Intesa is looking to sell its custodian unit. (IPE.com, Wall Street Journal)

Turkey: Conservative Funds May Be Tempted by Diversification

The Turkish regulator announced that Turkey's pension funds will be allowed to widen their scope of allocation classes, in order to increase diversification and potential returns. New investment vehicles will be private equity and real estate funds. At present, Turkish pension insurance companies are conservative. For example, in August Turkish government bonds made up 69.51% of an average portfolio. The rest were allocated as follows: equities (10.37% of assets), alongside reverse repos (14.61%), overseas equities (0.39%), money market investments (0.01%) and other investments (5.11%). In 2008 the asset volume of Turkish asset funds grew by 41%, meanwhile total returns were 9.5%. Assets are expected to increase in 2009 as well.

Head of Department at the Prime Minister's Directorate of Insurance, Selamet Yazici, said that private pensions are not very popular in Turkey as the system is quite new – it was launched 6 years ago. The Turkish Treasury intends to increase the private pension assets to GDP ratio from 1.7% to up to 10% during the next 15 years. For comparison, in Italy this ratio is 3.4%, in Mexico – 10.4% and in Portugal the figure is 12.2%. The Turkish private pensions system includes 12 companies that manage TRY8.5bn (3.93 euro) for 1.93 million contributing members. By the end of the year the regulator expects to have 2 million participants and TRY9bn in assets and the goal is 6 million participants in 2023. (IPE.com)

Germany: Employer Lobbyist Says Lifeboat Levy Should Be Risk-Based

At present all companies in Germany with non-insurance based pension plans have to pay into the German pension insolvency lifeboat called Pensionssicherungsverein (PSV). It calculates levies according to the sum needed to cover insolvencies during a 12 months period. The German Federation of Employer Representatives (BDA) insists on switching to a risk-based levy because they believe that this will reduce contributions in the long-run. The German Occupational Retirement Federation argues against the risk based levy because it says it is very difficult to evaluate investments when it comes to risk of insolvencies. The metal worker union IG Metall fears that this scheme might burden small companies more. However, BDA representative Alexander Gunkel argued



that small companies would actually pay less to the PSV and also suggested that a risk-based levy would eliminate defects in the choice of pension instruments. (IPE.com)

GRAPH AND NEWS:

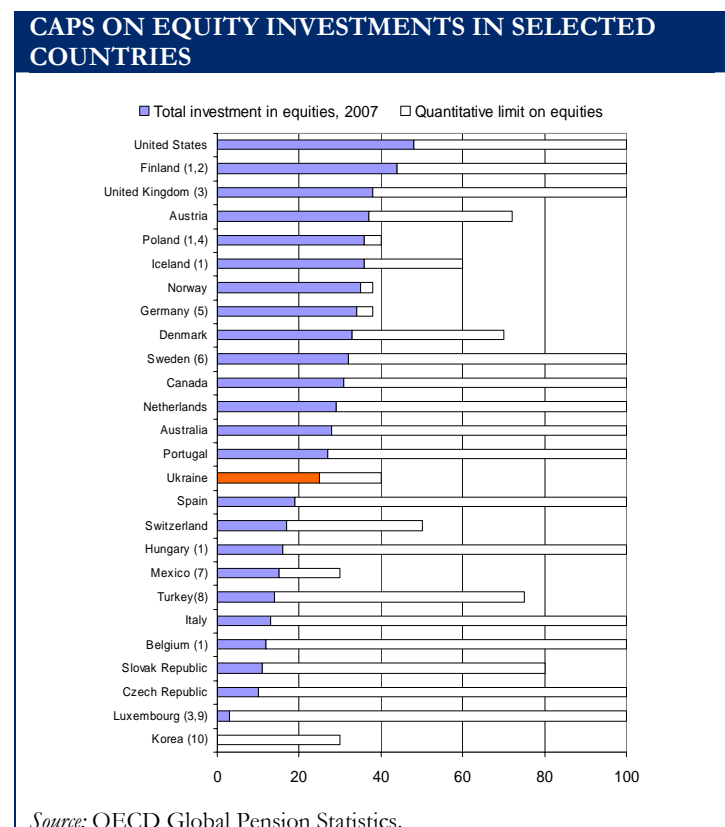
QUANTITATIVE STATUTORY LIMITS ON ASSET CLASSES

Having crushed more or less realistic hopes of high returns on investment and having possibly compromised the capacity of pension schemes to meet the actuarial expectations to cover future liabilities, the financial crisis has given new momentum to the issue of diversification and asset class allocation. Many funds, and also governments, are pondering where the best balance lies between low-risk/low return investments and higher risk and possibly higher return investments.

On a policy level such concerns are met by the introduction of life-cycle funds as in Poland for instance to allow for a wider choice of portfolios according to age/risk, lifting quantitative limits on some asset classes (mostly foreign securities and equity), or, on the contrary by restricting certain investments (see below).

According to a July report by the OECD on “Investment Regulations and Defined Contribution Pensions”, the limits that are set in certain asset are usually set at high levels and, with few exceptions, there is a little evidence that they are binding.” In other words, in most countries it appears that these limits are not restricting investment since actual investment in these classes is significantly lower than the limit. The graph below shows that only Poland and Norway appear to be investing close to the statutory ceiling.

Graph: Caps on Equity Investments in Selected Countries



Notes: (1) Investment limit refers to listed equities; (2) Investment limit refers to statutory pension plans; (3) Data

refer to the year 2006; (4) Investment limit refers to mandatory personal pension plans; (5) Investment limit refers to Pensionskassen (pension institutions); equity investments are probably overstated due to the inclusion of investments in mutual funds that should be broken down and reallocated both to equity and bond investments; (6) Pension foundations are not subject to uniform investment rules and are not, therefore, covered here; (7) Investment limit refers to Basic Fund; (8) Data only refer to personal pension plans; (9) Investment limit refers to ASSEP -Association d'epargne-pension (pension savings association) and SEPCAV - Society d'epange-pension a capital variable (pension savings company with variable capital); and (10) Investment limit refers to corporate DB plans.

Hungary: Government Plans to Cap Investments in Foreign Assets Criticized by Funds

The Government is limiting investments in foreign assets for pensions funds in a move aimed at limiting foreign exposure risk. Beginning January 2010, mandatory pension plans will have to cap their exposure to foreign investments at 45% in the riskiest portfolios of the lifecycle model, and for the two remaining more conservative lifecycle strategy portfolios at 20% and 5%, respectively. The lifecycle model with different risk profiles depending on age was introduced this year, and offers a maximum cap on equity investments at 40% for the riskiest model. However, private pension funds fear that such limitations will play out negatively for pension savings. Csaba Nagy, chief executive of the OTP Private Pension Fund says that the domestic stock market is too small and does not allow sufficient diversification possibilities for pension funds to be limited to it. (IPE.com)

Iceland: Government to Lift Crisis-Spurred Capital Restraints

After Iceland's financial system crashed last year, the government introduced strict capital controls to avoid any further instability of the domestic currency and the economy. These controls included a ban for pensions funds investing in any more foreign currency denominated assets. Lifting these restrictions depended on the progress made by the Icelandic financial, budget, and economic systems. According to the Icelandic Central Bank, progress has been made in reducing the perceived risk of investments in Icelandic assets, a key component in stabilizing the system and eventually lifting the limitations. A number of steps were adopted to fulfill these pre-requirements such as the adoption of a medium-term fiscal plan, progress in the bank recapitalization process, the signing of loan agreements with Nordic countries, and a stability pact between local economic and social partners. The Government is also encouraging the development of a private equity fund scheme, the Icelandic Investment Fund (IIF) so funds may invest in business that have suffered in the economic crisis. (IPE.com)

Brazil: Limits on Equity Investments Eased

The Government now allows closed corporate pension funds more investment freedom, lifting caps on investments and giving easier access to international investments. The ceiling on domestic equity investments was raised from 50% to 60%, and the allocation to investments abroad is now at 10%, while previously access was restricted to multi-strategy funds. As part



of the new regulation introduced by Brazil's National Monetary Council which formulates monetary policies for the domestic Central Bank, pension funds will also be able to put up to 20% in structured funds that invest in areas such as infrastructure or real estate, up to 10% in international funds approved by the securities regulator or that trade on the Sao Paulo exchange, and, 8% in real estate, the country's pension fund secretary Ricardo Pena said, quoted by Bloomberg. "Pension funds have too much of a stake in the debt -- approximately 15 percent of the public debt," Pena said. "Funds will have to search out other investments. They'll have to take more risk." According to PiOnline, the changes were made to allow funds a chance to increase their returns.

Traditionally, pension funds have invested heavily (two-thirds of their allocation) in safe but low-return investments but now compromised due low returns on government bonds. These inflation-linked securities have quite systematically brought yields that exceeded actuarial estimates of how much was needed to meet liabilities. Currently, government bond portfolios are still returning about 6.2% points in excess of inflation, just meeting the actuarial liability estimates. However, these results are being eroded by falling interest rates and returns are expected to diminish. While funds are expected to reallocate towards equity, experts say most are still far from reaching even the initial ceiling of 50% in equity. Larger funds are therefore expected to seize the opportunity of investing abroad relatively soon, while mid-size funds will be shifting allocation more slowly. (Bloomberg.com, dowjones.com, pionline.com)

ANALYSIS OF THE MONTH: ASSESSING PENSION SYSTEMS THROUGHOUT THE WORLD

Global: Melbourne Mercer Global Pension Index Awards No Perfect Grades

Mercer investment analysts compared eleven leading pension systems in respect of adequacy of benefits, long-term sustainability, and the integrity of the private sector component. Calculated on the basis of 40 indicators, none of the systems earned an "A-grade" (or an index value above 80%). The retirement systems of the Netherlands, Australia, Sweden, and Canada were awarded a B grade, meaning that their systems have "a sound structure, but has areas needing improvement." The UK, USA, Chile and Singapore received an average C-grade. According to Mercer's report this means the systems have some good features but also show shortcomings that need to be addressed to ensure long-term sustainability. Germany, China and Chile ranked lowest revealing "major weaknesses" that can compromise sustainability, unless addressed. No system received an F-grade.

The assessment was divided into three sub-categories, measuring adequacy, sustainability, and integrity. The scope of results varied most with regards to integrity. Australia, the UK, the Netherlands, and Chile earned an above 80 score for integrity, reflecting their pension funds' good disclosure and communication standards. China and Germany on the other hand received an F grade in integrity (below 35). Factors included in the study ranged from those pertaining directly to the pension system (like the level of mandatory contributions

into a pension scheme) to those reflecting the general savings culture (net household savings rate).

OECD: New Methodology and Guidelines for Assessing OECD Principles of Pension Regulation

The OECD has developed a methodology in order to assess more efficiently how well countries are implementing its principles that guide the regulation of privately managed occupational pension systems but can also be used to evaluate personal private pension plans. The methodology is intended as the primary tool to examine the private pension systems of countries that are looking to join the OECD. It is based on an analysis of seven "core principles" that are described in detail in order to establish concrete guidelines.

Core principle #3 for instance concerns pension plan liabilities, funding rules and winding up plans; guidelines indicate that occupational pension plans should be funded (and not defined benefit) through pension funds. Core principle #4 on asset management lays out rules on disclosure, but also allocation limits and investments abroad. Other 'core principles' include rules for establishing a pension fund, liabilities, rights of members and adequacy of benefits, on governance, on supervision. (OECD website)

This newsletter is prepared by the Capital Markets Project pension and communication team as part of the project's pension reform program. The project is funded by the U.S. Agency for International Development (USAID).

The USAID Capital Markets Project (CMP) was launched in October 2005, and is a five-year program designed to assist the country in developing a vibrant and effective financial sector. This effort will promote sustained economic growth and reduce the costs and risks to a sound pension system. You can find out more on the CMP website www.capitalmarkets.kiev.ua or on the website about pension reform in Ukraine: www.pension.kiev.ua

USAID's assistance focuses on the following areas: Economic Growth, Democracy and Governance, Health and Social Sector. Since 1992, USAID has provided \$1.6 billion worth of technical and humanitarian assistance to Ukraine to further the processes of democratic development, economic restructuring and social sector reform in the region. For additional information about this and other USAID programs in Ukraine, please call USAID's Development Outreach and Communication Office, tel. (044) 492-7101 or visit the USAID website at: <http://ukraine.usaid.gov>.