

KEY ISSUES RELATED TO THE OPERATIONS OF NON-STATE PENSION FUNDS

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In the four years since the launch of the Pillar III voluntary pension provision system level, the number of non-State pension funds (hereinafter referred to as NPF) has grown to about 100. The question whether or not to participate in NPFs is voluntary and at the discretion of individuals and employers, but for them to make an informed decision, both individuals and employers need to be aware of the NPF types and special features of their operations.

What is a non-State pension fund (NPF)?

NPF is a financial institution established for the purpose of accumulating pension contributions for additional non-State pension entitlements and NPF pension benefit payouts.

NPF participants are individuals for the benefit of whom pension contributions are paid to NPF, whereas *contributors* are persons that pay such contributions to NPF (the participants himself, or his employer, or his professional association, or a member of his family).

NPF are created, operate, and are liquidated in conformity with the Law of Ukraine "On Non-State Pension Provision". NPFs have the status of a not-for-profit organization, that is, their purpose is not to turn a profit for its subsequent distribution among the NPF founders. All the investment income received by an NPF is only distributed among its participants.

Pension contributions become the property of an NPF participant once they are recorded into the participants' account at the NPF, whether the contributions have been paid by the participant, his employer or next of kin. Pension assets cannot be withdrawn from an NPF by other persons or redistributed among other participants of the relevant NPF. An NPF participant is entitled to disposing of his/her pension assets in accordance with the law, that is, during the accumulation period, namely, move to another NPF and, under certain conditions, to get access to as a lumpsum payment. Pension assets of a participant can be inherited by his/her heirs.

NPF cannot go bankrupt or be liquidated under the bankruptcy legislation. The NPF liquidation may be performed in accordance with a special procedure under the control of the State Commission on the Regulation of Financial Services Markets of Ukraine. Under this procedure, pension assets of participants of the NPF in question are transferred, upon the participants' choice, to other NPFs, insurance organizations or banking institutions providing private pension provision services.

NPF Types

Depending on the composition of their founders and participants, NPFs may be of three types: corporate, occupational, and open. Employers-contributors may join an existing corporate fund by signing a participation agreement with the board of the corporate fund, which is simpler and faster than to create a new fund.

Companies planning to form a corporate pension fund (or to become employer-contributors) are required to have operated without losses for at least 12 months prior to forming an NPF (or prior to joining an existing NPF). The financial sustainability requirement is related to the employer's obligation to pay contributions to a corporate NPF on behalf of all its employees.

In return, it only founders of a corporate NPF that are permitted to invest the assets of their fund into their operations, - it allowed to invest into securities of such followers up to 5% the NPF assets (up to 10% for the first five years after the creation of the NPF), provided they comply with the legislation requirements.

Other companies (in particular, contributors to a corporate, occupational or open NPF) are permitted to invest up to 5% of pension assets of a relevant NPF in securities of a single issuer, provided they comply with the legislation requirements.

Participants of a corporate NPF can be only employees of those companies that are employers-founders of contributors to such a fund. Therefore, in the event of such an employer ceasing to be a founder or terminating the participation agreement with a corporate NPF, or in the event of terminating an employee, such a participant of a corporate NPF is to terminate its participation and transfer its accumulated assets to another NPF.

Contributors to a corporate NPF can also be employees of employer-founders and contributors.

Occupational NPFs can form associations of legal entities-employers, associations of natural persons, including trade unions or natural persons related by their professional activity (activities).

Participants of an occupational NPF can only be natural persons, indicators of whose professional activities coincide with the characteristics specified in the NPF charter (for instance, employees of the steel making

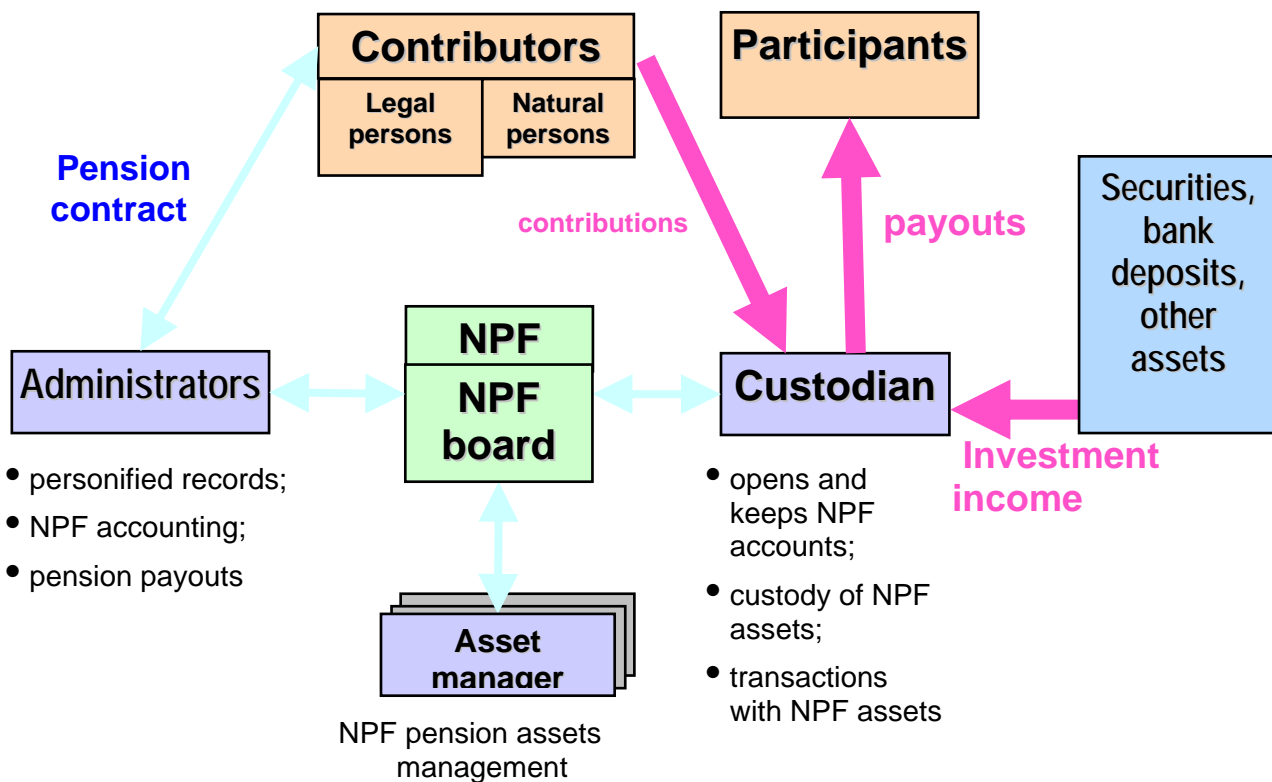
industry). An advantage for participants of an occupational NPF is that they may continue the status of the occupational NPF participants when changing jobs, as long as they remain in the same industry, without changing their occupation.

Contributors to an occupational NPF can be professional associations, employers and natural persons as specified in the charter of such NPFs.

Open NPFs may be formed by any legal entities, irrespective of the profitability of enterprises. Open NPFs shall not be founded by legal entities whose operations are funded by the State or local budgets.

How does an NPF operate?

The principal approaches to the operations of an NPF are indicated in the following drawing:



Participants of an open NPF can be any natural persons, irrespective of the place of their residence or the nature of their work. They can continue to be participants even in the event contributions in their favor are no longer forthcoming.

Contributors to an open NPF can be participants themselves, their spouses, children, parents or employers.

A legal entity may form only one corporate or one occupational NPF. This legal entity may not be a founder of one or more open NPFs.

The governing body of an NPF is the NPF board overseeing the current operations of the NPF and approving decisions on the principal matters of its operations (in particular, it approves the NPF investment declaration). The NPF board is composed of at least five persons appointed by the founders and also, in the event of a corporate NPF, by employer-payers; thus, the board has an impact on the NPF operations and investment policy. The Board reports to the NPF founders meeting, which is the NPF supreme governing body, or to the founder, if the NPF has just one founder.

For performing its functions, an NPF makes use of other legal entities, - the administrator, the asset managing company (AMC), and the custodian. The NPF board

selects such companies, enters into service agreements with them, and controls their operations.

Contributors transfer pension contributions to an NPF account opened at the custodian. The NPF administrator keeps records of the amount contributed and of the investment income on individual pension accounts of the NPF participants. The AMC increases the funds contributed by investing them in shares, bonds and other investment products. However, the AMC has no direct access to pension assets. All operations with pension assets are performed via the custodian, which, having verified compliance with the investment declaration requirements, transfers the money to purchase various financial instruments.

The investment income, less the administrative expense for NPF servicing, is distributed among the NPF participants and recorded in the individual pension account of each participant. The investment income obtained this way is then re-invested, so that the NPF assets grow as a result, based on the compound interest principle.

This structure of NPFs has been envisaged for the purpose of preventing any loss of pension savings and for the sake of ensuring 'transparency' of the operations of NPFs. An NPF is legally separated from the founders, employer-payers, and service providers. Hence, even in the event of a bankruptcy or liquidation of anyone of such service providers, including the custodian, pension assets will not be lost.

The operations of entities involved in non-State pension provisioning are controlled by the State Commission on the Regulation of Financial Services Markets of Ukraine and by the National Bank of Ukraine. In addition, NPF participants may control the effectiveness of the NPF operations, too, analyzing the information on the status of their pension savings (including the information on the investment income); if they are not satisfied with the operating results of an NPF, its participants may transfer their assets to another NPF.

How does one become an NPF contributor?

In the event of an owner of an enterprise or a body authorized by the owner approving a decision to pay contributions to an NPF in favor of its employees, the employer turns to the NPF administrator, selects a *pension scheme* from among those offered by the NPF, and enters into an agreement with the NPF called a *pension contract*. A pension scheme selected at the NPF can be changed, but no more frequently than once every six months.

Pension schemes at corporate and occupational NPFs are to be agreed with representatives of work collectives of the relevant legal persons-employers, so as to amend the collective agreement accordingly.

Pension Scheme

A pension scheme is an NPF document that determines the terms of the non-State pension provisioning of the NPF participants, including the amount of contributions and the pension benefits that can be drawn from the NPF.

An NPF may use one or more pension schemes, for example: separately for contributors-legal persons and contributors-natural persons; depending on the periodicity of paying pension contributions (monthly, quarterly, annually etc.).

All Ukrainian NPFs may use pension plans with defined contributions, under which the amount of contributions is defined by an agreement, but neither the full amount of a future pension nor a certain percentage of income in contributions are promised. The income on all pension

schemes of a specific NPF is the same, as determined by the results of investing the pension assets.

However, an agreement of the NPF with its administrator may specify that the income should not be less than the official inflation rate for the purpose of protecting pension assets against devaluation.

The employer's obligations are terminated at the completion of contributions payment, so employers will not have to fund additionally the future pensions of its employees if, for instance, the relevant NPF records a low investment income.

Pension contributions

Pension contributions are paid to NPFs by the method and in the amount specified in the pension contract. NPFs can take into account varying financial situations of contributors, since it is possible to alter the amount and periodicity of contributions in keeping with the terms of the pension schemes selected and, under certain conditions, suspend payment of contributions temporarily or completely.

The minimal amount of pension contributions can be established by an NPF board at no more than 10% of the minimal wages per month (this amount is UAH 46 since 1 October 2007). The maximal amount of contributions is not limited, but, as a rule, it does not exceed the limit of tax benefits. For example, an enterprise that pays pension contributions for a private pension of an employee may account such contributions as gross expense in the amount of up to 15% of the annual salary an employee, but not in excess of the maximal amount of the additional social benefit, which is the total amount of the sustenance level for able bodied individuals multiplied by 1.4 (which is UAH 740 in 2007). Besides, pension contributions are not included in the payroll, which means they are not subject to the mandatory social deductions.

In addition to the employer, employees may also pay contributions at their own cost voluntarily to an NPF of any type. So as to encourage them to do so, it is worth organizing the payment of such contributions through the enterprise's accounting department; if so, it would be good to indicate separately in the salary printouts the amount of contributions paid by the enterprise and by the employee. Employees are eligible for individual income benefits within the limits indicated above.

Employers-founders and payers are obligated to pay contributions to a **corporate NPF** in favor of all of their employees. They may suspend paying contributions temporarily for up to 12 months. The amount of employer contributions to a corporate NPF is established in percent of the employees' total salary and can be defined as:

- an equal percent in favor of all the employees; or

- percent differentiated on the basis of a progressive scale depending on:
 - 1) the age;
 - 2) the duration of the employer's work record at the enterprise;
 - 3) the age and work record simultaneously (i.e., a combination of the first two options);
- and an equal percent of salary deductions is established for each of the employee group established by the employer.

However, the rate of contributions to a corporate NPF cannot depend upon the position of employees or upon any other criteria.

The above methods of the establishment of the amount of contributions will not result in equal pensions, since the amounts of contributions are calculated on the basis of the total salary of each employee, rather than the total payroll of the enterprise. Employers may improve the efficiency of their personnel policy through differentiating the approach to determining the contribution amount. For example, it is worth differentiating the amount of contributions to an NPF depending on the work record so as to encourage qualified personnel to stay in their job longer term (see the Table below).

Table

An example of setting the amount of contributions to a corporate NPF based on the work record of employees at a given enterprise.

Work record at the enterprise	Pension contributions as % of the employee's salary
1-5 years	3
6-15 years	6
16-20 years	10
21 + years	15

It is not mandatory for employers to pay contributions to **an occupational NPF**, but if they decide to do so, similar principles apply as those of a corporate NPF.

The amount of pension contributions to a corporate or an occupational NPF at the cost of their founders or employer-payers may be specified in a collective agreement.

If participating in **an open NPF**, employers may decide on their own which employees to contribute for, in what amount, when to start and when to stop paying contributions.

Pension payouts

One may draw an additional non-State pension in addition to the State pension. The amount of a pension benefit drawn from an NPF does not depend on the work record, unlike the amount of State pensions; instead, it depends on the total amount of an employee's contributions accumulated at the NPF.

Pension savings of an NPF participant are equal to the pension contributions and the investment income less the administrative cost of the NPF services. The lower the administrative cost, the more the accumulated amount of savings. However, in any case, the cost of services of service providers cannot exceed the maximum amount established.

The share of the investment income to be added to the amount of contributions depends to a significant degree upon the duration of participation in an NPF, i.e., the earlier one becomes an NPF participant, the more pension assets can one accumulate. And one can pay relatively small contributions to an NPF periodically.

NPFs may pay out pensions for a certain period, as well as lumpsum payouts in specific situations. Besides, having reached the retirement age, a participant may transfer his pension assets from an NPF to an insurance organization and draw a life annuity.

An NPF participant determines his age of retirement and the period of drawing pension benefits. The pension age may be lower or higher than the general retirement age for the State pension, but this difference cannot exceed 10 years; in other words, it is 45-65 years for women and 50-70 years for men.

The duration of paying certain period pension benefits may be 10 years or longer, the total amount of accumulated pension assets being distributed over the whole of this period when calculating the pension benefit payouts.