

# Regulating Voluntary Private Pension: The Case of Turkey's DC Schemes

by

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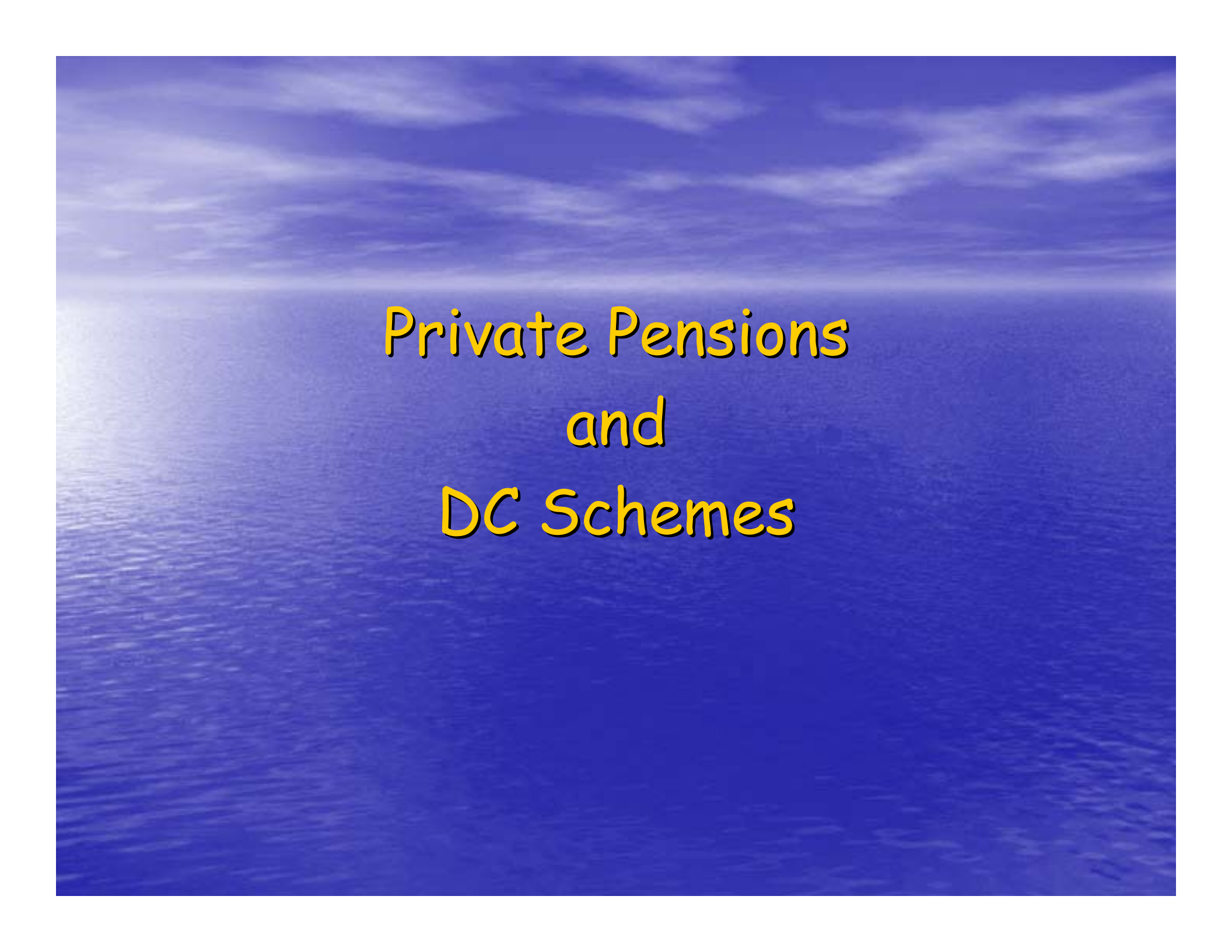
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# Agenda

- Private Pensions and DC Schemes
- Turkish Private Pension System  
(Why we introduced?)
- Basic Characteristics of Private Pension System
- Structure of Supervision
- Basic Indicators



# Private Pensions and DC Schemes

# Trends and Developments in Pensions

- Ageing population
- Increasing Pension Liabilities for Government
- PAYG to Individual Accounts
- Unfunded to Fully Funded
- Defined Benefit to Defined Contribution
- State-Run to Private Pensions
- More focus on
  - Specialisation
  - Asset management
  - Individual Choices
  - Design of System

# Advantages of DC Schemes

- Actuarial balance between benefits and contributions
- No hidden or contingent liabilities for government
- Flexibility in product design
- Allows individuals' risk and return preferences
- Individual responsibility and sense of ownership
- Mobility of vested rights
- Private and professional management of funds
- Higher rate of real return than state-run pension systems
- Labor incentive to work and save
- Additional financial resources promote marginal savings

# Disadvantages of DC Schemes

- No redistribution of income
- Investment and mortality risks on individuals
- High volatility in level of retirement benefits
- High administrative cost in individual accounts
- Reduced share of income available to social security system
- Need for well-functioning financial markets
- Need for detailed regulations and effective supervision

# Key Issues in Voluntary Private Pensions

- Setting up and Licensing the Service Providers
- Product Design and Coverage
- Charges and Expenses
- Marketing cost
- Qualifications for Intermediaries
- Collection of Contributions
- Choices for Individuals
- Asset Management

## Key Issues in Voluntary Private Pensions contd.

- Record Keeping
- Regulatory Compliances and Communication
- Distribution of Benefits
- Actuarial and Other Professional Services
- Supervision and Monitoring

# Key Issues in Regulating Private Pensions

- Which financial institutions provide service?
- Requirements for licencing/no of providers
- Level of comlexity of products and funds
- Scale economies
- Level of charges and expenses
- Level of outsourcing
- Level of individual rights and choices
- Level of centralisation in collection of contributions and recordig keeping
- Degree of regulation
- On-site vs. Off-site supervision
- Linkage to state-run pension system

# Structure of the Market before introducing Private Pension System

- Bad experience in saving type life insurance products marketed as "pension products"
- Non-supervised foundations and societies providing pension type products
- Bad experience and reputation of state-managed compulsory saving plans
- High fluctuations in growth rate and inflation
- Developed banking sector but still open to financial crisis as in 1994 and 2001
- Well developed capital markets with high volatility in stock prices
- Financially non-sustainable state pensions



# Turkish Private Pension System (Why we introduced?)

# How we Draft the Law?

- Committee for Complementary Pensions in August 1999
- Several meetings with
  - Members of various related government institutions and the representatives of the private sector
  - the representatives of Trade Unions, life insurance companies, Asset Management Companies, Foundations, Academicians and experts
- Difficult to reach consensus
- Conflict of interest between different government bodies
- Strong reaction arising from life insurance companies who resist to change the existing system
- Need for strong coordinator and leading group

# Chronology of Private Pension System

- Law submitted to Parliament in March 2000
- Approved by Parliament in April 7, 2001
- Came into force in October 7, 2001 after six months of publication date
- Most by-laws completed in 2002
- First pension contract signed on October 27, 2003

# Basic Aims of Introducing Private Pensions

- Timely utilization of favourable demographical characteristics, since the composition of population is expected to change in 20 years' time
- Scissor effect: Increasing life expectancy together with decreasing birth rate
- Providing additional income for pensioners
- Reducing social security burden to state
- Accumulating funds for sustainable economic growth
- Deepening capital markets by increased number of institutional investors



# Basic Characteristics of Private Pension System

# Main Features of Turkish Private Pension System

- Voluntary Contributions
- Fully funded defined contribution system
- Private personal pension plans
- Individual accounts with constrained choices
- Tax incentives
- Complementary to state social security system
- Specialisation in providing services

# Pension Companies

- New financial institution specialised in pension business
- Initial paid up capital at least ~\$7 mio (and additional \$~7 mio must be paid within 3 years)
- %51 of shares owned by the institutions operating in financial sector
- Criterias for efficient IT infrastructure met
- Strong financial structure to recover initial capital strain
- Optionally have right to operate in life and individual accident insurance
- Licensed by Undersecretariat of Treasury
- No discrimination to foreign companies

# Pension Mutual Funds

- Not separate legal entity
- Collective investment instruments issued especially for participants of private pension systems by pension companies
- Open-ended funds
- At least three funds having different risk composition
- Legally separated from assets of pension company
- Assets of funds kept by Custodian Bank
- Quantitative restrictions for investment instruments in each fund
- Constrained investment choice when allocating contributions
  - Min 30% invested in funds composing of government securities
  - Max 15% to foreign asset dominated funds
- No rate of return guaranteed

# Portfolio Management Companies

- Regulated and supervised by Capital Market Board
- Manages individual and institutional funds
- Contract with pension companies
- Responsible for active fund management of pension mutual funds in accordance with pension company's fund management policies
- Pension company has the right to make contracts with different portfolio management companies for different funds
- Dynamic and competitive markets

# Individual Pension Intermediaries

- Licensing requirement for promotion, marketing and selling of pension products
- No regulation for commissions
- Certain qualifications for intermediary license
  - Eligibility conditions set forth in regulation
  - Bachelors degree or associate degree in insurance and/or banking
  - Success in e-BEAS (e-intermediaries exam)
  - Continuous education (BESES)
- Accurate and reliable information to participants
- Importance on financial education/literacy and awareness
- Efforts against fraud and mis-selling

## e-BEAS (e-intermediaries exam)

- Examines professional knowledge and skills of candidates
  - Electronic exam based on Internet Technology
  - Held frequently at computer lab of universities in Istanbul, Ankara and Izmir and Pension Monitoring Center
  - Academically tested question pool
  - **Dynamic and random** question **set for each** candidate
  - **Prompt results**
  - Direct **e-reporting** to the Undersecretariat of Treasury
  - Generating statistics for future educational activities
- 13,628 succeeded over 19,674 e-BEAS holders
- 11,237 active intermediaries (as of April 3, 2006)
- ~ %80 percent have bachelor degree

# Individual Accounts

- Separate accounts for each participant
- All contributions are accumulated and invested on behalf of individuals
- Pension plans (for individuals or groups)
- Prior approval by Treasury
- Groups pension plans
  - Not related to employment contracts
  - With or without employers contributions
  - Currently no vesting for employers' contributions (planning to introduce)
  - Employers' contribution into same accounts
- More than one account in same or other pension companies allowed
- Consolidation of accounts at retirement depending upon individual's choice
- Entrance fee for new accounts

# Individual Rights and Choices -1

- Any person capable to use civil rights (aged 18 or above) has right to participate
- Voluntary contribution by individuals
- Participation on voluntarily basis
- Defining contribution relative to income level
- Minimum amounts for contributions stated in each pension plan
- Normal retirement
  - Age 56 years
  - Minimum 10 years of coverage period
- Participants have right to transfer life insurance portfolio in same company (until October 7, 2006)

## Individual Rights and Choices -2

- Right to change the allocation of contributions between funds stated in pension plans
  - Upto 4 times a year
  - Compulsory analysis of risk-return profile of participants
- Switching between pension plans of same company
  - Upto 4 times in a year
- Switching between pension companies
  - Once a year
  - Competition leads to high quality service and higher returns
  - Raise marketing and administration costs

## Individual Rights and Choices -3

- Amount of regular contributions can be altered
- Availability of additional lump-sum payments
- Waiving contributions
  - Additional small charges after 12 months
- Early withdrawals
- At age 56
  - Lump sum
  - Annuity
  - Continue to contribute
- Detailed regulation for the contents of the information and documents submitted to participants
- Easy access to accounts

# Fees and Charges

- Entrance fees
  - For new individual account
  - Up to monthly gross minimum wage (~ \$425)
  - Payable in installements within one year
  - Postponed for 5-10 years subject to withdrawals
- Administration charges
  - Up to %8 of each contribution
  - Fixed amount deducted from total assets upto 1/6 of monthly legal minimum wage(~ \$70) per year (in case of waiving contributions for 12 months)
- Fund management charges
  - Daily basis
  - As percentage of total assets in funds
  - Up to %0.01 per day

## Fees and Charges contd.

- Fees and charges disclosed in contracts, proposal form of pension plans
- Fund accumulation is very sensitive to charges
- Importance of scale economies
- Due to competition decreasing rapidly
  - No entrance fee for group pension plans
  - Entrance fee as quarter of cap or less in some pension plans for individual participants
  - Mostly nil or postponed to reduce withdrawals or switching to other companies for 3 years
  - Mostly 0-5% depending on amount of monthly contributions
  - No charge on initial or additional lump sum payments
  - Fund management fee
    - 3-6 per 100,000 for group pension plans
    - 4-10 per 100,000 for individual pension plans

# Transparency

- Best advice during the commencement of plans
- Regulation for contents of booklets, documents and information provided with contracts
- Qualified intermediaries
- Disclosure of fees and charges
- Monitored advertisements
- Easy access to individual accounts
- Availability of daily/weekly information on funds returns, participants, total funds
  - Internet
  - Call center
  - Web sites of supervisory bodies
  - Pension monitoring center
  - ISE Settlement and Custodian Bank

# Tax Incentives

- Contribution Stage
  - Contributions are tax deductible up to %10 of income with a cap of annual minimum wage (currently apprx. 5,000 pa or \$425 pm)
  - Employers' contribution are also tax deductible subject to the same limits
  - Government has right to double limits and rates
- Investment stage
  - No tax on fund returns excluding instrument based withholding taxes
- Benefits payment at retirement
  - %25 tax free lump-sum
  - Remaining subject to %5 withholding tax
- Early withdrawals; %15 before 10 years of contribution, and %10 if not eligible to retirement after 10 years of contribution
- Single premium life annuities are tax free

# Structure of Supervision



**Danışma Kurulu / Advisory Board**  
Hazine Müsteşarlığı / Undersecretariat of Treasury  
Sermaye Piyasası Kurulu / Capital Markets Board  
Çalışma ve Sos. Gv. Bakanlıđı / Ministry of Labour and Social Security  
Maliye Bakanlıđı / Ministry of Finance

Tavsiye Kararları  
Advisory Resolutions

Tavsiye Kararları  
Advisory Resolutions

Dzenleme ve Denetleme  
Regulation and Supervision

Emeklilik Yatırım Fonu Dzenleme ve Denetlemesi  
Regulation and Supervision of Pension Mutual Funds

**Emeklilik Şirketi**  
Pension Company

Portfy Ynetim Szleşmesi  
Portfolio Management Contract

Saklayıcılık Szleşmesi  
Safekeeping Contract

Bireysel Emeklilik Szleşmesi  
Pension Contract

Gnlk Gzetim  
Daily Monitoring

Dzenleme ve Denetleme  
Regulation and Supervision

**Sermaye Piyasası Kurulu**  
Capital Markets Board



**Hazine Msteşarlıđı**  
Undersecretariat of Treasury

Gzetim Verilerinin Sunumu  
Submission of Monitoring Data

**EMEKLİLİK GZETİM MERKEZİ**  
Pension Monitoring Center

Kamuyu Bilgilendirme  
Informing the Public

**Katılımcılar**  
Participants

Fon İşlemleri ve Bilgi Akışı  
Fund Transactions and Exchange of Information

Bireysel Hesaplar  
Individual Accounts

Bilgi ve Belge Sunumu  
Submission of Information and Documents

Bilgi Alışverişi  
Exchange of Information



**Takasbank**  
ISE Settlement and Custody Bank Inc.

# Efficiency in Supervision

- Clear separation of regulatory and supervisory powers
  - Individual Pension Advisory Board
  - **Undersecretariat of Treasury**
  - Capital Market Board
- On-site supervision of companies and pension mutual funds at least once a year
- Off-site daily monitoring and controls
  - **Pension Monitoring Center**
  - ISE Settlement and Custodian Bank
- Reports
  - Independent External Auditing
  - Internal Auditing
  - Actuarial Investigation
- Regular financial data and statistics

# Pension Monitoring Center

## Shareholder Structure

- Equal shares of 11 pension companies
- Group "A" share of the Undersecretariat of Treasury (%0.1)
- Powered by Undersecretariat of Treasury
- Functions and duties are stated in by-laws
- Established on July 10, 2003
- Share capital \$1.5 mio

# Functions

- Daily electronic monitoring and surveillance of pension companies' activities and e-reporting to the authorities
- Storing standardized data for all individual accounts
- Generating statistical information and special analysis (benchmark for pension companies, increases competition in sales)
- Implementing e-exam for intermediaries and keeping track of electronic registries
- Meeting demand for common presentation, training activities, software and allied subjects

# Functions contd.

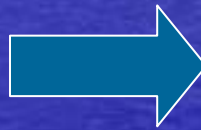
- Responding information requests and managing complaints from public, companies, participants and intermediaries,
- Participating in projects of international organizations to develop the system, giving support to pension companies
- To increase employment level in the field of pensions, universities and pension companies are supported on projects funded by the World Bank and the European Union
  - Privatization Social Support Project
  - Active Labor Market Strategy Project on New Opportunities
- Governing member of the International Organization of Pension Supervisors (IOPS) since February 2005.
- Satisfaction and confidence on system

# e-Governance

Good example of

- cooperation of public and private sectors
- self regulated e-governance application

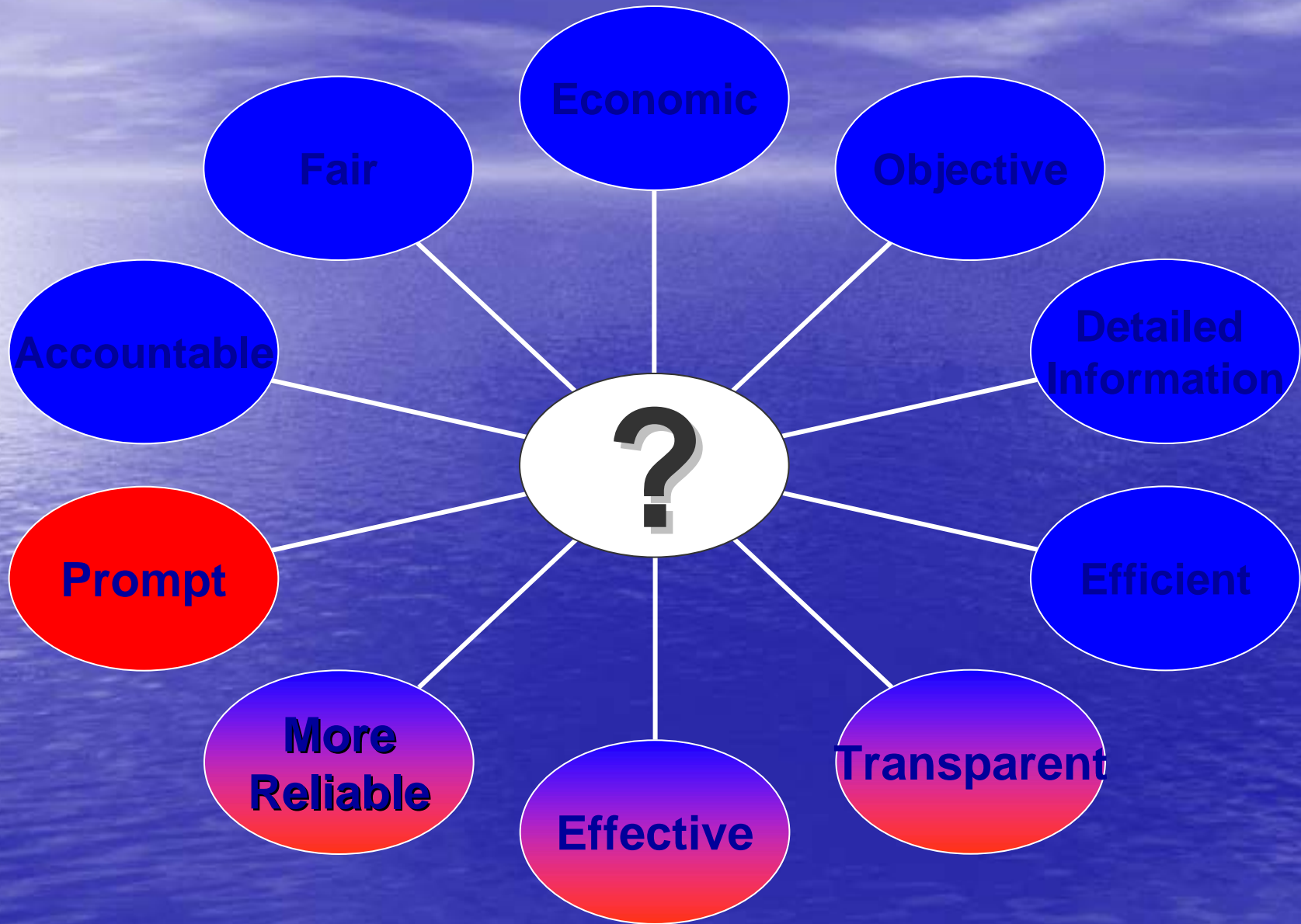
- appropriate control
- communication



- good decision making
- proper and timely execution
- transparency
- regular review and assessment

Monitoring **tool** of regulatory and supervisory authority

# Why e-supervision and monitoring?





# Basic Indicators

# Structure of Private Pension Market

- Dynamic and competitive market
- High initial cost to market access
- High marketing and selling cost (less compared to life insurance)
- Additional capital requirement to cover loss in first 4-5 years
- 10 or 15 companies operating after 5 years
- New expectation for new comers except merging and acquisitions
- Several advantages for participants due to high competititon

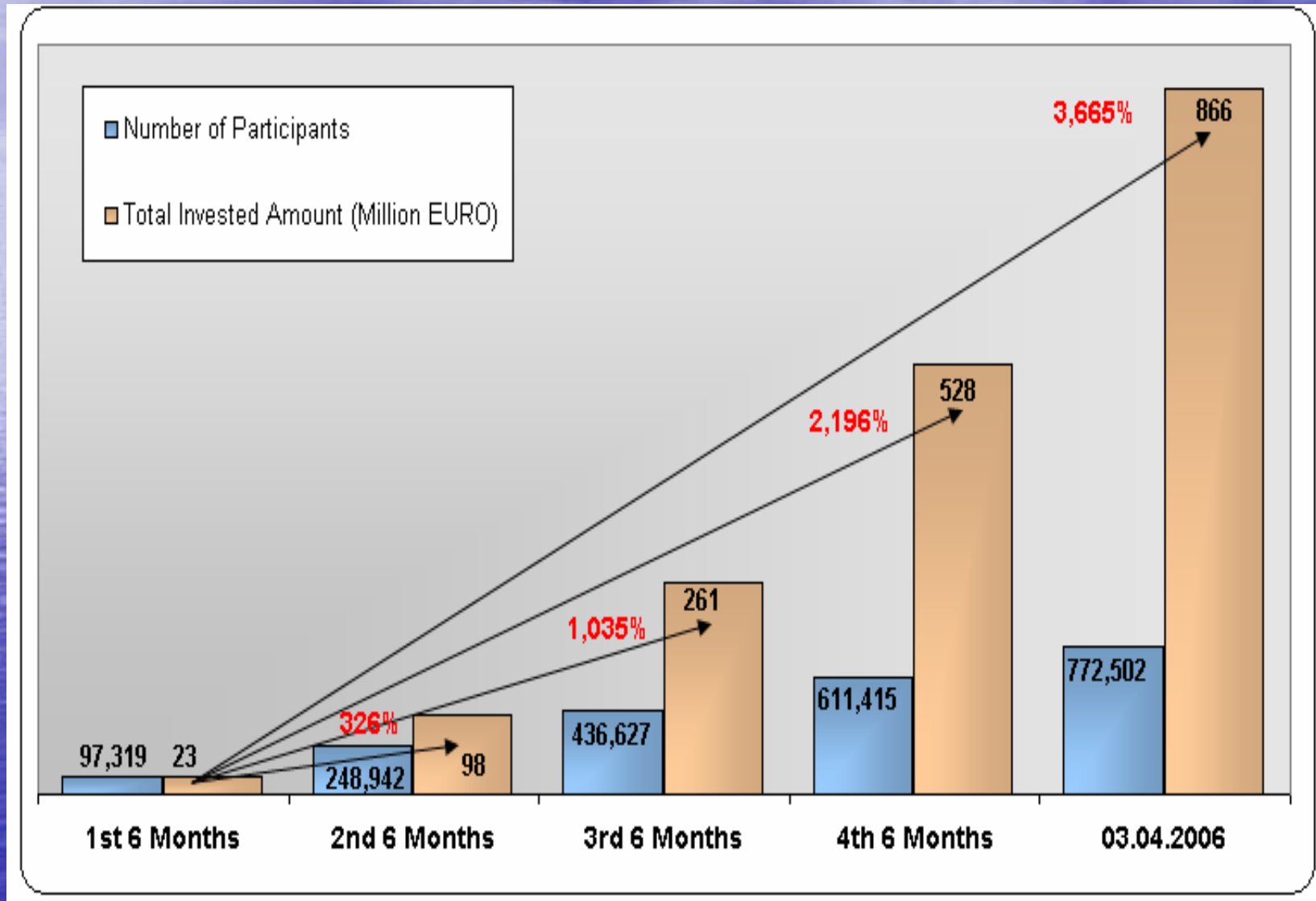
# Macro Economic Effects

- Increase the welfare of the individual at retirement
- Increase fund available to create new jobs
- Improve coverage and reduce the effects of financial burden of state-run social security system
- Raise long-term funds available in financial sector
- Deepening capital market and reduce market volatility
- Enable government to borrow long-term
- Positive impact on inflation and assist sustainable economic growth

## Basic Indicators (April 03, 2006)

Pension Companies	11
Pension Plans	980
Pension Mutual Funds	96
Pension Intermediaries	11,237
Participants	772,502
Pension Contracts	818,191
Accumulated Funds	~ \$1,240 Mio

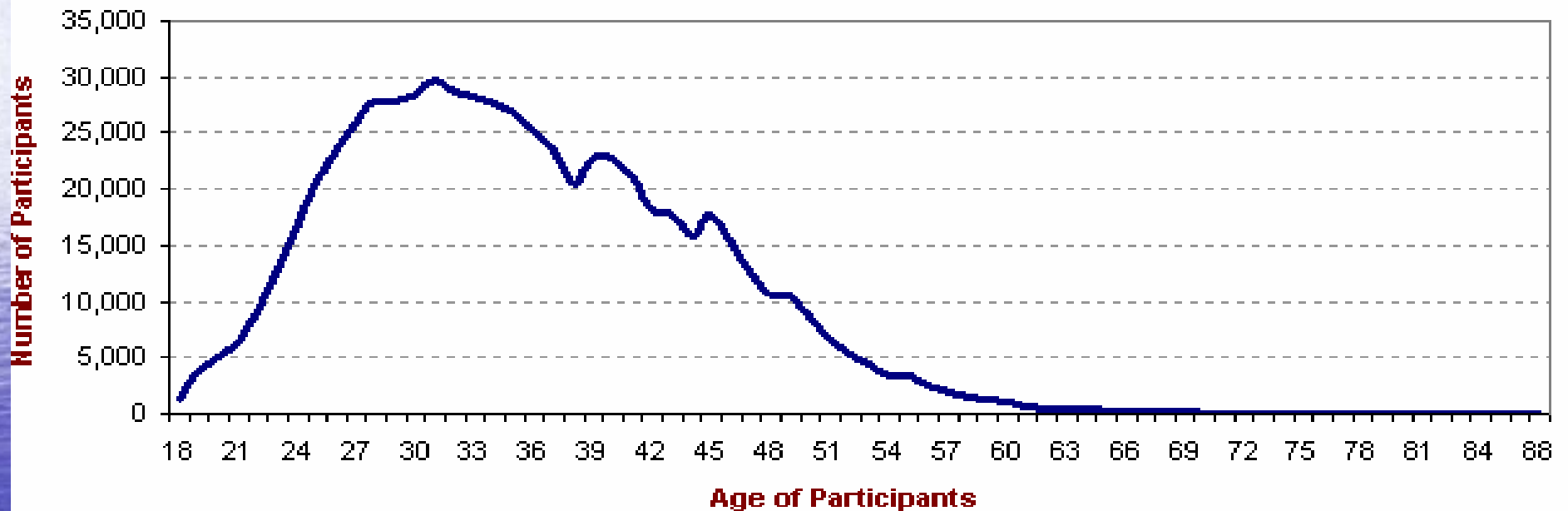
# Number of Participants & Net Contributions Invested



# Projections for Accumulated Funds and Number of Participants

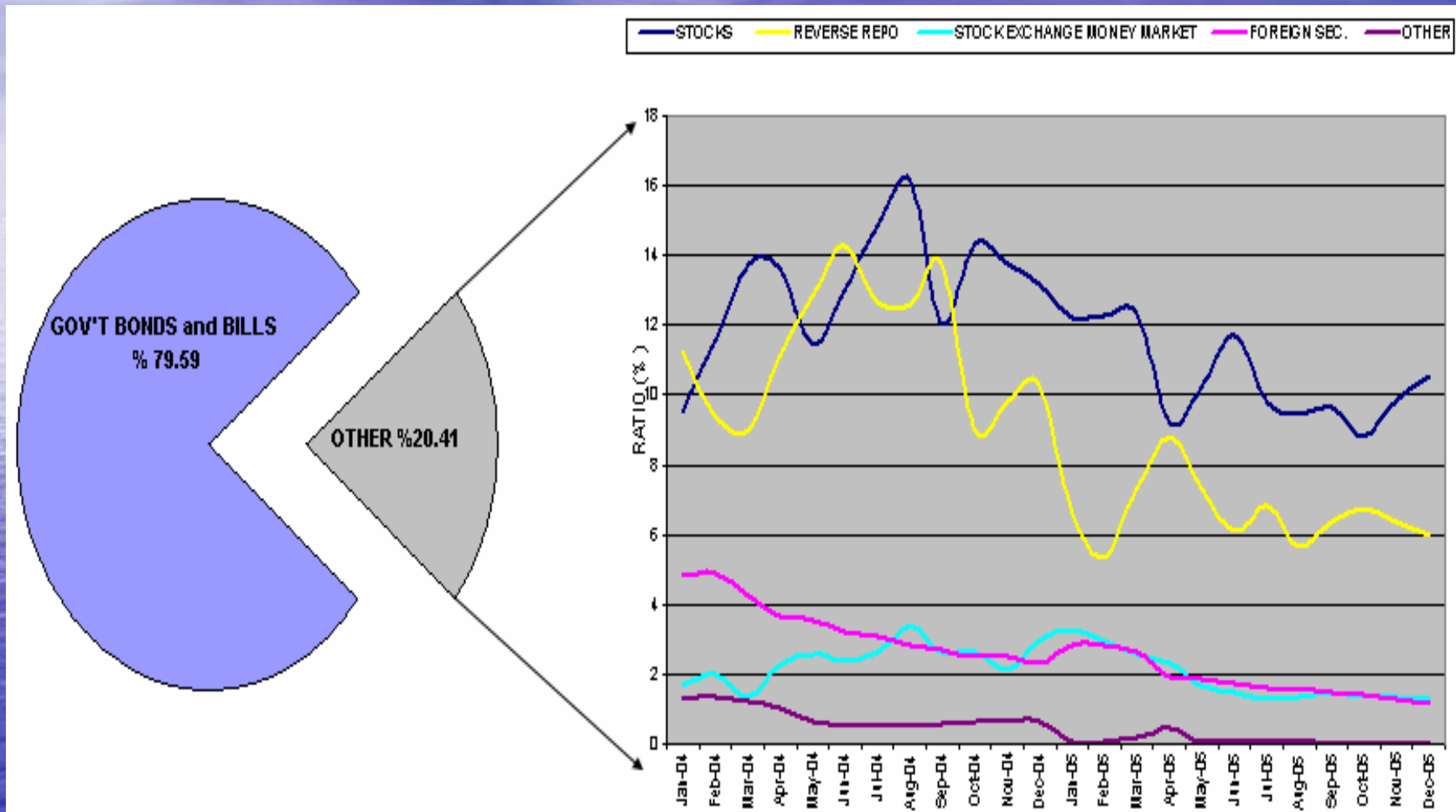
Years	Number of Participants (in Millions)	Total Funds (in Billions \$)
10	5.7	14
15	7.7	37
20	8.2	67

# Distribution of Participants according to Age Groups



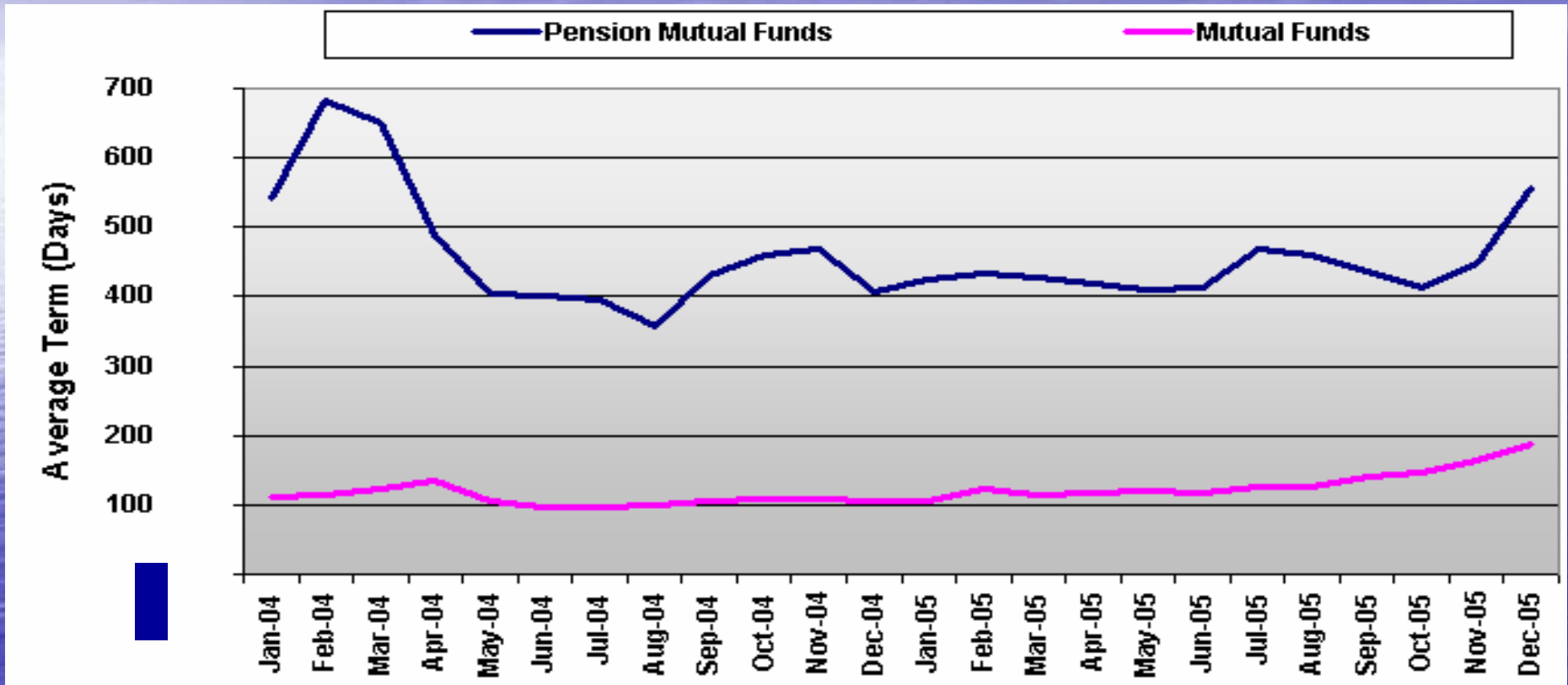
*As of December 31, 2005*

# Consolidated Asset Allocation of Pension Mutual Funds



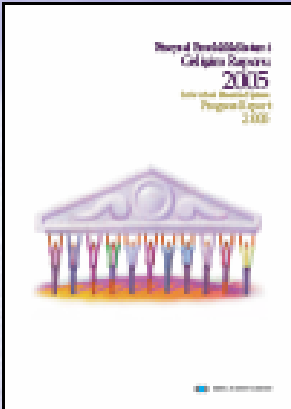
As of December 31, 2005

# Average Term of Pension Mutual Funds

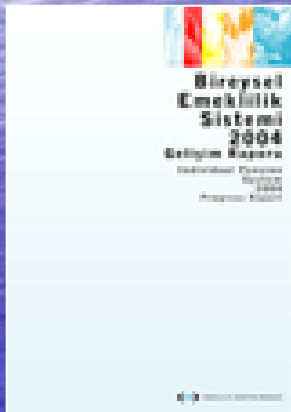


As of December 31, 2005

# Annual Progress Reports



- Second year (2005) report is available at <http://www.eqm.org.tr/bes2005gr.htm>



- First year (2004) report is available at <http://www.eqm.org.tr/bes2004gr.htm>

# Challenges

- More efforts on financial education
- Importance of confidence
- Focus on assessment and evaluation of management performance, business strategies and policies
- Utilizing IT in evaluation of financial data
- Improving risk based supervision
- Compliance with the needs of competitive and dynamic structure of markets
- Improving corporate governance
- Experience of other markets or countries
- Promoting economies of scale
- Planning
  - introduce vesting for employers' contribution
  - voluntarily transfer of funds from foundations and societies providing pension type products