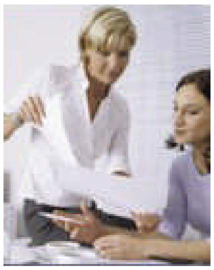
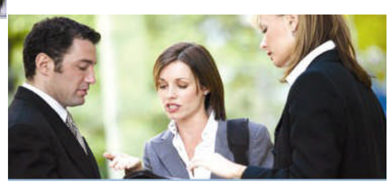


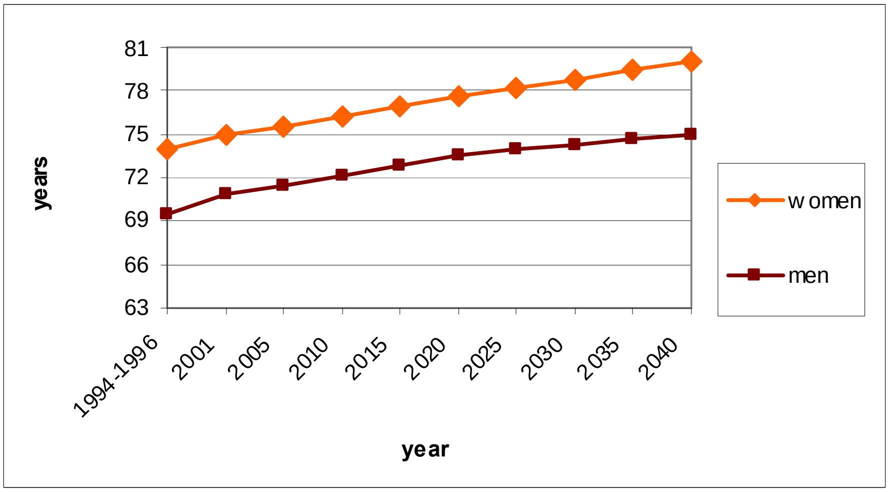


Preparing the Financial Market for an Aging Population - The case of Macedonia

Created by Zorica Apostolska

Reasons for pension reform

For a better picture of the Pension Reform in the Republic of Macedonia it is necessary to say a few words about the reasons for the pension reform. Social end economical changes in the Republic of Macedonia at the beginning of the 90s had an influence on the pension system, as well. The pension system faced financial difficulties in its operations, particularly in the regular payment of pensions. The longevity of the population as a world trend did not bypass Macedonia. The analyses show that life expectancy is expected to increase by 5 years in the following 40 years.



Increased number of elderly people in total population, at the same time means increased number of pensioners, while increased life expectancy means longer usage of pension benefits. Additionally, unfavorable developments in the economy influenced decrease of active contributors, on one hand, and increased number of pensioners, on the other hand. Because Macedonia had PAYG system these factors had very important influence on the pension system: decline in the ration of contributors to pensioners, increase in the ratio of pension expenditures to GDP, etc. Especially, all these factors have strong impact on the long-term solvency of the Pension and Disability Insurance Fund of Macedonia and actuarial projections show that the system would function with deficit that would increase rapidly and extensively.

Preparation and Implementation Strategy

Practical implementation of the reformed pension system in Macedonia, started in 2005, preceded with many years of preparation. Key topics for preparation were:

- Government commitment to Pension Reform (Pension Steering Committee and Actuarial Unit were established and comparative analysis were prepared. Afterwards we continued with development of a concept, discussion and legislation adoption)
- Support by the Government by establishing a Ministers Council. The Ministers Council consists of the Minister of Labor and Social Policy, Minister of Finance, Governor of the Central Bank in Macedonia, President of the Securities and Exchange Commission, Director of the Agency for Supervision of Fully Funded Pension Insurance, Director of the Pension and

Disability Fund. The main duties of the Council are to make key policy decision and to control overall pension reform implementation strategy.

- A working group was also established for the operational and technical issues.

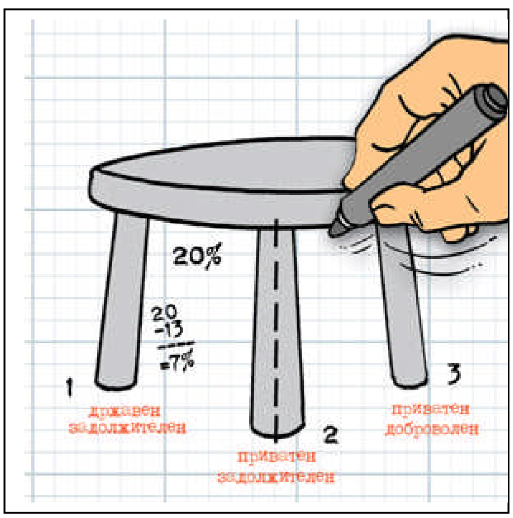
During the overall process Macedonia had strong support and assistance from the World Bank.

Structure of the reformed pension system

In order to overcome and to prepare for expected developments in pension area, a thorough reform of pension and disability insurance in our country was conducted. Multi-pillar pension system was established by the reform, with combined manner of financing and diversification of demographic and economic risks, which will at the same time enable long-term financial solvency of the pension system.

The basis of the reformed pension system as a three-pillar pension system which is part of the social insurance in the Republic of Macedonia was set in the law in 2000.

The structure of the reformed pension system is as follows:



- Mandatory rationalized PAYG system **(first pillar)**
- Mandatory fully funded system **(second pillar)**
- Voluntary fully funded system **(third pillar)**

First pillar is financed on a pay-as-you-go basis, which means that contributions of current contributors are used to finance pension benefits of current pensioners. This pillar provides defined pensions according to predetermined formula, and shall provide one part of old age pension, disability pension, survivors' pension, as well as a minimal pension.

Second pillar means introduction of new, fully funded pension insurance, with defined contributions, on a mandatory basis, for contributors employed for the first time after January 1, 2003 (and voluntary for contributors employed before January 1, 2003). This pillar provides one part of old age pension.

Third pillar, which is in a process of establishment, is fully funded as the second pillar, but the difference is that it shall be open for membership on a voluntary basis.

Expected outcomes

It is expected that the pension system reform and the establishment of the multi-pillar pension system as combined system of public, pay-as-you-go financing and private, fully funded pension insurance in the Republic of Macedonia shall provide long-term stability of the system, which is important element of the social insurance. Consequently this will lead to safety in acquiring rights from the pension and disability insurance. The design of the reform is based on persistence of principles and maxims of the current pension system: compulsoriness of the pension and disability insurance, dependency of the rights on duration and scope of assets paid in, social justice, compliance with conventions and recommendations of ILO. At the same time, new system is compliant with the Constitution of the Republic of Macedonia according to which all citizens have the right to a social security and social insurance. It means persistence of the principle of insurance against all risks (longevity, death and disability).

Fulfilling these goals shall result in long-term advantages for individuals participating in the pension system, for the pension system itself, as well as in additional effects for the economy in general.

Expected advantages for the individuals	Expected advantages for the system
• Greater security • Risk diversification • Transparency of operations	• Solvent pension system • Increase in national savings • Increased power of investment • Economy Growth • Increased efficiency of the Macedonian labor market

Fully funded pension insurance radically differs from previously existing pay-as-you-go financing regarding the treatment and registration of paid contributions and pension benefit determination. Every member has individual account in which his assets are registered, which is very similar to saving. This type of insurance provides close relation and dependency between the scope of asset paid into the system – contributions and future pensions that will be acquired by each person, based on market principles. This way of insurance is based on the principle of asset accumulation on individual accounts and their investment. Rate of return on investments, lowered for the costs of operations, is fully allocated to the assets accumulated in the individual accounts. The future pension shall depend on the accumulated assets and the life expectancy at retirement, i.e. the expected period of pension usage. It is important to emphasize that pension saving is a long term saving, during which, gradually, but continuously assets will increase. Due to this, while the contributor is young, savings are low, but in the future, when the contributor will reach the retirement age, savings will be substantially higher.

One important characteristic of the second pillar is that it is privately and competitively managed, and contributions paid are invested by pension management companies. This way, it is provided that economic goals determine investment strategy, creating possibility for maximizing the overall return in best interest of members. Diversification of investment risks (including international diversification) is also one of the important characteristic of the system.

Main characteristics of the reformed pension system

All the contributors employed before January 1, 2003 were given possibility to decide whether to enter the two-pillar pension system and to choose a pension fund in which they would like to be members. All newly employed contributors were given the possibility to choose one of the two pension funds. All contributors that shall enter two-pillar pension system will have the right to transfer from one to another pension fund. The reformed pension system is mainly designed for the young employees and employees with few years of service before entering the two-pillar pension system. For older employees and employees with lots of years of service there were strong reasons to remain in the mono-pillar system, taking into account that in the new system they will have less time for accumulating enough assets in their accounts before retirement.

The total contribution rate is 21,2% of gross wage and it is split between two pillars: 65% goes to the first pillar and 35% goes to the second pillar.

The fully funded pension insurance offers a great degree of transparency, which is one of its important characteristics and useful news in the pension system. Pension companies are legally obligated to regularly, at least once a year inform their members in written format, about their individual accounts, dates of contribution payments and transfers during the relevant time period, fees charged, conversion of contributions and transferred assets into accounting units and balance of the individual account. At least once a year, pension companies submit to their members data on the value and pension fund assets participation invested in each type of asset, including data on the issuers and brokerage fees. Pension companies also, once a year, publish informative prospectus which contains data on the fund and pension company that among other contains data about Supervisory and Management Board of the company, main principles of investment, fees they are charging, investment, net assets, realized return, etc.

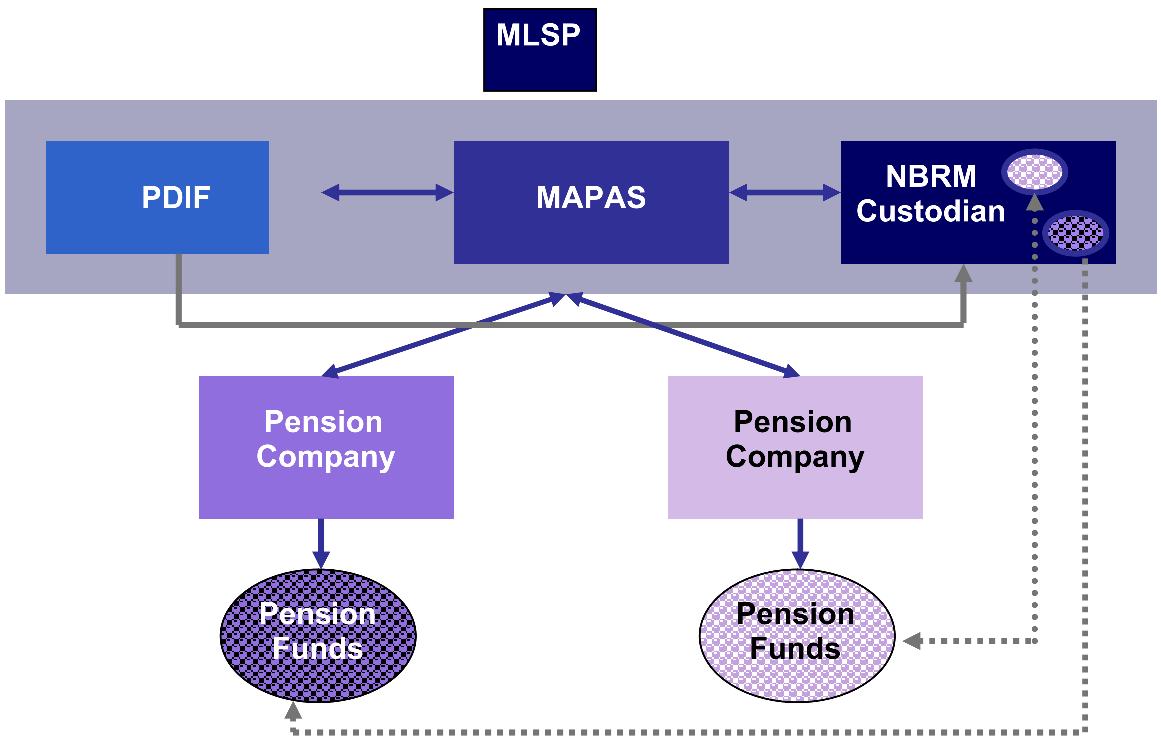
Institutional infrastructure

Institutions that comprise the reformed pension system are the following:

- *Ministry of Labor and Social Policy* – responsible for creating and implementing the policy on pension and disability insurance and for supervision of the legality of operations within this insurance
- *Agency for Supervision of Fully Funded Pension Insurance (MAPAS)* – regulatory and supervisory body that protects the interests of pension fund members and stimulates the development of fully funded pension insurance, which reports to the Government of the Republic of Macedonia for its operations
- *Pension Management Company* – joint stock company founded by financial institutions with big capital and experience, whose sole activity is management of pension fund assets
- *Custodian of pension assets* – safely keeps pension fund assets, in a separate account, separate from the assets of the pension company (for the first five years the National Bank of the Republic of Macedonia shall be the custodian)

- *Pension and Disability Insurance Fund of Macedonia (PDIF)* – undertakes centralized contribution collection and allocation of contributions and relevant data for the members in the elected pension funds and companies

Schematic representation of the institutional infrastructure



A pension company for managing pension funds shall be a joint stock company that manages a pension fund and shall be established and shall operate in accordance with the Trade Company Law and the Law on Mandatory Fully Funded Pension Insurance. The sole activity of the pension companies is the management of pension funds, representing them in front of third parties and other activities related to the pension fund's management.

A pension fund shall be an open-end investment fund whose establishment and operation are in accordance with the Law on Investment Funds, unless this is regulated in a different manner by the Law on Mandatory Fully Funded Pension Insurance. A Pension Fund shall be comprised of assets derived from contributions made by pension fund members and the returns on investments of those contributions. A pension fund shall be owned by its members whose individual ownership rights shall be determined by the assets standing on their account. The assets of the pension fund shall be fully separated from those of its managing pension company. This asset segregation is of extreme importance in order to provide high level of security of the assets.

For a period of ten years one pension company can establish and manage only one pension fund. During the early stage of the system's establishment it is envisaged only one pension fund per pension company to be allowed, and during later stages, if there are conditions for it, depending on the financial market development, it will be allowed bigger number and greatest variety of pension funds to exist.

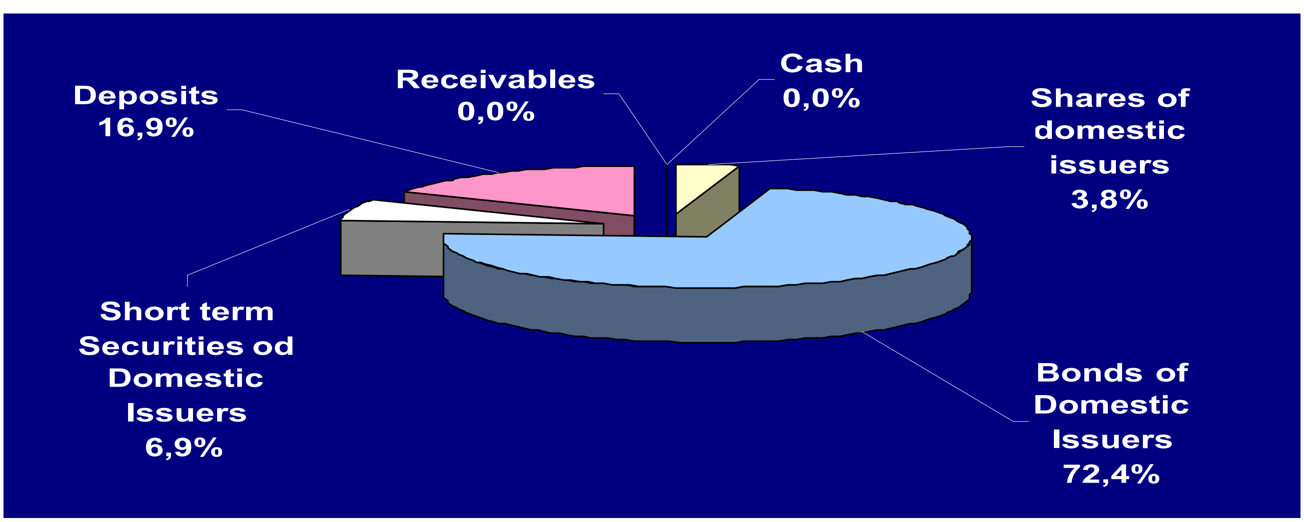
Due to the size of the financial sector and expected number of members in the new pension system, for the Republic of Macedonia it was important to limit the number of participants in the pension market at the start of the system. The Agency for Supervision of Fully Funded Pension Insurance granted licenses for establishment of only two Pension Companies for a period of ten years.

Licenses for establishment of Pension Companies and approvals for pension fund management were granted through public tender. On April 4, 2005 licenses were granted to the following two Pension Management Companies:

Akcionersko dru{tvo za upravuvawe so penziski fondovi NOV PENZISKI FOND Skopje	**KB Prvo dru{tvo za upravuvawe so penziski fondovi AD Skopje**
which manages with	*which manages with*
NOV PENZISKI FOND – Otvoren penziski fond	**KB Prv otvoren penziski fond – Skopje**
Founders of Akcionersko drustvo za upravuvanje so penziski fondovi NOV PENZISKI FOND Skopje are Nova Ljubljanska Banka DD, Ljubljana, Republic of Slovenia, which represents a portion of 51% of the Pension Company capital and NLB Tutunska Banka AD, Skopje, Republic of Macedonia, which represents 49% of the Pension Company's capital. The founding capital of the Pension Company is 2.0 million Euros.	Founders of KB Prvo drustvo za upravuvanje so penziski fondovi AD Skopje are Prva pokojninska Druzba DD, Ljubljana, Republic of Slovenia, which represents 51% of the Pension Company capital and Komercijalna Banka AD, Skopje, Republic of Macedonia, which represents 49% of the Pension Company's capital. The founding capital of the Pension Company is 1.5 million Euros.

Membership process started in September 2005 and in January 2006, started the second pillar contribution flow – around 20 millions of Euros were paid in second pillar.

Pension funds investment portfolio (December 31st,2006)



Usually, fully funded pension systems use proactive control and qualitative and quantitative limits of investments. Therefore, the Law and the secondary regulations prescribe investment objectives and principles, the quality of instruments in which pension assets can be invested, the investment limits in regard to instruments and issuers, prohibited investments, excess of investment limits etc. The Law regulates the main principles of pension fund investment, which are security of assets, diversification of investment risk and maintenance of adequate liquidity with a purpose of maximizing the return in favor of the pension funds members. The Law and the secondary regulations prescribe that pension funds assets can be invested in bank deposits and certificates of deposit, bonds and other securities, shares, commercial notes in the Republic of Macedonia and in the countries of the EU, Japan, and the United States of America. The Law prescribes maximum proportions of any company or asset and any kind of instrument in which the pension fund assets can be invested in order to obtain adequate diversification among different types of investments. In order to prevent investments in instruments unsuitable for pension fund investing the Law prohibits investments in unlisted shares, bonds etc that cannot be immediately valued, several forms of commodities that have uncertain valuation, for example antiques and works of art.

The contributions paid in the pension funds, decreased for the fees, are immediately invested. The total return is assigned to the pension fund i.e. to the individual accounts of pension funds members. Once a month the pension companies charge the management fee as a percentage of the total assets. In addition, the pension funds are charged with brokerage fees upon every transaction with the pension funds assets. The valuation of pension funds assets is performed on a daily basis. It is being determined based on the market value of each asset or on the basis of the depreciated value of the asset in case the instrument is kept until its maturity or in case its market value can not be determined. The value of the pension funds assets increases as a result of the accumulated contributions, the investment return and the increase of the asset value or it decreases as a consequence to contribution payment, decrease of the asset value or payout of pension benefits.

Third pillar in the pension system

The overall structure of the pension system includes also voluntary fully funded pension insurance (third pillar) regarding which Macedonia is in a stage of intensive preparation.

Primary objective of the voluntary fully funded pension insurance in the Republic of Macedonia is:

- To provide higher income after retirement to the insurers covered with the first and second pillar and to those who are willing and able to separate additional assets for higher material security or higher living standard after retirement.
- To provide higher retirement benefits to persons not covered with the mandatory fully funded pension insurance, including unemployed spouses, long-term unemployed, employed on projects, in foreign missions etc.
- To provide preconditions for establishing occupational plans in the process of harmonization of the Macedonian social security system with the one of the EU.

Preparing the Financial and Capital markets

Since the ninetieth years, when Macedonia became independent country, we have been passing throw a long transition, continuous macroeconomic measures for stabilization and structural reforms – price and trade stabilization, stabilization of the currency (denar), privatization, legal reforms, reform of the financial sector, privatization of the banks, corporate finance etc.

Securities and Exchange Commission was established in 1992, Stock Exchange in 1995, Central Securities Depositary in 2002. Macedonian agenda for accession to EU is additional incentive to all process and the pension reform is one of the fundamental components of the structural reforms.

<u>Obstacles for which we had to think about and find solutions were:</u>

- Feasible size of transition costs and a way to finance them. They include issuing a public debt, budget (taxes), privatization of assets.
- Low scope –s mall countries with low number of contributors and assets in second pillar at start of the system

In the beginning of the pension reform, the financial and capital market were underdeveloped with low absorbing power and not enough instruments to invest in. Also the commercial banks did not perform custodian function. We faced with important questions: What comes first? Pension funds introduction or financial market development? There is a mutual link. Minimum precondition for introduction of pension funds are: competitive and liquid market, minimum investments instruments, legislation and regulation. On the other hand introduction of pension funds means new assets on the market and incentive for new instruments.

<u>What Macedonia did to overcome the obstacles?</u>
The foreign and domestic experts were engaged to prepare assessment of the fiscal, financial and macroeconomic aspects of different pension reform options and analysis of capital markets. Then, action plan was developed for legal and institutional changes in pension regulation and financial and capital market. Based on others countries experiences, we aimed to provide conditions for second pillar portfolios which at start are largely concentrated in government debt and bank deposits.

Ministry of Finance and the Central Bank of the Republic of Macedonia prepared strategy for development of government securities market. One of its objectives was creating financial instruments adequate for the needs of institutions emerging from the pension system reform. Another objective was financing transitional deficit. One of the significant measures was that the start of the second pillar contribution flow was connected by Law with issuance of first continuous issuance of government bonds (issuance: November 2005, start of the contributions: January 2006).

Now in Macedonia we have more available instruments: T-bills (3, 6 and 12 months), government bonds (2, 3 and 5 years) terms.

Law gives possibilities, at the start of implementation, to increase maximum limits per instrument, in order to adjust to market conditions. Thus, we had limit of 100% in government debt securities at start (regular is 80%) and limit of 100%, then 80%, then 60% in bank deposits (regular is 60%).

Due to limited numbers of banks in Macedonia and many roles that they could have (Pension company founder, custodian, providing instrument for pension fund investment) it was decided that the Central bank will be a custodian of the pension assets for the first 5 (five) years of the system.

<u>Following effects are expected from the reformed pension system:</u>

- Better stability and solvency of the pension fund in general, but also additional effects on the financial and capital market is expected, in terms of increased savings, strengthening of the investment power.
- Development of financial and capital market via
  - boost of the demand for lager amounts, longer term and broader varieties of financial instruments;
  - motivation for a new financial services;
  - upgrade of regulation and supervision.
- Development of insurance market via annuity payments and economy growth.

Future challenges:

- Improved contribution collection and evasion elimination, increase of employment rate
- Appearance of new instruments (corporate bonds, mortgage backed securities, etc.)
- Start of investment abroad
- Custodian function at commercial banks
- Start of third pillar operations
- Start of payments of pension benefits from second pillar