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PROPOSED CHANGES TO THE PENSION SYSTEM INCREASE RISKS FOR THE 1,5 MILLION PENSION FUND PARTICIPANTS

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EXECUTIVE SUMMARY

In the past year or so Georgia has experienced significant declines in economic governance. In addition to the anti-democratic Law on Transparency of Foreign Influence (known as the Agents Law), several laws and legal amendments initiated by the ruling party and the Parliamentary majority have drawn significant attention from stakeholders, experts, and the general public. These developments raise serious concerns about the weakening of economic governance in Georgia. Key changes amongst others include alterations in the governance of the National Bank of Georgia, the so-called Law on Offshores, and amendments to the pension legislation, which are currently under review by Parliament. The note compares Georgia's proposed changes to the pensions system with successful models from countries like Canada, Sweden, the Netherlands, and Denmark, emphasizing that balanced governance structures, ensuring high competence and independence of the board, and stakeholder involvement are crucial for an effective pension system and for ensuring its best possible risk management in the interest of pension fund participants and their welfare.

Firstly, the proposed amendments will replace the existing supervisory and investment boards, appointed by Parliament, with a single governing board. This new board, based on the proposed amendment, is to be appointed solely by the Prime Minister rather than approved by Parliament, and its representatives will have lower professional qualifications. The subject Board will manage both the investment and administrative functions of the pension scheme. While such centralization is announced to serve to streamline the management, it risks reducing transparency and stakeholder involvement, potentially compromising the independence and effectiveness of the governance structure and increasing risks of political influences. Unlike Georgia, countries like Canada and Sweden employ diverse and inclusive processes for selecting board members, ensuring a wide range of expertise and perspectives, thereby enhancing governance quality.

Secondly, the proposed amendment eliminates the involvement of private asset managers, meaning that assets will not be managed externally by choice of individuals. This restriction significantly reduces competition within the pension system and limits the choices available to pension scheme 1,5 million participants. Successful models in countries like Sweden and the Netherlands demonstrate that allowing participants to choose among different asset managers leads to higher returns and a more robust capital market. Georgia's approach could hinder market development and reduce overall system efficiency.

Thirdly, the proposed amendments propose to increase the limits on investment opportunities, allowing the pension fund to invest in a broader range of assets including the higher-risk category of other types of assets. The lack of a clear definition for "other types of assets" introduces risks, particularly concerning potential investments in government projects. Such investments, without

proper oversight, could lead to mismanagement and corruption, jeopardizing the fund's integrity and 1,5 million participants' financial security. While the Ministry of Finance asserts that funds will primarily be invested in bonds, the expanded investment freedom increases the risk of politically influenced decisions. Such risks become even more alarming in light of the changed course of strategic partnerships and intentions of involving sanctioned Chinese companies in the major strategic port project. Successful pension systems, like those in Denmark and the Netherlands, maintain stringent controls and balanced governance to mitigate such risks.

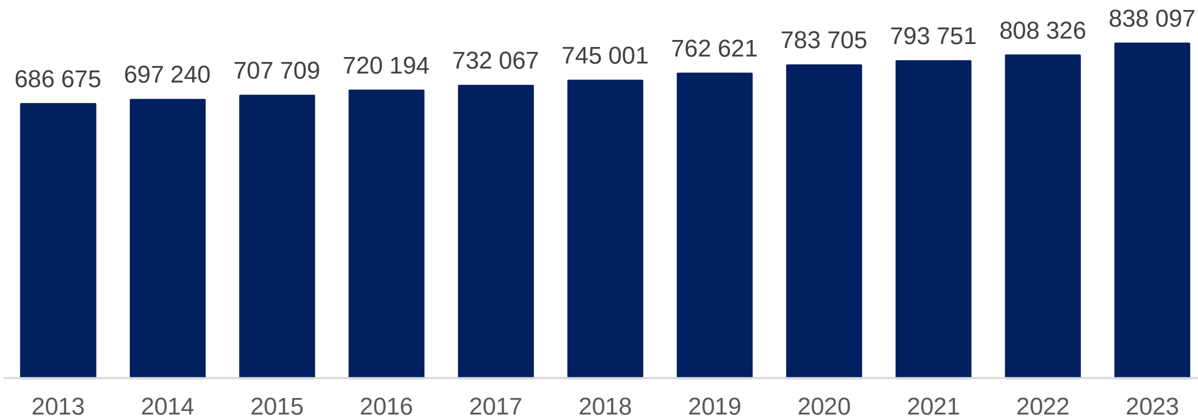
The proposed legal regulatory changes to the pension system bear the risk of adversely affecting future welfare of pension funds 1.5 million participants.

INTRODUCTION

Pension systems are fundamental to the financial security and well-being of elderly populations, serving as a crucial foundation of social protection. By providing regular income to retirees, pensions help to reduce poverty and ensure that older citizens can maintain a decent standard of living. Beyond individual welfare, a robust pension system contributes to broader societal and economic stability. It helps mitigate the financial burden on families and the state, thereby supporting intergenerational solidarity and social cohesion.

A well-functioning pension system also has significant macroeconomic implications. It can influence national savings rates, consumption patterns, and labor market dynamics. For instance, adequate pensions can stimulate consumer spending among retirees, which in turn supports economic growth. Conversely, insufficient pension provisions can lead to increased demand for social assistance and healthcare services, straining public finances and potentially leading to higher taxation or reallocation of resources from other critical areas. Georgia's population is aging, with a significant increase in the number of pension recipients and a notably low replacement rate. This demographic trend is attributed to the extremely low fertility rates in the early 1990s and a high negative migration balance. By the end of 2023, there were 838,097 individuals receiving pensions (Figure 1), reflecting the challenges faced by the pension system in maintaining adequate replacement rates (15.9% in 2023).

Figure 1. Persons Receiving Pension



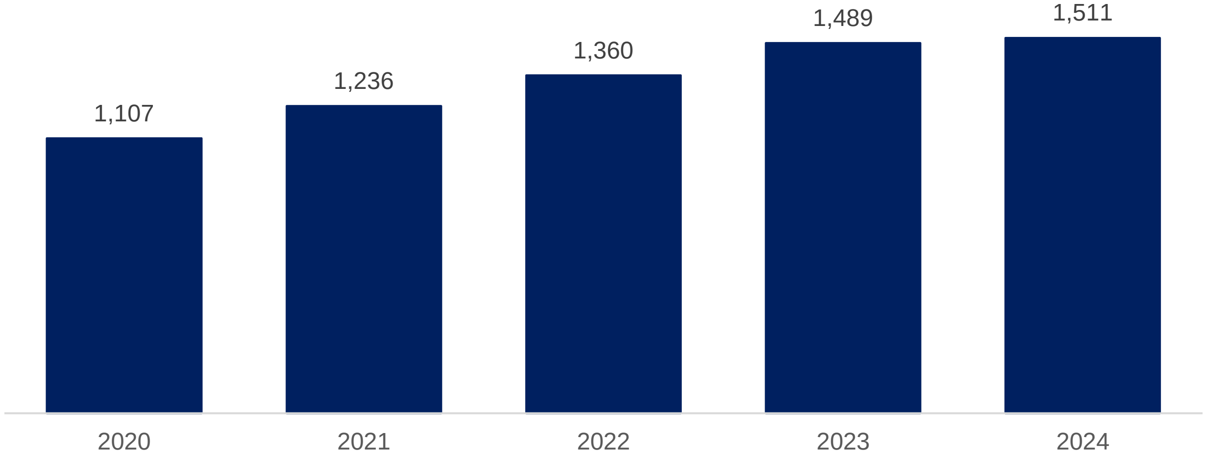
Source: Geostat

Recognizing the importance of adapting pension systems to evolving economic landscapes, many countries, including Georgia, are undergoing significant reforms. In the early 2000s, Georgia embarked on a journey to transition its predominantly pay-as-you-go system to a multi-pillar pension framework. This restructuring reflects a broader global trend towards more diversified and sustainable pension systems. In Georgia, this new system comprises three main pillars:

The first pillar is the state pension, **providing a basic, flat-rate pension to all eligible individuals.** Financed through mandatory contributions from both employees and employers, the eligibility age for this pension is gradually increasing, reaching 65 for men and 60 for women.

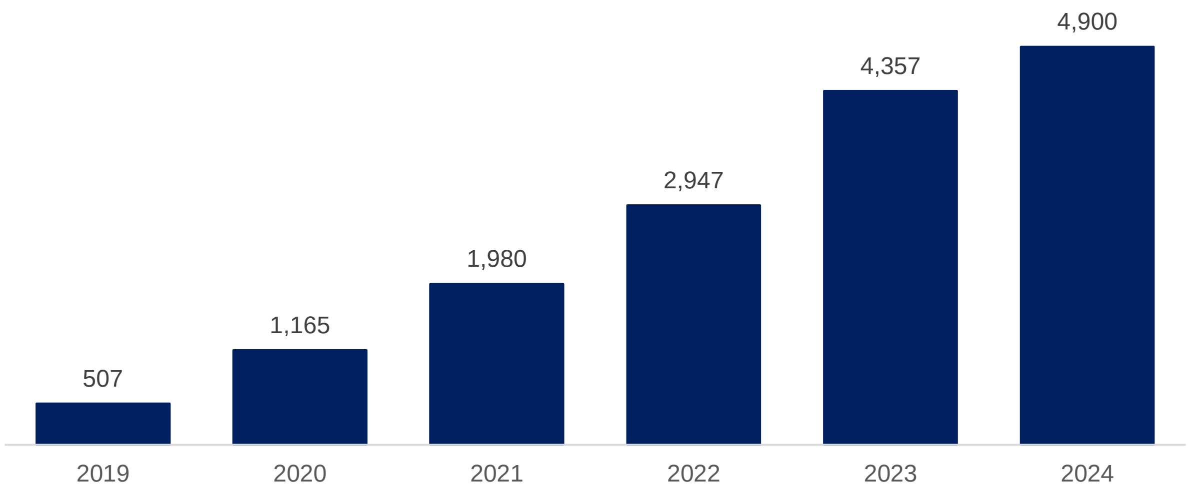
The second pillar is a mandatory funded pension system. Here, a portion of an individual's income is automatically deducted and contributed to a pension fund. These funds are invested in various financial instruments with the aim of generating returns for the contributors. Upon retirement, individuals receive pension payments from these accumulated savings. Participation in this pillar is compulsory for employed individuals under a certain age. As of April 30, 2024, the number of participants in the pension scheme is 1,511,000. A total of 9,637 individuals of different categories have benefited from the accumulated pension, with 31.9 million GEL paid out to them. The value of pension assets amounts to 4.9 billion GEL (see Figures 2 and 3).

Figure 2. Registered Participants in the Funded Pension Scheme, thsd. Persons



Source: Geostat

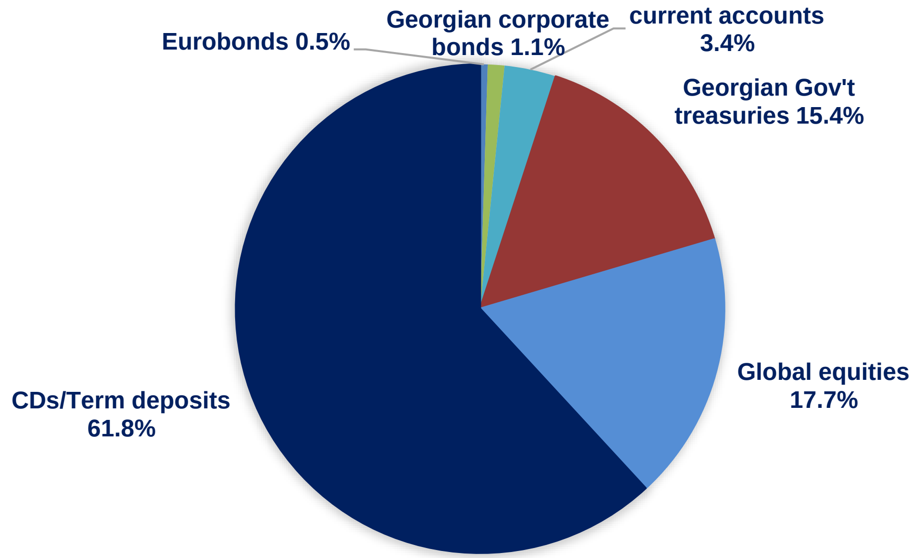
Figure 3. Total Amount of Pension Fund Asset Portfolio (Value of the Fund), mln. GEL



Source: Pension Agency

It is also worth noting that, as of 30 April 2024, the accumulated funds are primarily invested in CDs/term deposits (61.8%), global equities (17.7%), and Georgian government treasuries (15.4%) (see Figure 4).

Figure 4. Asset Allocation (as of 30 April 2024)



Source: Pension Agency

The third pillar allows individuals to voluntarily contribute additional funds to their pension savings through private pension funds or insurance companies. Contributions to this pillar are optional and provide an opportunity for individuals to enhance their retirement savings beyond the mandatory scheme. Currently, the funds are managed by JSC Insurance Company Aldagi, JSC Insurance Company GPI Holding, and LTD Sakaeronavigatsia. As of December 31, 2023, their pension reserves amount to 42 million GEL[1].

The Government of Georgia intends to significantly reform the governance structure of the Pension Agency. These proposed changes have sparked concerns about their potential impact on pensioners and the broader economy, particularly regarding transparency, independence, and the overall effectiveness of the pension system. The proposed changes include restructuring the pension agency board, revising the procedure for electing governing board members, and altering portfolio selection strategies. However, there are concerns that these changes could compromise system efficiency and may not effectively address the fundamental challenges opposing pensioners.

This policy brief aims to provide a comprehensive analysis of the proposed reforms to Georgia's pension system, leveraging experiences from both developed and developing countries. It will

[1] Insurance State Supervision Service of Georgia

examine the current state of the Georgian pension system, outline the proposed changes, and evaluate their potential impact.

CENTRALIZING GOVERNANCE IN GEORGIA'S PENSION REFORM

The pension reform established by Georgia's 'On Funded Pension' law took effect on January 1, 2019. During the subsequent years, it became clear that a major challenge of the reform lies in the management structure of the pension agency. As stated in the explanatory card of the bill, the current structure, which consists of a supervisory board and an investment board, has failed to provide unified management and comprehensive supervision of the pension scheme. If the changes proposed by the draft law come into effect, **the pension agency will replace the two unequal management boards (the investment and supervisory boards) with a single management body, the "governing board."** This new board will implement unified management of the accumulative pension scheme, performing both investment and administrative/operational functions, as well as other necessary tasks. **The governing board will consist of no fewer than 9 and no more than 15 members.** Successful state pension funds typically have governing boards composed of 7 to 15 members, ensuring a balance of expertise and stakeholder representation. For example, the Canada Pension Plan Investment Board (CPPIB) has 12 directors chosen for their investment and business acumen. In the United States, the California Public Employees' Retirement System (CalPERS) board has 13 members, including elected officials and representatives of employee groups. The Australian Future Fund's board of guardians usually consists of 7 to 9 members with financial expertise, while Dutch pension funds like ABP have boards ranging from 9 to 15 members, incorporating representatives from employers, employees, and independent experts. The UK's National Employment Savings Trust (NEST) trustee board includes 11 members with diverse skills from financial services to public policy[2].

Furthermore, in Georgia, proposed amendments to the funded pension system involve a shift in the appointment process for the Governance Board of the Pension Agency. Under the new proposal, the Prime Minister will appoint board members based on recommendations from a selection committee. This represents a departure from the current system where members of the Investment Board are selected by the Parliament of Georgia. **This change has raised concerns about reduced independence and transparency in the selection process, potentially endangering the recruitment of competent and impartial candidates.** Previously, various branches of the government were involved in the selection process for board members, with the Parliament playing a key role as a representative body in a parliamentary republic. This setup facilitated thorough discussions within Parliament, enhancing public awareness and involving a

[2] Namfisa, Roles, and Responsibilities of Members of Pension Funds; Randle, T., & Rudolph, H. P. (2014). Pension risk and risk-based supervision in defined contribution pension funds.

wide range of stakeholders, including opposition parties and civil society. However, the new proposal eliminates Parliament's direct role, centralizing the appointment authority with the Prime Minister. Although Parliament approves the Prime Minister, the appointment decisions are made unilaterally by him, reducing parliamentary scrutiny and limiting opportunities for public debate and transparency. Consequently, this could lead to concerns about potential biases and the appointment of less qualified candidates due to the diminished oversight and diverse input that was previously ensured through parliamentary involvement.

Successful examples from other countries highlight the importance of diverse and balanced board member selection processes. In Canada, the Canada Pension Plan Investment Board (CPPIB) has a robust selection process where members are appointed by the federal and provincial finance ministers. This process involves a nominating committee that seeks individuals with relevant expertise in investment, financial markets, and pension management, ensuring a high degree of professionalism and competence[3]. Similarly, in Sweden, the board of the AP funds, which manage the national pension buffer funds, includes members appointed by the government based on recommendations from various stakeholders, including employer organizations and trade unions. This ensures that the board has a wide range of perspectives and expertise, contributing to effective oversight and governance[4]. In the Netherlands, the board of the Algemene Pension Group (APG), one of the largest pension fund administrators, consists of members appointed by the Supervisory Board, which itself is composed of representatives from employers, employees, and independent experts. This structure ensures a high level of expertise and balanced representation from different interest groups[5]. In Denmark, ATP, the largest pension fund, has a Supervisory Board with members appointed by the Minister for Employment based on nominations from social partners, including trade unions and employer associations. This collaborative approach helps maintain a balance between government oversight and stakeholder representation[6]. Armenia's funded pension system employs a more diversified approach to board member selection. While specific details may vary, Armenia typically involves multiple stakeholders in the appointment process. For instance, government representatives, including those from the Ministry of Labor and Social Affairs and the Ministry of Finance, play a role in nominating and appointing board members. In addition, the Central Bank of Armenia is often involved in appointing representatives with financial regulatory expertise. This multi-stakeholder approach aims to ensure a balanced representation on the board and promote transparency and accountability in the selection process[7].

[3] cppinvestments.com
[4] Första AP-fonden
[5] apg.nl
[6] atp.dk
[7] parliament.am

On the contrary, there have been several cases where pension funds were involved in corruption due to a lack of proper control and oversight. In South Africa, the Public Investment Corporation, which manages the Government Employees Pension Fund, faced a scandal in 2019 when an inquiry revealed that poor oversight led to questionable investments and mismanagement of funds, with senior executives implicated in corrupt activities, including accepting bribes for approving investment deals[8]. In Peru, the private pension fund system known as AFPs faced allegations of corruption in 2017 when an investigation revealed that certain AFPs were involved in bribery and fraud to secure favorable regulatory conditions, facilitated by weak oversight mechanisms and lack of transparency[9]. In Brazil, the Postalis pension fund, serving employees of the postal service, was plagued by corruption, with investigations showing that billions of dollars were misappropriated due to fraudulent investment schemes and corrupt practices by fund managers. **The lack of stringent controls and proper governance allowed these activities to persist, leading to significant losses for the pension fund[10].** These cases highlight the critical need for robust controls, transparency, and independent oversight in the management of pension funds to prevent corruption and protect beneficiaries' interests.

Overall, the proposed change in Georgia raises questions about the balance between political influence and independence in board member selection, highlighting the importance of robust governance mechanisms to safeguard the integrity of pension systems. Successful practices from countries like Canada, Sweden, the Netherlands, and Denmark demonstrate that involving a diverse range of stakeholders and ensuring transparent, merit-based selection processes can significantly enhance the effectiveness and credibility of pension system governance.

LIMITING EXTERNAL ASSET MANAGEMENT IN PENSION FUNDS

The proposed amendments will restrict the involvement of external asset managers in overseeing pension assets. Consequently, pension fund participants will no longer have the opportunity to select their preferred asset manager to manage their savings, as originally intended under the legislation set to take effect from January 1, 2025. Such limitations on competition will have a detrimental impact on pension system participants. In the medium term, this will hinder the development of Georgia's capital market and, more significantly, limit the rights of pension fund participants.

The literature highlights several challenges that private pension funds face, particularly when the market does not ensure sufficient competition, as evidenced by examples from various countries:

[8] Bloomberg: https://www.bloomberg.com/news/articles/2020-03-12/inquiry-into-south-africa-s-pic-implicates-senior-management

[9] OECD: https://www.oecd.org/daf/anti-bribery/peru-phase-2-report.pdf

[10] Reuters: https://www.reuters.com/article/idUSL2N1MF0JN/

1. High Administrative Costs:

- **Chile**: One of the significant issues with the Chilean pension system managed by private companies (AFPs) is the high administrative costs. These costs were initially as high as 15% of accumulated assets and, although they have decreased, they still pose a burden on contributors. High administrative costs reduce the net returns for pensioners, leading to lower payouts[11].
- **United States (401(k) Plans)**: In the U.S., individual retirement accounts like 401(k) plans often incur higher administrative and management fees compared to defined-benefit pension plans. These fees can significantly erode the retirement savings of individuals over time[12].

2. Insufficient Payouts:

- **Chile:** Despite promises of high returns, many retirees receive much lower pensions than expected. The average pension payout is significantly below the promised 70% of pre-retirement income, often only 20% to 30%. This shortfall has led to widespread financial hardship among retirees, contributing to public discontent and protests[13].
- **Poland:** Similar to Chile, Poland's experience with privatized pension funds led to lower-than-expected payouts. The government eventually reversed some of the privatization to ensure better coverage and higher payouts for retirees[14].

3. Complexity and Lack of Financial Literacy:

- **Chile:** Choosing between different private pension fund managers requires a certain level of financial literacy, which many individuals may lack. This complexity can lead to suboptimal choices, with individuals potentially selecting high-fee, low-performance funds due to lack of information[15].
- **Australia (Superannuation Funds):** Australia's superannuation system also allows choice among multiple private funds. However, many Australians struggle

[11] Joaquin Vial Ruiz-Tagle, Francisca Castro, The Chilean Pension System, OECD Ageing Working Papers, 1998, page 18.

[12] The Dialogue (2022). Would Boric's Plan Strengthen Chile's Pension System?

[13] Heine (2020). Solving Chile's Crisis Starts With Fixing Its Pension System

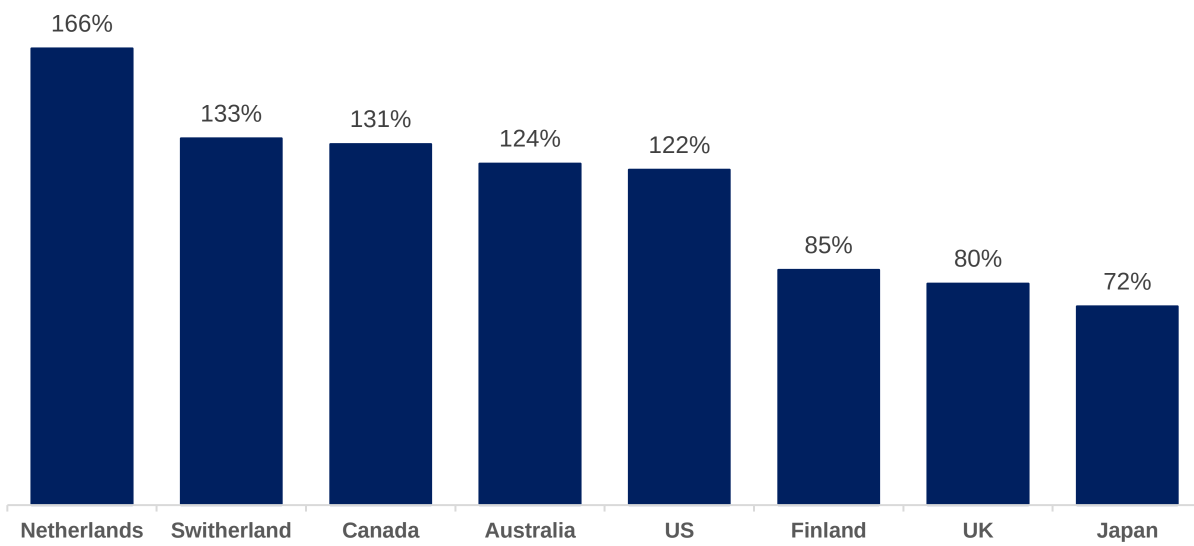
[14] Heine (2020). Solving Chile's Crisis Starts With Fixing Its Pension System

[15] Heine (2020). Solving Chile's Crisis Starts With Fixing Its Pension System

with the complexity and end up paying higher fees than necessary or choosing funds that do not meet their retirement needs[16].

However, looking at successful examples from other countries, Sweden stands out with its well-regulated, competitive pension system. In Sweden, the premium pension system allows participants to choose from a wide range of private funds, promoting competition and efficiency. This system has contributed to higher returns and a well-developed capital market[17]. Other European countries also demonstrate diverse and competitive pension management systems. Dutch pension funds, for example, are managed by professional asset managers, and participants have some degree of choice in how their pension contributions are invested. This has resulted in a stable and high-performing pension system with one of the highest asset-to-GDP ratios in the world[18].

Figure 5. Ratio of pension assets to GDP in selected countries in 2022



Source: Statista

In Denmark, the pension system includes both public and private elements, with significant involvement from private pension funds and insurance companies. Danish pension funds are known for their strong governance and risk management practices, which have contributed to high returns and financial stability for retirees. Participants often have options to choose between different investment strategies, enhancing the competitive environment.

[16] Heine (2020). Solving Chile's Crisis Starts With Fixing Its Pension System

[17] https://economy-finance.ec.europa.eu/system/files/2021-05/se_-_ar_2021_final_pension_fiche.pdf

[18] https://www.pensioenfederatie.nl/en/home

Armenia has taken a different approach in managing its pension system. Armenia allows the involvement of multiple external asset managers, giving pension fund participants the freedom to choose their preferred managers. This competitive environment has encouraged better performance and transparency in managing pension assets, benefiting the participants. The Armenian model aims to maximize returns for retirees by leveraging the expertise and efficiency of various asset managers, fostering a more robust capital market.

By comparing Georgia's proposed restrictions with Armenia's competitive approach and the successful models of Sweden, the Netherlands, and Denmark, it becomes evident that limiting the choice of asset managers can stifle competition, reduce returns, and impede capital market development. Allowing multiple asset managers and maintaining a competitive environment, as seen in other countries, can enhance the efficiency and performance of pension systems, ultimately safeguarding the interests of pension fund participants. In addition, a lack of competition and the absence of a guarantee to delegate pension fund management to private companies can increase the risk of corruption.

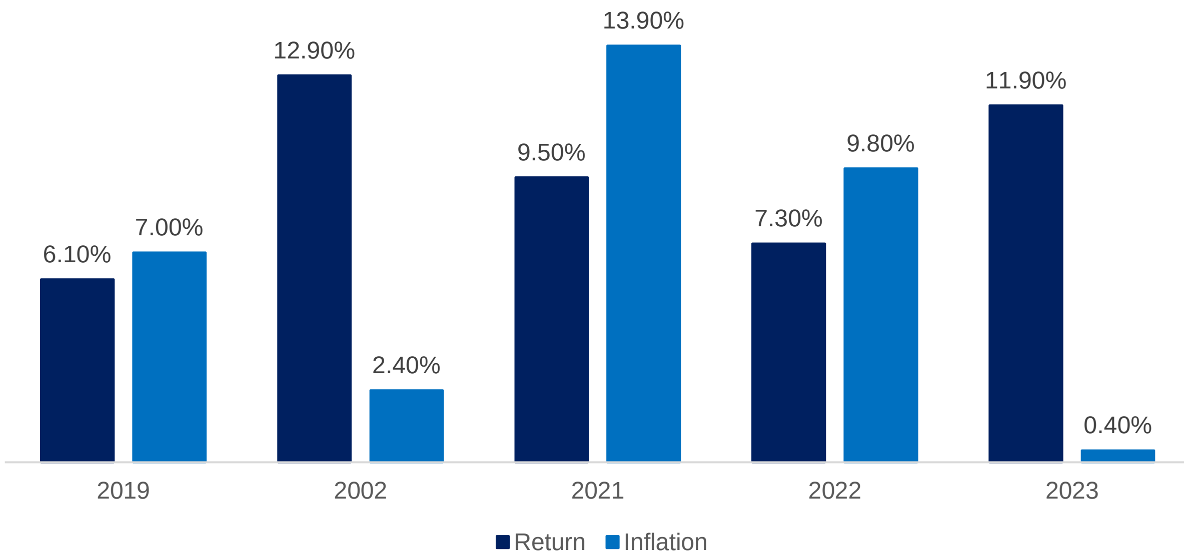
LOOSENED CONSTRAINTS: CHANGING PENSION FUND INVESTMENT BOUNDARIES

The proposed amendment increases the thresholds for various investment options, providing the pension fund with greater flexibility to utilize a broader range of financial instruments within its investment portfolios while reducing due diligence requirements. Specifically, the types of investment portfolios and their permissible investment limits across broad asset classes will be redefined as follows: 15% (previously 0%) of a conservative (low-risk) portfolio, 20% (up from 15%) of a balanced (medium-risk) portfolio, and 25% (up from 20%) of a dynamic (high-risk) portfolio can be diversified in other types of assets.

This change was primarily motivated by inflationary pressures. As illustrated in figure 6, during the years 2019, 2021, and 2022, inflation exceeded nominal returns on investment, resulting in negative real returns. Consequently, the proposed amendment aims to address this issue by providing more avenues for investment diversification, potentially mitigating the impact of inflation on the fund's returns.

It's important to highlight the lack of a clear definition for "other types of assets," if any. This category might encompass loans, investments in government projects, etc. Moreover, given the Prime Minister's sole authority in appointing Board members and the limited involvement of external asset managers in the asset management process, this increased investment freedom intensifies the potential risks, particularly regarding investments in government projects, further endangering pension system participants. These risks encompass market volatility and the inherent uncertainties associated with these investments. However, the most significant risks might be political in nature, particularly concerning corruption.

Figure 6. Return on Investment and Inflation



Source: Pension Agency

This concentration of power not only increases the potential for decisions to be influenced by political agendas but also raises concerns about transparency and accountability in the investment process. Without adequate checks and balances, there is a heightened risk of investments being made for reasons other than maximizing returns for pension system participants.

Moreover, the lack of external oversight from asset managers could lead to a gap in risk management practices, leaving the fund vulnerable to unforeseen market fluctuations or investment pitfalls. In particular, investments in government projects, while potentially lucrative, carry inherent risks such as regulatory changes, mismanagement, or delays, which could adversely affect the fund's performance and expose the financial security of pension beneficiaries.

Therefore, while the intention behind the proposed amendment may be to address inflationary pressures and enhance investment diversification, it is crucial to consider the potential consequences of increased investment freedom within the context of the pension fund's long-term sustainability and the well-being of its participants.

CONCLUSION

Pension systems are vital for the financial security and well-being of elderly populations, contributing significantly to poverty reduction and societal stability. Georgia's proposed amendments to the pensions law are announced to enhance the system's effectiveness, however, they raise alarms about governance, competition, and investment risk, risking the benefits of 1.5 million pension fund participants.

Centralizing the governance by establishing a single governing board could compromise the system's independence and transparency. International practices show that involving diverse stakeholders in board member selection enhances accountability and expertise, thereby safeguarding the pension system's integrity. Countries like Canada and Sweden demonstrate the benefits of inclusive and merit-based selection processes, ensuring balanced and effective governance. Changing the appointment mechanism and lowering qualification requirements also risk compromising professional competence of the board.

Restricting external asset management, as proposed, may simplify operations but limits competition and participant choice, which could hinder market development and reduce returns. In contrast, competitive environments, such as those in Armenia and Sweden, encourage better performance and transparency in managing pension assets, ultimately benefiting participants.

Loosening investment boundaries aims to address inflationary pressures by allowing greater diversification. However, this increased investment freedom introduces risks, particularly with potential investments in public projects. The lack of external oversight and expanded investment limits heighten the potential for mismanagement and corruption, endangering the fund's sustainability and participants' financial security. This is a particularly risky proposition as the direction of strategic partnerships has changed as proven by the announced intention to involve a sanctioned Chinese company in the most strategic port project. Robust governance and strict controls, as seen in Denmark and the Netherlands, are essential to mitigate such risks. Therefore, proposed pension system changes raise major concerns about its associated risks for long-term pension system viability and participants' security. By learning from successful models worldwide, Georgia shall build a resilient and effective pension system that safeguards the social security and financial well-being of its elderly population. ensuring high competence and independence of the board, and stakeholder involvement are crucial for an effective pension system and for ensuring its best possible risk management in the interest of pension fund participants and their welfare.

The discussed risks are even more acute now as in the past year or so Georgia has experienced significant declines in economic governance. In addition to the anti-democratic Law on Transparency of Foreign Influence (known as the Agents Law), several laws and legal amendments such as alterations in the governance of the National Bank of Georgia, the so-called Law on Offshores, and the changed course of strategic partnerships by the intention of involving sanctioned Chinese companies in the major strategic port project create the context that makes the risks even more alarming.

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