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PENSION REFORM

Pillar II Preconditions: Implications for Ukraine

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Abstract

This report examines the preconditions necessary for instituting a successful Pillar II mandatory funded pension system in Ukraine. The essential preconditions include: 1) sound macroeconomic policies; 2) an adequate financial system; and 3) implementation capacity in human resources and technology. This report concludes that Pillar II pension reform in Ukraine should be delayed while steps are taken to meet the preconditions. Delay now is appropriate to achieve subsequent long term success.

Financial Sector Development Program (USAID/FINREP-II)

This report is intended for review and comments by the Ministry of Social Policy, the Ministry of Finance, and Ukrainian pension policy makers.

FINREP-II is the USAID Financial Sector Development Program in Ukraine, implemented by Financial Markets International, Inc. (FMI). www.fmi-inc.net.

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Executive Summary

This paper examines whether the preconditions for instituting funded pensions in Ukraine are in place at this time. Mandatory funded systems are referred to as Pillar II plans. A mixed pension system consisting of a solidarity plan in combination with a funded Pillar II has been an attractive way for countries in Eastern Europe and Central Asia to provide higher pension replacement rates to future retirees without excessive stress on the government's fiscal framework.

Overall, our findings suggest that Pillar II pension reform should be delayed while steps are taken to meet the preconditions outlined in this report. With a strengthened macroeconomic framework and better financial sector regulation, supported by technical assistance to improve government capacity, successful Pillar II implementation could be started with reasonable safety after several years delay. Going forward on the current time schedule would add untoward risk to the economy.

In 2004, Ukraine adopted framework legislation to reform its pension system based on the introduction of a mandatory second pillar. Recently, the Ministry of Social Policy (MSP) proposed a draft law that would consolidate all pension legislation, including Pillar II. The Draft is to be completed and introduced to the Rada on May 1, 2015 and forwarded to the Council of Ministers. The proposed legislation is intended to initiate a funded pension system for workers hitherto entitled to privileged and special state pensions by January 1, 2016, and a full Pillar II system for all workers contributing to the solidarity system by January 1, 2017. This proposal is currently under discussion by government and non-government partners.

The MSP initiative would constitute a major reform at a difficult time in Ukraine's history in the face of considerable economic dislocation, in part but not in whole, due to conflict in the Eastern oblasts of Donetsk and Luhansk. Uncertainty about Russia's intentions with regard to further escalation means that Ukraine must maintain a state of military readiness. In addition, overarching corruption, as perfected by former President Victor Yanukovych, likely has added to the current economic distress. Due to this combination of severe economic crisis and military conflict, the International Monetary Fund (IMF) granted Ukraine financial support amounting to about $17.5 billion under a four-year Extended Arrangement.[1]

At this crucial point in the legislative process, FINREP-II examines whether the preconditions necessary for Pillar II, which have been established in numerous World Bank documents,[2] can be met by the 2016-2017 proposed implementation deadlines.[3] This report reviews Pillar II preconditions step-by-step, citing specific studies and

[1] International Monetary Fund (2015).

[2] For example see World Bank (2001), World Bank (2005a) and World Bank (2006a).

[3] This report is not intended to address issues related to contribution rates, the division of contributions between employers and employees, retirement ages, replacement rates, benefit formula or payout options -- In other words, the structure of the system. Further, it does not discuss the viability of continuing privileged and special pensions. However, these could simply be cashed out and provided as a wage supplement.

identifying areas in which strengthening is required before going forward with Pillar II pension-reform implementation.

Pillar II preconditions are: (1) sound macroeconomic policies, (2) an adequate financial sector, and (3) implementation capacity. These issues are addressed in three sections that describe the reasons for the preconditions and the extent to which the preconditions are fulfilled in Ukraine. A concluding section offers recommendations for ensuring that key preconditions can be met within a reasonable timeframe in areas where compliance is lacking.

Pillar II pension reform in Ukraine should be delayed while steps are taken to meet the precursors necessary for success. The population of Ukraine does not deserve a pension system that may fail. Although Pillar II reforms have been delayed for 11 years, an additional delay is warranted. This would provide sufficient time for implementation planning, allowing the economy to stabilize and ensuring the population access to secure funded pensions in the future.

A. Macroeconomic Outlook

The World Bank stresses that macroeconomic stability is necessary to reduce the risks of Pillar II failure. Stable monetary and fiscal policies are needed if multi-pillar systems are to achieve long-run retirement-income objectives because large macroeconomic imbalances, high inflation, and excessive debt burdens create uncertainty and destabilize financial markets.

Economic stability can be measured by a series of indicators including (i) real GDP growth; (ii) inflation, (iii) the fiscal deficit, (iv) government debt, and (v) development assistance as a percentage of the government budget.

Real GDP Growth: Without GDP growth, the stability of pension contributions and investment opportunities are at risk. Long-term growth ensures stability in the solidarity system, stability of contributions to Pillar II, and stability in financial markets. Currently, Ukraine's economic stability is in crisis. The IMF's March 2015 estimates indicate that real GDP decreased by 6.9% in 2014 and that another reduction of 5.5% is anticipated for 2015.[4] Although the IMF projects positive GDP growth in 2016, we would assess that this projection with a low degree of confidence, as an earlier September 2014 IMF forecast indicated that real GDP growth would be a positive 2.0% in 2015. The projected 5.5% decline is a substantial revision over a six-month period.

Table 1 shows real GDP growth from 2005 to 2013.[5] While Ukraine had strong growth in earlier years, after the crash of 2009, GDP growth never robustly recovered and has been going downhill every since.

[4] IMF (2015)
[5] World Bank, World Development Indicators (last updated 03/12/2015).

Table 1: Real GDP Growth

	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP growth (annual %)	2.7	7.3	7.9	2.3	-14.8	4.2	5.2	0.2	1.9

We conclude, that with regard to this indicator, one should want to wait for a couple of sound years of growth before a severe risk to the execution of Pillar II could be avoided.

Inflation: High inflation can destabilize economic growth and capital markets, whose stability is necessary for financial sector development. High inflation can restructure investment decisions away from more stable financial instruments and towards greater risk in a search for returns to outpace prices. Hyperinflation can distort incentives even further.

According to the IMF, inflation, as measured by end-of-period consumer prices, was 24.9% in 2014 and is projected to increase to 26.7% in 2015, remaining high for the next two years at 8.7 and 7.2% in 2016 and 2017 respectively.[6] This is much higher than inflation targets for developed countries, which tend to be in the range of two to three percent per annum.

Part of the very large 2015 increase in consumer prices is due to the elimination of fuel subsidies, which will be passed on as an increase in utility prices effective April 1, 2015. This will lead to an inflationary jump in April with additional rises in November and December when the heating season begins. However, fuel-related increases are estimated to account for only 8-9 percentage points of inflation overall.[7] The rest is driven by exchange rate depreciation. The exchange rate virtually doubled[8] from 11.8 UAH/USD one year ago to 23.1 UAH/USD on April 5, 2015, after government stabilized the rate from a high of 28.6 in late February.

Inflation in Ukraine is not new. World Bank data[9] indicate that it was a constant macroeconomic risk factor from 2005 - 2013, except for the last two years.

[6] Year-over-year CPI inflation is projected to be lower than either changes in the GDP deflator or period-average CPI increases.

[7] Private conversation.

[8] http://www.oanda.com/currency/historical-rates/

[9] World Bank, World Development Indicators (last updated 03/12/2015).

Table 2: Consumer Price Inflation

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Consumer Prices (change %)	13.6	9.1	12.8	25.2	15.9	9.4	8.0	0.6	-0.3

In view of a past history of high inflation, price stability is likely to remain a challenge for Ukraine and would need to be stabilized before Pillar II pension reform implementation should be considered.

Budget Deficit.

Large fiscal deficits, leading to imbalances in pension revenues and expenditures, often motivate countries to reform their pension systems. However, the transition costs of switching from a PAYG system to a funded system would temporarily increase the fiscal deficit, as governments must continue to pay current pensions at the same time, as some contributions are diverted to investment instruments.[10] For this reason, countries with large budget deficits cannot maintain fiscal stability if they entertain the implementation of Pillar II. According to the IMF, the budget deficit for 2014 is estimated at 4.6% of GDP. In December 2014, the authorities adopted a 2015 budget targeting a deficit 3.5 percent of GDP. The budget deficit demanded by the European Union stands at 3% of GDP, not that this guideline is always followed.

While Ukraine's deficits do not initially appear to be discouraging, in point of fact, international assistance[11] to Ukraine is projected to be 10.7% of GDP in 2015, up from an estimated 6.2% in 2014 and 3.5% in 2013. This amounts to about 20.8% of current government expenditures, compared to 8.2% in 2014 and 2.8% in 2013. While an extraordinary degree of international support is essential, this level of assistance should be a signal that Ukraine is not ready for Pillar II implementation. Countries whose budgets are heavily dependent on external aid are unlikely to have a sufficiently stable revenue base to support a multi-pillar system.

Government Debt and Donor Funding: High levels of government debt may constrain the development of capital markets. In this case, such countries are not likely to be able to afford the additional debt resulting from the implementation of funded systems. The structuring of government debt is one of the central concerns of the IMF agreement with Ukraine including strict agreements on debt restructuring and tax arrears.

[10] Transition costs will be estimated using the Ukrainian Actuarial Model based in the Ptukha Demography and Social Research Institute of the Academy of Sciences of Ukraine.
[11] IMF (2015).

As a benchmark, public debt at 60% of GDP is generally regarded as extremely high.[12] The IMF (2015) reports that public debt (excluding guarantees) was 33.5% of GDP in 2013, but increased to 62.7% of GDP in 2014 and is projected to be 72.9% in 2015.

In sum, before embarking on a multi-pillar reform, Ukraine needs to achieve fiscal balance and sustainability. This may be achieved by expenditure rationalization and revenue reform, including additional parametric reforms to the pension systems.[13] It will take time.

B. Financial Sector Readiness

The development of the financial sector is both a precondition for pension reform as well as a possible result of pension reform. Initially, the World Bank specified that only a simple standard of financial market readiness was necessary -- that is, countries starting a funded system would need "at least a small number of sound and well-functioning banks and insurance companies coupled with a willingness to implement capital market reforms and openness to foreign expertise."[14] Later World Bank research showed that Pillar II is unlikely to succeed in countries in which the dominant banks are state owned, financially insolvent, and operationally inept.[15] Subsequently, these criteria were expanded to include "specific requirements in the areas of payments and security settlement systems, custody, and trading platforms….accurate, transparent and enforced accounting, financial reporting and valuation systems that promote fair valuation of instruments and the need for independent and competent auditors to promote self regulation."[16] A thorough review of financial sector organization is needed to determine whether all the attributes outlined above are in place in Ukraine.

Banking: Anecdotal evidence suggests that Ukraine has a long way to go at this time of crisis. Forty-seven banks are reported to have failed since March 2015. While this may not indicate that a core banking-sector is unavailable, a thorough review of the banking sector will need to be undertaken. Further, since the start of the current crisis, a significant proportion of both local and foreign currency deposits have been withdrawn as a direct result of the skyrocketing hryvnia/dollar exchange rate. Non-performing loans are also increasing and it is not possible to determine the extent to which foreign banks may pull out of Ukraine.

Capital Markets: The financial sector in Ukraine is thought to be underdeveloped, and stock market regulation could be strengthened. Market capitalization as a percent of GDP fell from a low 29.0% in 2005 to an even lower 11.7% in 2012. This compares unfavorably to the Europe and Central Asia (ECA) region overall, where capitalization was 25.5% in 2012. Many ECA countries have rates that are higher. Stocks traded in

[12] World Bank (2006).

[13] The draft law includes some new parametric changes to the solidarity system, which could improve the platform for a future Pillar II reform.

[14] Vittas (1998)

[15] Impavido, Musalem, and Vittas (2001).

[16] Rudolph and Rocha (2009).

Ukraine were an infinitesimal percentage of GDP in 2012 at 0.7% and the turnover ratio was 5.2[17].

While the expansion of the demand for government debt can improve market efficiency and lead to the development of longer duration instruments, a strategy of concentrated investment in government debt fails to yield the benefits provided by diversification. Further, the government debt market in Ukraine has been failing.

Overall, the capital markets in Ukraine have not been flourishing. A weak capital market, compounded with the risk of purchasing government bonds, suggests that a flood of funds into the banking system, even if only from the funding of privileged and special pensions, would neither benefit future pensioners nor encourage macroeconomic stability.

Voluntary Pensions: In recent years, a number of voluntary funded pension plans have been started. In 2009, 108 non-state pension funds (NPFs) were registered in Ukraine but only about 74 were actually in operation. Thirty-six asset management companies were licensed to provide investment management services. It is reported, however, that by 2015 most voluntary plans had closed, including the largest – that of the Ukraine National Bank. It appears that there has been little demand for Pillar III pensions in Ukraine. That said, the management of even a small number of existing plans was a significant challenge.

A World Bank study on the operation of voluntary pension plans in Ukraine identified the following issues[18]:

- The practice of having funds with a mass of members and close to zero assets under management is not known in other countries.

- The World Bank is not convinced that there are sufficient regulatory powers to trace the ultimate controllers of asset managers, administrators, custodians and founders and to disclose the conflict of interest. Enhancing capacities to trace the ultimate controllers and reveal / prevent conflicts of interest should be a priority for regulators

- The achievement of optimum risk-return combinations in NSPFs portfolios for the benefit of members of NSPFs is limited due to underdeveloped capital markets in Ukraine.

[17] Turnover ratio is the total value of shares traded during the period divided by the average market capitalization for the period. Average market capitalization is calculated as the average of the end-of-period values for the current period and the previous period.

[18] World Bank (2008).

- The foreign exchange regulation ban should be lifted on grounds of risk management and prudent investment considerations subject to more detailed regulation, which should prescribe investment in liquid low-risk instruments in developed markets.

- Regulators should allow investment only in the assets where valuation methods can be applied consistently across funds.

- Market transparency has been very weak in Ukraine. As the first two steps, all major players in the industry should begin to implement International Financial Reporting Standards (IFRS).

- Resources for on-site inspections and horizontal cooperation between regulatory agencies should be significantly expanded in parallel with the enhancement of regulators' powers to deal with the conflict of interest in an efficient way.

Undiversified pension portfolios are a result of government-imposed investment guidelines, a lack of domestic investment opportunities, and/or economic crisis. Ukraine is subject to all three conditions.

The World Bank review on the operation of voluntary Pillar III pension plans would be at least as valid for the rollout of Pillar II. While some issues may have been addressed in the intervening years, it is likely that many have not been. This creates a major challenge for an accelerated implementation of Pillar II even with favorable macroeconomic conditions. Nonetheless, a substantial and substantive review of administrative and legal requirements for funded pensions can begin immediately in anticipation of an improved macroeconomic environment in years to come.

C. Implementation Capacity

Barr and Diamond (2008) state: "The importance of implementation is often underestimated. It requires skills that are just as demanding as policy design, and those skills need to be involved when the policy is designed, not as an afterthought. Policy makers and advisers frequently take an unduly optimistic view of the extent to which a country meets the preconditions for effective reform."

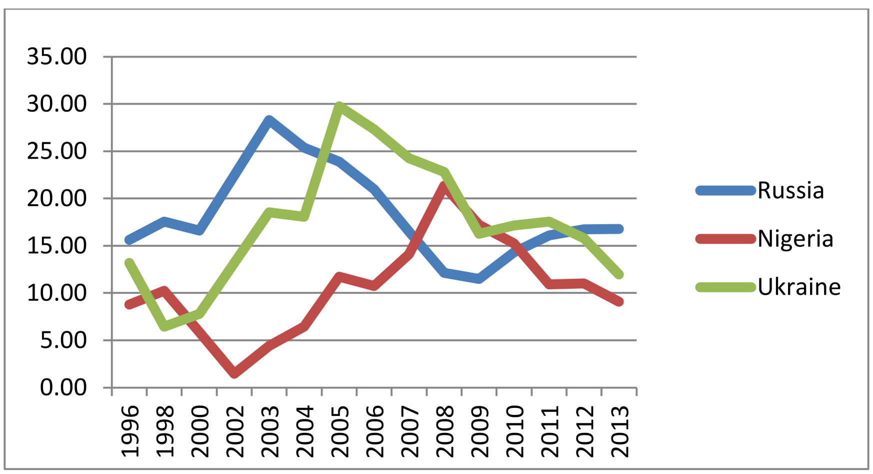
Implementation for Pillar II needs to be assessed in several areas including (i) corruption, (ii) contribution collection and solidarity system administration, (iii) Pillar II administration, and (iv) financial market management. Financial sector requirements were reviewed in the previous section. The first three topics are discussed below.

Corruption: Funded pillars are vulnerable to corruption and weak governance from both the government and the private sector. As a result, strong regulation and supervision of pension funds, asset managers, and other financial intermediaries is essential if multi-pillar systems are to operate prudently and effectively. Strong regulators as well as rigorous regulations are necessary. If regulatory and supervisory standards are not enforced, the opportunity to deplete funds owned by pension contributors is high.

One signal of government commitment to regulatory reform is the World Bank's index of control of corruption, which can be used to assess the potential for regulatory effectiveness. Even if regulators are honest, they will be hard pressed to regulate financial assets in a country in which business dealings are highly corrupt.

The World Bank measures corruption through its Worldwide Governance indicators. An index of corruption is constructed using data from a number of sources and aggregated into an index and as percentile rankings across countries.[19] In terms of worldwide rankings, Ukraine is among the lowest ranking countries in the world at 11.9% in 2013. Further, there has been little improvement over time. Chart 1 shows how Ukraine's rankings crisscross those of Russia and Nigeria.

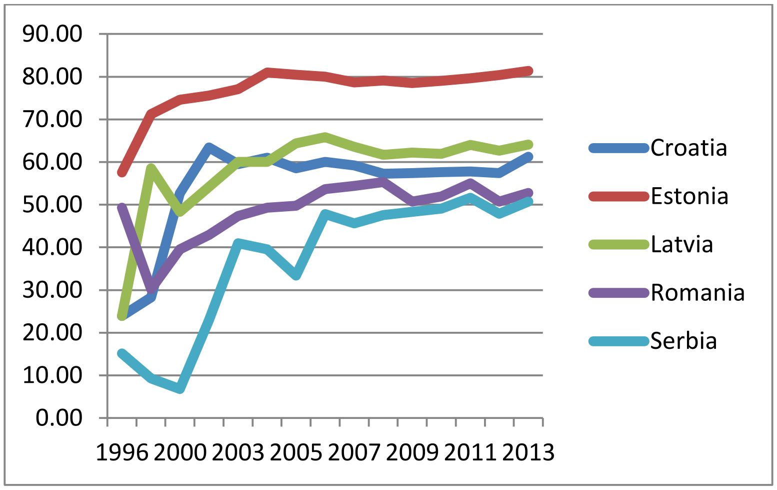
Chart 1: World Bank Corruption Index: Ukraine, Russia and Nigeria (Percentile rankings)



Data by region indicate that there has been little change within regions since the mid 1990s, with OECD countries ranking highest and Southern African countries generally ranking last. Nonetheless, several Central and Eastern European countries have improved their corruption ratings substantially over time (Chart 2), suggesting that such a path is feasible for Ukraine as well.

[19] Control of corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. This table lists the individual variables from each data sources used to construct this measure in the Worldwide Governance Indicators. Thirteen indicators of corruption are included in the index. See http://info.worldbank.org/governance/wgi/index.aspx#reports

Chart 2: World Bank Corruption Index: Five CEE Countries (percentile rankings)



Compared to the corruption index, Ukraine scored relatively better on the World Bank's index of regulatory quality[20] where it reached the 28.71 percentile rank. However, in comparison to other ECA countries this was low, with the ECA average slightly under the 70 percentile. Further, other ECA countries have improved their regulatory quality over time, while Ukraine has not.

Transparency International publishes its highly regarded Corruption Perception Index.[21] Ukraine's score was 26 (rank 142) compared to Croatia's score of 48 (rank 61) and Poland's score of 61 (rank 35). Even Russian had a better score than Ukraine --27 (rank 136).

The international community has continued to be concerned about corruption in Ukraine. The European Commission recently recommended that Ukraine "duly implement the comprehensive anti-corruption legal package adopted in October 2014, starting with setting up and ensuring effective functioning of the National Anti-Corruption Bureau and the National Agency for the Prevention of Corruption."[22]

Corruption is foremost in the minds of the public as well. A 2014 survey of the Ukrainian population[23] indicated that fifty percent of respondents thought that Anticorruption/Public Procurement should be the priority of the Council of Ministers. [24] This was higher than the next two highest ranked issues -- Defense/Military (24%) and

[20] Twelve indicators of regulatory quality are included in the index.
[21] http://www.transparency.org/research/cpi/overview

[22] As reported by InterFax Economy (2015)
[23] International Republican Institute (2014).
[24] Support of Anticorruption/Public procurement was higher in Western Ukraine with 57 percent of respondents indicating that this was their primary concern. In addition, 36 percent felt that Defense/Military was the Council of Ministers most important priority. Other differences are observable for Central and Eastern Ukraine with each of these priorities somewhat less important.

Pension/Social Benefits (24%). A 2013 survey[25] indicated that corruption was on the public mind, as well, with the primary concerns of the population reported to be (i) inflation – 56%, (ii) poverty – 51%, (iii) unemployment – 50% and (iv) corruption – 47%.

This review barely scratches the surface of corruption in Ukraine, as corruption is a multi-faceted problem that must be addressed incrementally and with great difficulty. According to Fjeldstad and Isaksen (2008) “corruption can best be tackled when political reform and regulatory restructuring are complemented by a systematic effort to inform the citizens about their rights and entitlements and increase their capacity to monitor and challenge abuses of the system”. There have been recent signs that the current Ukrainian government is willing to do this.[26] Nonetheless, until this happens, depositing significant funds into a failing financial system could risk real losses for millions of workers.

Solidarity system administration: Several aspects of solidarity system administration are parallel to those required for Pillar II, including the collection of contributions, recordkeeping for contributors, and benefit calculation and benefit payment. In Ukraine, at least two organizations must work together to develop effective processes – the Pension Fund of Ukraine (PFU) and the State Fiscal Service (SFS). The newly organized SFS took over the collection of contributions from the PFU in 2014 as a means to centralize tax collection on a national basis.

Solidarity system administration is often underestimated, with governments more desirous of obtaining IT equipment than understanding that it is reformed business practices that make the IT processes efficient. IT systems should not simply computerize current operations without reforming them as well. The desire of the PFU to improve administration through both types of changes is good first step.

The solidarity system in Ukraine faces special challenges tied to weak rule of law. In particular, at least two types of informality exist so that actual social insurance contributions only partially reflect the income of the population. First, in some sectors workers pay no social insurance contributions at all. These workers are primarily found among small employers and those in rural areas.[27] The bulk of the earnings undercount, however, is more likely among those who receive part of their salary “in the envelope”, that is, salaries are partially received in cash, even among companies that pay social insurance contributions.[28] Further, there are arrears in salary payments, and, consequently in pension contributions.

To date, we have found no estimates of the size of payments ‘in the envelope’. However, according to Schneider, Buehn and Montenegro (2010), the shadow economy

[25] USAID (2013).

[26] For example, the recent removal of Igor V. Kolomoisky as governor of Dnipropetrovsk and the arrest of two officials publicly on television at the Council of Ministers, as well as legislation and policy measures to combat corruption at a number of levels and in a number of organizations.

[27] Kupets, (2011). Their report suggests that the maximum gains to contribution and tax collection from formalization would be UAH 627.5 million.

[28] Of course, some firms may pay some employees ‘in the envelope’ in part and others in totality.

accounted for 46.8 percent of GDP in 2007. Other studies suggest somewhat smaller and larger shadow sectors – but all are very large by international standards.[29] Observers agree that high social insurance contributions contribute to overall tax evasion, apparently to the current benefit of both employers and employees. However, it would appear that this situation is also related to the intractable overarching challenge of corruption.

The draft pension legislation under consideration proposes giving the PFU the responsibility for contribution collection for Pillar II. The proposal is made in view of dissatisfaction by the PFU with the speed with which total employer are reported to them by the SFS. Nonetheless, this is a matter that should be solved by better collection policies on the part of the SFS, primarily by implementing collection reforms using improved information technology in conjunction with streamlined reporting. In view of the size of the shadow economy and difficulties with fully collecting taxes-due from employers and employees, improving the collection facilities of one agency would be preferable to duplication of effort.

That said, we understand that the IMF will be sending an expert to provide technical assistance to the FSF on tax collection. The PFU should be part of those discussions so that social insurance contribution collection is not ignored. Unfortunately, without a specific emphasis on social insurance, collection procedures may be a secondary or tertiary priority for the SFS as fiscal agencies are generally more interested in improving VAT collection procedures and the collection of other types of taxes. However, the full collaboration of the Ministry of Finance can overcome any reluctance on the side of the SFS to only focus on some of their collection challenges.[30]

The IMF has also drafted a study on changes in tax policy that could be beneficial to Ukraine.[31] This would shift a greater burden to the income tax that could possibly encourage improvements in the social insurance contribution rate in the future. Better tax collection could also reduce the degree to which salaries are provided 'in the envelope.' However, improved tax collection is only one step in many to reduce the atmosphere of corruption in Ukraine. A robust economy may reduce labor market informality to an even greater extent.

The PFU should focus on record keeping, benefit calculations, and the distribution of pension contributions, developing payment systems and contributor records for both the solidarity and proposed Pillar II pensions.

The PFU needs assistance to assess its progress and design a plan that would include improvements in the administration of the solidarity system, including business

[29] Ehrke, Betliy, Kirchner, Giucci (2011). For example, they cite that the National Institute for Strategic Studies, which provides the most up-to-date estimates, gives figures of 37 percent in 2009 and 33 percent in 2010.

[30] See section on Pillar II administration indicating the need for many ministries to work together for such a pension reform. These include the Ministry of Finance, the Ministry of Social Policy, the Pension Fund, the State Fiscal Service, and financial market and insurance regulatory agencies.

[31] IMF (2015).

practices, software and hardware, as well as initial planning for Pillar II. Such projects require documenting current practices, including collection of salary histories, record verification, pension calculation, and payments procedures. Administrative and legal measures are needed to detect fraud and abuse at all levels of the recordkeeping and payment process. The SFS and PFU would be well advised to work together to ensure that procedures are complementary, effective, and non-duplicative.

Pillar II administration: Pension reform is not simply a change of laws but requires major reforms in governance, the collection of contributions, record keeping, client information, asset management, regulation and supervision, and benefit disbursement. Much of the framework for Pillar II administration can be twinned with financial sector regulation and solidarity system recordkeeping and collection.

Rudolph and Rocha (2009) provide a detailed view of Pillar II administration, expanding the pre-conditions that need to be met at the time of the reform and including a roadmap for the first five years of reform implementation. They note that “the success of a new second pillar requires not only strong political support at the time of the reform, but also constant monitoring of the reform during the implementation period, through the creation of a permanent committee or the appointment of a designated official. The committee or the official should have sufficient resources and authority to identify and implement the necessary regulatory changes and promote the development of market infrastructure that ensures the success of the second pillar.” In addition, a permanent group is suggested composed of members of key ministries involved in the pension system to ensure that continued implementation is in line with system requirements.

Specific requirements can be identified in the areas of payments and security settlement systems, custody, and trading platforms. Good accounting, financial reporting and valuation systems are important for the fair valuation of financial instruments. In addition, independent and competent auditors are needed to ensure correct valuation.

According to Rudolph and Rocha, “many reforming countries faced payments problems in the initial stages, and had to make great efforts to remedy these problems.” One solution in terms of IT system development has been the use of automated clearinghouses to process payments timely and efficiently at lower cost and reducing operational risk.

Rudolph and Rocha specify the following requirements:

- “It is essential to have an independent depository institution that enables book entry transfer of financial instruments.
- It is essential that pension fund managers and custodians employ accounting practices and safekeeping procedures that fully protect the assets of the pension fund, particularly against the creditors of pension fund managers.
- It is essential to have a set of independent external auditors with the capacity to provide a professional opinion on the financial statements of pension funds and pension fund managers.

- It is essential that pension fund portfolios are valued on a mark-to-market basis in a context of accurate, transparent and enforced systems of accounting and financial reporting.
- It is desirable to start the process of convergence of local accounting standards to International Financial Reporting Standards (IFRS) to avoid misinterpretation and confusion about the value of the funds."

More generally, the legal framework and institutional framework must be supportive of the reform, including (i) payment systems; (ii) securities settlement, (iii) exchanges or electronic trading platforms, (iv) custodian or depository institution; (v) accounting, auditing valuation and rating, and (vi) preparation for the payout stage. Efficiency and effectiveness in each of these areas is not easy.

Without a separate study of the financial system and Pillar II legislation, it is not possible to determine how many of these factors are currently in place. Given the weaknesses identified in financial markets and the poor infrastructure for voluntary funded pension plans, Ukraine would be well advised to obtain international technical assistance to review the preconditions outlined, and develop a plan to have the necessary elements in place prior to the formal introduction of Pillar II.

Successful administration of Pillar II also involves the development of policy capacity, including a program of ongoing actuarial calculation and policy development. We understand that policy development is housed in the MSP and that an ongoing actuarial model is part of the Academy of Sciences. Improved coordination is needed, however, as draft legislation should include actuarial projections of proposed changes very early in the process before any drafts are circulated. Further, actuarial calculations should be made on a regular annual basis for both the solidarity system and Pillar II, with reports available in print and on-line so that the public can assess the financial stability of the pension funds.

Another area that can be strengthened is that of public information.[32] It is increasingly important that the policy reforms be introduced in a positive environment, and that the public receive educational and informational materials about Pillar II and funded pensions.[33] A good public affairs office should provide: (i) a source of ongoing contact and outreach to the media and (ii) direct information to fund contributors and beneficiaries. This is particularly important since the population is likely to have reduced trust in the financial sector as evidenced by the withdrawal of local currency from the banking system.

[32] See HSTPE (2006) for a good discussion of communications strategy.

[33] For example, Kazakhstan has focused on public information to support pension reform since 1998, initially supported by USAID. A recent TV clip was produced on the recent changes to merge separate pension funds into one Unified Pension Fund. See http://kazakh-tv.kz/en/programms/viewArchive?id=6714

D. Conclusions

In view of the challenges in introducing funded pensions in so many areas - - macroeconomic conditions, the financial sector, and implementation capacity - - the recommendation of FINREP-II is that the start-date of any funded pensions, including Pillar II, be delayed until each of these areas has improved significantly.

Pillar II should be supported once these challenges are addressed. Funded pensions are the good way for younger generations to benefit from higher replacement rates and security in retirement.

Some of the key roadblocks to funded pension implementation cannot be solved by improvements in pension administration – these include macroeconomic stability, financial market stability, and reduction in corruption. Further macroeconomic stability will also depend on whether there is continued escalation of the conflict in the East by outside parties.

For that reason, we recommend that government institute a set of indicators prior to the implementation of Pillar II that would act as green lights for stability, including positive economic growth for at the least a period of two years, low inflation targets agreed upon with the IMF, confidence in and a market for government bonds, and a reduction of debt including repayment of IMF loans.

Other impediments to a strong functioning pension system also must be tackled before contributions to Pillar II begin. These include improvements in financial sector regulation, as well as the institution of appropriate business practices supported by information technology (software and hardware) that will facilitate the smooth collection of solidarity and funded contributions, contributor records, investments, and payments. [34] It is critical that there be a continued commitment of all relevant government agencies to have sufficient resources and conditions to achieve successful reform:

> The Pillar II reform effort… "should have *sufficient resources and authority* [italics added] to coordinate with the pension fund supervisor and other government agencies, including ministries of Finance, Justice, Labor and Social Security, the Central Bank, and banking, securities, and insurance supervisors."

With sufficient preparation and a sustainable macroeconomic climate, Ukraine should be ready to launch a Pillar II system by 2018 – 2020, depending upon events.

[34] World Bank World Bank Implementation Completion Reports (ICR) for pension projects can be found at: http://www.worldbank.org/en/topic/pensions/projects/operational-documents?qterm=icr+pensions&lang_exact=English

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