

SUPPLEMENTARY NOTE ON PENSION REFORM

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **The pension reform process began with a diagnostic of the existing environment in 2014–2015, in the light of which the Cabinet adopted pension reform policy proposing (i) link future increases in the universal basic pension to inflation and (ii) introduce an additional contributory (Pillar II).** The initial diagnostic, undertaken by the Ministry of Economy and Sustainable Development (MOESD) with technical support under the Asian Development Bank (ADB) technical assistance (TA), assessed that the current universal pension scheme could at most protect retired citizens against poverty due to projected fiscal implications and that citizens needed to accumulate additional individual assets to improve adequacy of retirement income through the introduction of a contributory pension savings scheme. In addition, the practice of ad-hoc indexation of universal basic pension was resulting in unplanned pressure on fiscal planning and should be linked to price inflation to maintain purchasing value. These policy proposals were accepted and adopted by Cabinet on 21 March 2016.

2. **The work on developing the legal framework for the proposed Pillar II pension scheme began on policy adoption and culminated with the approval by Parliament of the Pension Savings Law on 21 July 2018.** The MOESD led a Working Group of key governmental departments to draft the legal and institutional frameworks to implement the proposed Pillar II pension scheme, the working group was supported by legal and institutional expertise provided under an ADB TA to carry out their task. The ADB TA team provided the Working Group a first draft of the Pension Savings Law in May 2016 for review and further refinement. The ADB TA team supported the Working Group in tailoring the legal framework to the local environment and in response to the feedback received on the early drafts from wider stakeholders. The consultation and refinement processes were completed in October 2017, with the draft law undergoing 13 redrafts, and finally submitted to Parliament in November 2017. The Pension Savings Law although approved by Parliament on 21 July 2018 became effective on 6 August 2018 when it was officially published.

3. **The MOESD, in parallel to drafting of the Pillar II pension law, also drafted a detailed business plan and roadmap for establishing the pension administration agency proposed under the draft law, completing the work in November 2018.** The ADB TA team worked with the MOESD to outline all business process and systems of the proposed pension administration agency during 2017 and 2018. These processes were included in a detailed business plan and implementation roadmap document completed in November 2018.

4. **The Pension Savings Scheme (i.e. the Pillar II pension scheme) was successfully launched on 1 January 2019 under the management of a newly created public pension agency.** The Pension Savings Law established the Pension Savings Scheme (PSS) and mandated its application on 1 January 2019, it also described a new public entity to administer the scheme. The government established the Pension Agency (PA) as a legal entity under public law and notified its charter on 15 August 2018. The Supervisory Board of the PA appointed its Director, who has overall management responsibility, on 15 September 2018 following a competitive selection process. Despite the extremely short period available the Director and his staff were able to achieve a successful launch of the PSS as required by law on 1 January 2019.

5. **The compliance with the Pension Savings Law and the performance of the PA has exceeded expectations for the first full year of PSS operation.** High levels of participation were observed largely with almost no effort in enforcement especially in the first six months of PSS launch. By end of 2019, a total of 61,160 employers were registered with the PA. This resulted in 940,443 individuals being enrolled in the Scheme, with 164,189 having exited the scheme (mostly due to opt out option available to older employees but also some natural claims) this means there were 796,254 net registered participants. The pension fund had reached GEL 506.81 million (almost \$165¹ million) by end of 2019, of which GEL 16.91 million (approximately \$5.5 million) was generated from interest on bank deposits.

Item	30.06.2019	31.12.2019	30.04.2020	31.05.2020	30.06.2020	27.07.2020
Organization registered to-date	53,746	61,160	64,515	65,176	65,913	66,760
Participants registered to-date	825,614	960,443	1,013,601	1,021,191	1,030,579	1,042,145
Participants existing the Scheme to-date (opt-outs and other claims)	135,305	164,189	165,961	166,268	166,560	166,782
Net registered Participants	690,309	796,254	847,640	854,923	864,019	875,363
Actual Contributors in Month	528,829	545,606	491,348	476,267	487,315	482,953
Accumulated Contributions (employee, employer and Government) - GEL Mill	225.86	489.89	685.04	726.98	774.34	818.27
Accrued Interest - GEL Mill	3.01	16.91	40.66	48.55	57.82	66.31
Net Asset Value - GEL Mill	228.87	506.81	725.70	775.53	832.17	884.57
Total Units - Mill	22.41	47.75	65.83	69.61	73.84	77.71
Unit Price - GEL	10.2143	10.6127	11.0237	11.1406	11.2703	11.3826
Annualised Investment Return	5.3%	6.7%	12.1%	12.4%	12.8%	13.0%

Note: The numbers of registered organizations and participants are shown on accumulative basis.

6. **The level of compliance and the performance of the PA has continued to strengthen during 2020.** The initial efforts made by the PA to identify non-compliant employers is continuing to bear fruit, resulting in the vast majority of being registered by 27 July 2020, which were 66,760. The total registered participants have reached 1.042 million, with 875,363 net registered participants after adjusting for those exiting. The growth of the pension fund remains strong reaching GEL 884.27 million (almost \$288 million) including GEL 66.31 million (approximately \$21.6 million) of accrued interest, primarily from bank deposits but also from government bonds.

7. **The initial short implementation period required the PA to develop its human resources, its information and communication technology systems and other processes/procedures on as “needed basis”, this has been done without introducing any significant risk to the roll-out of the Pension Savings Scheme.** The PA initially focused on creating a robust information and communication technology (ICT) system to facilitate employers in registering and making pension contributions and to accurately track them. It then moved onto creating the systems and process to facilitate participants in making claims (opt-outs for those eligible, disability retirements, emigrating, etc.) and settling such claims promptly and accurately. The remaining activities of establishing the investment, risk management and financial reporting functions were largely completed in phases and are now all in place. The PA is continuing to receive ongoing technical and capacity building support under an ADB TA, in selected areas where requested, to assist in its ongoing efforts to enhance operations in key areas.

8. **The Pension Savings Scheme is quickly becoming the single largest source of long-term investment funds in Georgia.** The growth in net asset values is expected to sustain for the foreseeable future and its impact on the local capital market will become increasingly significant.

¹ \$1 = GEL 3.0721, prevailing National Bank of Georgia exchange rate.

After just the first 19 months of operation the pension fund is almost equal to the insurance sector's total assets and is reaching almost 3 times the sector's total financial assets, which at end of Q1 2020 were GEL 942.4 million and GEL 313.5 million respectively. The investment horizon for the vast portion of PSS assets will be long-term, thus, it is becoming the largest long-term investor in the Georgian capital market providing both stability and growth.

2. Pension Scheme Implementation Progress

9. **The total registered employers as of 27 July of 66,760 represent approximately 79% of active commercial entities (estimated at 85,000,² including state entities): not all entities are registered with the Revenue Authority, thus, the level of compliance will be even greater.** For the first three quarters of 2019 the PA dedicated its resources to creating awareness of the Pension Savings Law and training accountants on the procedures for registering employers and submitting salary declarations to identify the pension contribution obligations. Subsequently it began comparing list of entities filing tax returns with those already registered, this identified about 5,000 potential non-compliers. Follow-up with the larger non-complying entities resulted in an additional 3,000 registering by end of 2019. The PA is continuing the process to identify remaining non-compliers which are likely to comprise smaller entities. The PA is designing a strategy for institutionalizing data sharing with the Revenue Authority for regular comparison of entities filing tax returns and those registered with the PA to identify all potential non-compliers, the expectation is that these protocols will be in place by first half of 2021. This will allow the PA to achieve and maintain practically 100% employer registration.

10. **The total registered participants of 875,363 exceeds the estimated salaried workforce in Georgia, implying that several self-employed have voluntarily joined the Scheme.** Recent labour force estimates³ indicate that there were around 849 thousand salaried employees and 818 thousand self-employed at the end of Q1 2020, giving a total employed work force of 1.667 million. In addition, the general trend over recent years suggests a slightly reduced or static work force. Thus, there is strong indication that some proportion of self-employed have also registered for the Scheme.

11. **There were significant opt-outs from the Scheme during May 2019, when most of the participants eligible to opt-out completed their minimum period, but the number of net registered participants returned to increasing trend subsequently.** Participants aged 40 years or above on 6 August 2018 are eligible to opt-out of the Scheme after contributing for 3 months but within 5 months of joining. Vast majority of such participants were eligible to exercise their option to opt-out during the period May to August 2019, by the end of this period 159,563 opted out of the scheme (this includes a few other benefit claims). Those becoming salaried employees for the first time, due to entry into work force or otherwise, will continue to result in new registrations. Some of these new participants will be eligible to opt-out in appropriate period; subsequent experience has shown that these number will be quite small and will reduce over time.

12. **The trend in level of new contributions has generally been growing, the main exception has been due to impact of COVID 19.** Most participants are from salaried classes and generate stable new contributions due to monthly payroll processing. However, some categories of participants either do not have regular salaries or are not required to file monthly tax returns (such individuals must file tax return at the end of the year). This results in some volatility

² Based on information available on website of National Statistics Office of Georgia for 1 July 2020.

³ Based on information available on website of National Statistics office of Georgia.

in new contribution flows, especially towards the end of the year when a spike can occur. New contributions experienced a drop in contributions during May and June 2020, primarily due to impact of COVID 19, of approximately 15%. How quickly this drop will be mitigated remains to be seen.

3. PA Operationalization Progress

a. Human Resource

13. **The PA has hired and trained all staff required for all regular operations.** The departments necessary for the effective operation of the PSS (customer services, call center, general operations, legal affairs) were staffed in 2019. The back-office operations of ICT and accounting were also mostly staffed in 2019. The investment management and risk control units were staffed during Q4 2019 and Q1 2020. PA continues to receive support from multi-lateral agencies in managing remaining operational development activities.

Agency Function	Current Personnel Number August 2020		
	Male	Female	Total
Director	1	-	1
Deputy Director	2	1	3
Director Counsellor	1	-	1
Director's Apparatus	-	1	1
Legal Department	-	3	3
Managerial Accounting Specialist	-	1	1
ICT Department	3	1	4
Operational Department	2	11	13
Front office and Call center	1	8	9
Public Relations Department	-	3	3
Head of Administration Department	1	-	1
Human resource officer	1	-	1
Corresponding Specialist	-	1	1
Financial Division	-	2	2
Chief Accountant	-	1	1
Property and Logistic Division	2	-	2
Pass Bureau Specialists	1	-	1
Investment Unit	2	2	4
Investment Board	5	-	5
Risk Control Unit	4	-	4
Chief information Officer	1	-	1
Internal Audit Department	-	2	2
TOTAL	27	37	63

b. Registration of Members and Pension Contribution Collection

14. **The PA completed the development of key functions and support systems to facilitate employer/self-employed registrations; assist in filing salary declarations; make pension contributions; create/maintain individual participant accounts; provide secure online access to participants of their accounts before start of 2019.** The key functions included:

- (i) Complete development of website and Electronic System of Pension Contributions Administration (ESPCA) to support these activities;
- (ii) hire and train front-office and call center staff to assist employers and participants in meeting their obligations; and
- (iii) train accountants in the use of ESPCA for filing validated salary declarations.

15. **The PA negotiated with all commercial banks operating in Georgia to open bank accounts for receiving pension contributions provided they committed to send live electronic updates to the ICT system of the PA, 10 of the 16 banks provided the required service.** To facilitate employers and the self-employed in making pension contributions, bank accounts with commercial banks were opened so they could deposit money intended to finance pension contributions in any bank of their choice. These banks accounts were non-interest bearing accounts to allow return of money should it not be used. The money deposited would be automatically used by the PA to meet pension contribution obligation once a valid salary declaration was received by its ICT system, salary declarations are not accepted unless there is sufficient balance at the credit of the employer/self-employed. This ensures simple and timely guaranteed collection of pension contributions. Under the law only money which is received together with a valid salary declaration can become part of the Pension Fund.

c. Enforcement of Pension Savings Scheme

16. **The level of compliance with the Law on Pension Savings was very high from the outset and grew rapidly, thus, the PA initially focused only on increasing public awareness and supporting employers/self-employed to register and begin submitting salary declarations.** The PA estimates that there are approximately 56,000 employers regularly submitting income tax returns for their staff, which is required under Georgian tax law every time a salary payment is made. Thus, almost 68% of all employers registered in the very first month of the new pension law coming into force. By the third month compliance had grown to almost 84%.

17. **The PA identified approximately 5,000 unregistered employers in April 2019.** A comparison between list of employers submitting income tax declarations on behalf of their employees and those already registered with the PA was made in April 2019, this identified 5,000 employers still to be registered under the new pension law.

18. **By end of 2019 almost all identified delinquent employers having salaried employees had registered with the PA.** The PA sorted the 5,000 delinquent employers by number of employees and began to follow-up with the largest employers first. The PA was able to have all identified delinquent employers that were active and had salaried employees becoming registered for the PSS within the first year of implementation. However, it is expected that the process of identifying delinquent employers will continue due to new businesses starting up and ongoing improvements in the Revenue Agency's register of active businesses.

19. **The PA is currently formulating a long-term enforcement mechanism including electronic data exchange protocols with the Revenue Authority to continuously reconcile employers registered and active with both agencies.** The PA expects to finalize its drafting of its long-term enforcement mechanism by Q3 2020. Once the draft proposal is agreed with the Revenue Authority and approved, which should be within Q4 2020, it will begin implementation. The PA expects the enforcement mechanism to be fully operational by Q2 2021.

d. Investment of Pension Fund

20. **The Investment Board was appointed in June 2019 by Parliament and the post of the Chief Investment Officer has been advertised.** The sole authority to manage the investment of the Pension Fund lies with the Investment Board and the investment unit. As per law, a 7-member Selection Committee, comprising of 3 members of Parliament and 1 professional nominated by NBG and the Supervisory Board, was constituted in March 2019. The Selection Committee nominated 5 members after review of all applications received in response to an international placement and submitted to Parliament for approval which was granted on 13 June 2019. The first Investment Board members will be:

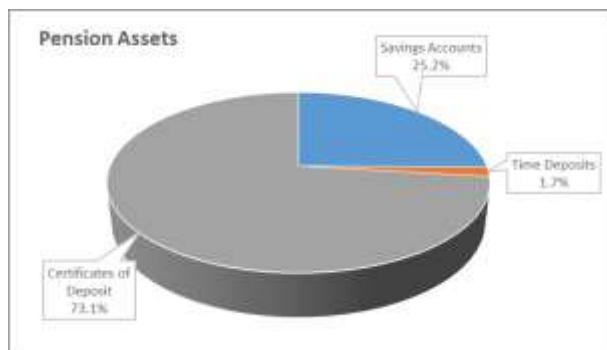
- (i) Timo Viherkenttä: Executive Officer of the Finnish State Pension Fund, also worked in the Ministry of Finance in his country
- (ii) Michael Ridley: adviser to Finance Minister of Iceland, former Deputy Director of J.P. Morgan's London representation
- (iii) Olivier Russo: Director of the Investment Fund of the PA of France, previously worked at the European Bank for Reconstruction and Development London Branch
- (iv) Jean-Frederic Paulsen: former adviser to the Minister of Economy and Sustainable Development of Georgia
- (v) Davit Tsiklauri: CFO of the Bank of Georgia until April 2019, earlier worked at TBC Bank for a number of years. Recently Mr Tsiklauri took up a new role in a financial entity and consequently relinquished his position; a replacement is currently in the process of being appointed.

21. **The PA obtained special permission in February 2019 from the NBG to transfer money allocated to individual participants within the same bank to interest bearing account while the investment function was being staffed and operationalized.** Recognizing the importance of showing the full potential of the new Private Pension Scheme to current and potential participants and to protect the pension savings from erosion due to inflation, the PA requested the NBG (being the regulator of investment activities) to transfer the money allocated to individual participant accounts to interest bearing accounts of the same bank. The request was accepted and the money transfers began from 12 February 2019. This has allowed the PA to generate GEL 16.91 million (~ \$5.5 million) by the end of 2019, which approximated to an annualized rate of return of 6.7%.

22. **The daily NAV of the interest-bearing bank accounts were calculated on accrual basis allowing the ESPCA to determine the investment unit price; assign appropriate investment units for each pension contribution and reflect the interest gain on each participant's individual account.** These processes were implemented from March 2019 onwards and prepared the groundwork for the PA to promptly settle any benefits claims that may be received. It also allowed each participant to know exactly the value of his/her pension account as at the close of last working day. This also meant that benefit payments could be made timely and accurately as and when they became due.

23. **The Investment Board adopted a Cash and Cash Equivalent Investment Policy that was agreed to by the NBG and notified by the PA on 22 January 2020 after which investments began to be managed accordingly.** In view of the fact that the investment unit and risk unit of the PA were still in the process of being staffed and operationalized, the Investment Board adopted a cash and cash equivalent investment policy to enhance the returns to participants without attracting any additional risk. This has allowed the investment performance to materially improve providing addition of GEL 49.4 million (~\$16.1 million) from 1 January to 27

July 2020. As a result, the annualized rate of return for 2020 reached 13.0%. The make-up of Pension Assets is now:



24. **The Investment Unit of the PA is now fully staffed with four members headed by Chief Investment Officer (CIO) and is receiving strategy and operational training from an international investment specialist provided by the ADB.** The Investment Board selected a candidate for the post of CIO and the Supervisory Board appointed the candidate on 1 April 2020. The remaining three members of the unit were appointed by July 2020. At the request of the Investment Board the ADB provided an international investment specialist to training the investment unit on investment strategies and operational requirements over a three-month period.

25. **The Investment Board is in the process of finalizing the Long-term Investment Policy with coordination of NBG and expects to complete the process by Q4 2020 at which point it will be notified by the PA.** The Investment Board has been in the process of drafting and refining the long-term investment policy in line with NBG regulations and guidelines, and also taking into account the risk management framework prepared by the Risk Unit of the PA. The final draft of the policy is being reviewed by all stakeholders and expected to be approved by Q4 2020.

e. **Opt-out and Other Benefit Payments**

26. **All operational systems and procedures were made ready and tested by April 2018 to allow eligible participants to apply for opting out of the Pension Savings Scheme.** Eligible participants (those were aged 40 or more on 6 August 2018) are allowed 2 months to opt-out of the PSS after having contributed for 3 months, they may rejoin the PSS any time after having left. The PA notified rules of procedure for opting out which included in-person submission of opt-out applications in order to ensure that participants fully understood the implications of their choice. To reduce any hardship, the PA signed an agreement with the Social Service Agency, which has offices throughout Georgia, to allow participants to submit their applications through their offices. A web-based portal was made available to the Social Service Agency to automatically print completed opt-out applications to be signed by the participant, staff from all these offices were trained in the use of this portal. This process allowed participants to submit their applications even during period of high demand in May 2019 when almost 82,000 exercised their right. The bulk of participants entitled to opt out have made their choice and now only those who joined the PSS for first time will be entitled to opt-out choice if eligible by virtue of their age; such participants will be a diminishing number,

27. **The numbers of active participants, the level of contributions and nest asset value are all expected to increase for the foreseeable future.** The reduction in the number of active participants due to opt-outs is now a matter of history. There can be unexpected events that lead

to temporary falls in active contributors, such as fallout from COVID-19, but in general the number will continue to grow as any new employers and/or new entrants into employment status are added. In addition, voluntary participants can be expected to join from the self-employed sector in increasing number as the PSS gains prominence and their confidence in its sustainability increase. Increasing share of voluntary participants can lead to somewhat greater volatility to numbers of active contributors simply because of their voluntary nature and ability to stop and start contributions as they deem appropriate.

f. Financial Reporting and Audit Framework

28. **The work on establishing a financial report framework for the Pension Savings Scheme initiated in 2019 was completed by Q1 2020.** The PA developed a comprehensive chart of accounts and a detailed accounting manual to maintain the financial accounts of the PSS with the support of ADB provided national accounting specialist. The PA then hired local IT consultancy firm, with financial support from ADB, to design, develop and implement additional modules to its ESPCA system to implement this accounting framework through an integrated and seamless process. The implementation of the IT accounting modules is in process and the work will be completed before the end of August 2020. Thereafter, the PA will be able to generate financial statements and management reports as and when required.

29. **The internal audit function is also being established.** An internal auditor was appointed at the start of June 2019 to develop the initial processes and procedures for the PA's operations, including those of the PSS. The internal auditor continues to expand and refine the process and procedures in line with the increasing functions and their complexities within the PA.

30. **The second external audit by an auditor appointed by Parliament was completed in May 2020, this included audit of Pension Savings Scheme's first year of operations.** The first external audit for financial year 2018 was completed in April 2019 and the report was submitted to Parliament in May 2019: this audit only included PA operations since the PSS was only launched at the start of 2019. The 2019 audit for both PA and PSS operations was again completed within the timeline set by Parliament, i.e. by May 2020. The auditor prepared the financials of the PA in line with all relevant International Public Sector Accounting Standards and the financials for the PSS in line with all relevant International Financial Reporting Standards. There were no observations made by the auditors in their reports. All financial statements for 2018 and 2019 are publicly available on the PA website.

g. Risk Management Framework

31. **The risk management framework for managing both operational and investment risks have been drafted and agreed in principle by all stakeholders and expected to be notified by Q4 2020.** The unique legal framework adopted in Georgia, with PA operations being overseen by a Supervisory Board and investment operations by an Investment Board, initially posed challenges in defining an appropriate risk management framework. The operationalization of the investment and risk functional units allowed the process of defining the risk framework to be initiated. The stakeholders (NBG, Investment Board and Supervisory Board) have all now agreed in principle to a draft risk management framework and it is expected that the formal adoption will be completed and notified by Q4 2020.