Private pension funds outpaced state peers by assets in 2016 and will also outperform them by the number of policies by 2020

By 2019-2020, the insured by non-state pension funds (NPFs) will outnumber clients of the Pension Fund of Russia (PFR). In terms of assets, NPFs have already left the PFR behind in 2016 and look set to adhere to an outstripping pension savings growth by 8.5% per year in 2017-2020, backed by deficit in the public pension system and the latter’s reform. NPF assets growth will be capped by yet another pension savings “freeze”, NPF market consolidation, and tighter Bank of Russia requirements for credit quality of private pension funds.

NPFs will replace up to RUB 350 bln of bank assets with stocks and bonds. By regulatory requirements, starting July 1, 2018, private funds are to reduce their banking sector investment exposure from 40% to 25%. By ACRA’s estimates, demand for Russian bonds and stocks may climb RUB 250-300 bln (3.3% of the market) and RUB 50-75 bln respectively.

NPFs’ own funds adequacy will stand at minimal levels. With the regulator deciding to run NPFs through the same stability assessment as the one other financial institutions are subject to, private pension funds will hardly strive to build up equity and are likely opt for keeping it at the minimum regulatory level instead. This will limit NPFs possibility to use capital as a preventive compensatory mechanism when private funds face deterioration in their asset portfolio credit quality.

The forecast has been prepared in line with the General Principles of Socioeconomic Indicators Forecasting.
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Table 1. Russian private pension system forecast

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Measurement unit</th>
<th>Actual data</th>
<th>Estimate</th>
<th>Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>PFR (VEB) pension savings¹</td>
<td>RUB bln</td>
<td>1,902.6</td>
<td>1,939.9</td>
<td>2,053.0</td>
</tr>
<tr>
<td>Growth rate</td>
<td>%</td>
<td>2.0</td>
<td>5.8</td>
<td>-41</td>
</tr>
<tr>
<td>NPF pension savings</td>
<td>RUB bln</td>
<td>1,088.4</td>
<td>1,132.4</td>
<td>1,719.6</td>
</tr>
<tr>
<td>Growth rate</td>
<td>%</td>
<td>4.0</td>
<td>51.9</td>
<td>25.0</td>
</tr>
<tr>
<td>NPF pension reserves²</td>
<td>RUB bln</td>
<td>831.6</td>
<td>900.0</td>
<td>991.6</td>
</tr>
<tr>
<td>Growth rate</td>
<td>%</td>
<td>8.2</td>
<td>10.2</td>
<td>10.6</td>
</tr>
<tr>
<td>Russian pension system</td>
<td>RUB bln</td>
<td>3,822.6</td>
<td>3,972.4</td>
<td>4,761.2</td>
</tr>
<tr>
<td>Persons insured by the PFR</td>
<td>mln</td>
<td>56.62</td>
<td>57.84</td>
<td>53.66</td>
</tr>
<tr>
<td>Persons insured by NPFs</td>
<td>mln</td>
<td>22.19</td>
<td>22.14</td>
<td>26.33</td>
</tr>
<tr>
<td>NPF participants</td>
<td>mln</td>
<td>6.57</td>
<td>6.37</td>
<td>5.81</td>
</tr>
<tr>
<td>Average Russian pension</td>
<td>RUB th</td>
<td>9.9</td>
<td>10.8</td>
<td>12.0</td>
</tr>
<tr>
<td>NPF own funds</td>
<td>RUB bln</td>
<td>127.5</td>
<td>143.2</td>
<td>160.3</td>
</tr>
<tr>
<td>NPF own funds / NPF liabilities</td>
<td>%</td>
<td>6.6</td>
<td>7.1</td>
<td>5.9</td>
</tr>
<tr>
<td>NPF pension assets / Russian GDP</td>
<td>%</td>
<td>2.7</td>
<td>2.6</td>
<td>3.3</td>
</tr>
<tr>
<td>Average pension account of an insured person</td>
<td>RUB th</td>
<td>48.9</td>
<td>50.9</td>
<td>64.8</td>
</tr>
<tr>
<td>Average pension account of an NPP participant</td>
<td>RUB th</td>
<td>126.6</td>
<td>141.4</td>
<td>170.8</td>
</tr>
</tbody>
</table>

Source: ACRA estimates

¹ Pension savings are made up by insurance contributions made by employers to the employee's funded pension within the mandatory pension insurance (MPI) framework, as well as by additional contributions under the State Co-Financing Program and by part of maternity capital intended for formation of the funded retirement pension.

² Pension reserves are formed from voluntary contributions by employers and/or employees.

Note. The average insured person’s account was calculated as a ratio of NPF mandatory pension liabilities to the total number of persons insured by NPFs. The average non-state pension provision (NPP) participant’s account was calculated as a ratio of NPF pension liabilities under NPP to the total number of NPP participants. The forecast NPF pension savings liabilities for 2019-2020 assumes transfer of NPF pension savings into initial individual pension capital (IPC).
The most discussed concept of the Russian pension system reform is the concept of individual pension capital (IPC).

Implementation of this concept implies that the state pension remains fully solidary, i.e. all employer pension contributions to the PFR are directed to the distribution system (solidarity of generations).

Employees will form their IPCs from a portion of their wages (in excess to pension contributions), with the size of that portion to be set at their own discretion. In return for IPC contributions, employees will receive a tax benefit in the form of a personal income tax deduction of up to 6% of their wages, while employers will also benefit as contributions (with a 1.03–1.06 surcharge rate) to the individual pension capital (IPC) system will be deducted in calculating taxable income.

See the ACRA March 28, 2017 Russian economy forecast titled “Russian Economy: Recession Knocked Out. What Next?”

State pension system reform to boost NPF assets

In 2016, NPFs saw their retirement savings exceed those kept with the PFR, with NPF-managed assets posting a 20.4% growth. In 2017-2020, NPFs are expected to further strengthen their role in the Russian pension system, while assets under their management should grow faster than pension savings in Russia as a whole – on average by 8.5% versus 5% per year respectively.

NPF asset growth is likely to be driven by the reform of the Russian pension system, which faced RUB 3 trillion of deficit in 2016. The key event for the pension sector expected after 2018 should be an introduction of the individual pension capital (IPC) system and cancellation of mandatory pension insurance (MPI) in order to reduce the need to fund the pension system from general-purpose taxes.

In 2017-2018, NPF asset growth will be hampered by the pension moratorium extension (i.e. the “freeze” of pension saving transfers from the PFR to NPFs in order to cover PFR’s deficit) until 2019. Another restraint will come from consolidation of NPFs into specific groups, which will result in a decreasing number of players on the pension market and waning competition. ACRA assumes that an NPF should boast at least RUB 7-10 bln of capital to qualify for an independent market player status.

NPFs will be more attractive for customers, as the latter will learn that the new pension reform involves conversion of their funded retirement pension as the first payment into the IPC. Notably, the “undecideds”, i.e. those who opt out of transferring their pension savings from the PFR to NPFs, will be randomly selected and transferred to a private fund (based on each NPF weight averaged across pension savings accrued by NPFs over the last three years), while the insured persons who hand over their savings to NPFs will remain at the selected private fund and form their initial IPCs on the basis of these savings.

The year 2018 is promising a turning point for pension reserves, as this will be a period of presidential elections, which, according to the ACRA macro forecast, are most likely to be followed by the market regulator taking unpopular measures aimed at tightening requirements for composition and structure of pension reserve portfolios, with particular regard to their credit quality.

Figure 1. MPI and NPP pension liability forecast for NPFs, RUB mln

Source: ACRA estimates
NPF own funds will not cover the negative revaluation of pension savings and reserves

Initially, the approach to estimating NPF financial sustainability was similar to that applied to credit institutions and was based on own capital. Since then, the assessment method has undergone major changes, and now pension funds’ financial stability hinges upon whether or not they boast a balanced asset structure with regard to financial risks and liabilities (pension liabilities) and accounting for actuarial risks for a five-year period (in line with the stress-testing methodology). This approach may be defined as intermediate between the Basel standard for banks and the Solvency standard for insurance companies (standards applied to regulation, risk management and supervision).

In view of the above, the Agency assumes that NPFs will not build up own funds above the regulatory requirement in 2017-2020, unless directly instructed to do so by the Bank of Russia. This will not concern NPFs, which will possess specific risk portfolios comprising mainly pension reserves, and which will not be able to prove to the Bank of Russia that they can successfully undergo stress testing in most cases. Such NPFs will be forced either to change the composition and/or structure of their pension savings/reserves portfolios, or to build up their capitalization.

An increase in MPI pension payments is expected in 2022-2027, although this timeline may move to later years via increasing the retirement age.

ACRA assumes that in 2017-2020 NPFs will see their ratio of own funds to pension liabilities at 3.1%.

Figure 2. Forecast of change in NPF own funds and the ratio of own funds to pension liabilities, RUB bln

Source: ACRA estimates

NPF pension assets to play a greater role in the Russian economy

In 2015, the pension reform introduced a new rule, which provides insured persons with a right to transfer their pension savings from one NPF to another not more frequently than once in every five years with no investment income forfeiture, while the previous rule allowed to perform such transfers every year. This change should have a positive effect on NPF customer base stability.
Private pension funds outpaced state peers by assets in 2016 and will also outperform them by the number of policies by 2020

Thus, ACRA believes that NPF pension assets (aggregated pension savings and pension reserves) are likely to play an increasingly important role in the Russian economy, which will provide for longer duration of investments in debt instruments intended to raise financing for domestic infrastructure modernization and other social projects.

The key growth driver of MPI at NPFs will be the transition from the funded retirement pension to the IPC, which will attract the most financially savvy part of the population to non-state pension funds.

Figure 3. NPF pension assets to GDP ratio forecast

Source: ACRA estimates

By late 2019 or in 2020, ACRA expects those insured by NPFs to outnumber PFR clients.

Figure 4. Forecast of the number of insured and NPP participants, mln people

Source: PFR, ACRA estimates
NPFs to replace bank assets with stocks and bonds

Changes to the NPF pension savings portfolio structure will be connected with the forthcoming reduction of NPF investments in the banking sector (the maximum percentage of bank assets should drop from 40% to 25% by July 1, 2018, as required by the Bank of Russia Regulation No 580-P), coupled with a decrease in other assets due to the coming into force of the Bank of Russia Ordinance No. 4060-U “On Requirements for Organization of the Non-governmental Pension Fund Risk Management System.”

By ACRA’s estimates, NPF pension savings investments in the banking sector totaled over RUB 900 bln as of December 31, 2015, whereas upon implementation of the No. 580-P their amount will decline to RUB 550 bln, which will translate into RUB 350 bln of pension funds outflow from the banking sector (less than 1% of Russian banking system’s total liabilities).

Substitution of NPF bank deposits with stocks and government and corporate bonds may increase demand for securities issued by high-quality Russian borrowers. By ACRA’s estimates, demand for Russian bonds and stocks may climb RUB 250-300 bln (1.5% of the total volume of corporate bonds on the Russian market) and RUB 50-75 bln respectively.

Figure 5. NPF pension savings portfolio structure change forecast for 2016 and 2017-2020

Source: ACRA estimates

The expected tightening of Bank of Russia requirements to credit quality of pension reserves will lead to a decline in the share of mutual fund investment units and other assets, and will result in an increase in the proportion of corporate bonds, including infrastructure ones. These changes will support Bank of Russia’s commitment to improve credit quality of pension assets and form the portfolio structure based on prudential supervision and control principles.
Private pension funds outpaced state peers by assets in 2016 and will also outperform them by the number of policies by 2020.

Figure 6. NPF pension reserves portfolio structure change forecast for 2016 and 2019-2020

Source: ACRA estimates

Legislative changes target better risk management at NPFs and tighter control over asset credit quality

The trend towards strengthening control over pension reserves credit quality is confirmed by the NPF stress testing methodology and scenarios for NPF stress testing published on the Bank of Russia website in April 2017. According to them, the value of corporate securities suffering from heightened risk (no ratings assigned) and/or limited turnover (mutual fund units, mortgage participation certificates) will be dramatically reduced for testing purposes, which should have a negative impact on NPFs' financial sustainability.

The forthcoming Bank of Russia Regulation No 580-P will create difficulties for NPFs in terms of using such financial instruments like mutual fund units, due to differences in legislation governing NPFs and mutual funds. In fact, when using mutual fund units, NPFs will have to account for not the units per se, but their contents and appropriate limits, while the units will be managed by asset management companies. In addition, mutual fund units will feature among the 10% of high-risk assets, into which NPFs will be allowed to invest pension savings.

ACRA expects interaction problems between NPFs and asset management companies, which have and/or will have under their management pension savings, pension reserves and IPC funds. These problems are likely to stem from functioning and interaction specifics of risk management bodies at NPFs and asset management companies.

The Agency forecasts that NPFs and asset management companies will have to build up expenses to pay for qualified personnel and software in order to meet the Bank of Russia regulatory requirements for risk management systems.

Changes in legislation will further divide self-regulating organizations operating on the pension market. SROs will split into two segments: a conservative one, not interested in any major fluctuations on the pension market and willing to operate within an established paradigm, on the one hand, and an aggressive
Private pension funds outpaced state peers by assets in 2016 and will also outperform them by the number of policies by 2020.

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one, advocating legislative changes aimed at liberalization (extension of the eligible instrument list, investment environment easing, etc.), on the other hand.
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