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NEWSLETTER

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GEORGIA

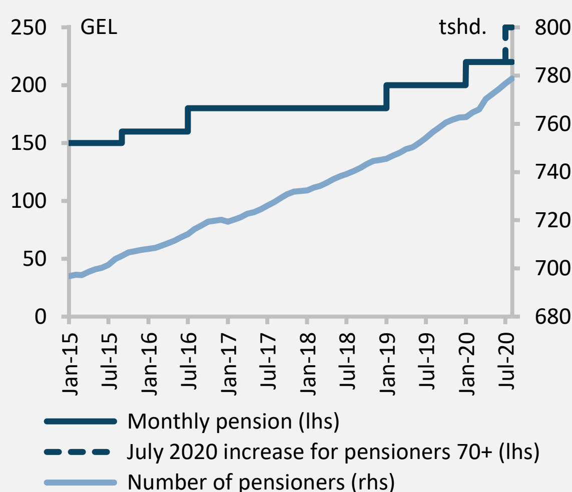
Private pension system: resilient in spite of the recession

With the establishment of a privately funded pension system in 2019 Georgia established a second pillar in its pension system alongside the existing basic pension. This was a step towards diversifying sources of retirement income, and boosting institutional investment in the local capital market. Steady participation rates and investment performance suggest the new system can be resilient in the face of the ongoing recession and spike in unemployment. The immediate challenge will be to specify the investment policy and diversify the asset allocation, and to widen the appeal of the system. As regards the asset allocation, the issuance of inflation-linked bonds by the government would be of interest for the pension agency.

Background: state basic pension

Prior to the introduction of the pension agency, the Georgian pension system was based solely on the tax-funded state basic pension. In this system, minimum eligibility age is 60 years for women and 65 years for men. Unlike pay-as-you-go schemes, pension size is not based on prior contributions and increases occur ad-hoc. The pension has last been raised in January this year to GEL 220 (approx. USD 66), with pensioners above the age of 70 receiving an additional GEL 30 (approx. USD 9) since July. Reflecting the trend in population ageing, the number of recipients has been steadily increasing, reaching almost 780,000 in August 2020.

Development of basic pension



Source: Social Service Agency

While the state thus provides a basic income to pensioners, there was a desire to establish a second pillar in the pension system that is funded by individual contributions, matching employer contributions, and a state subsidy.

Introduction of defined contribution scheme in 2019

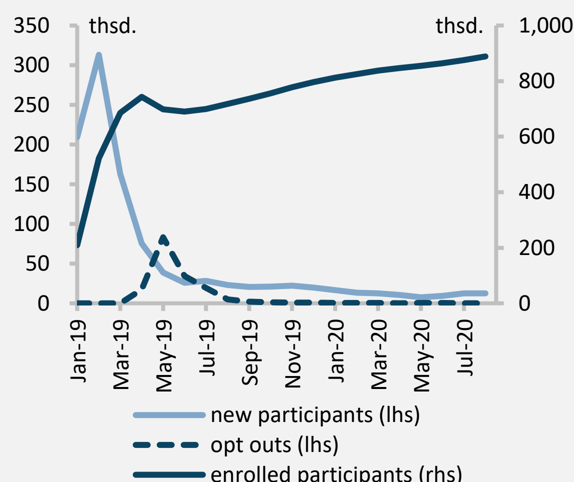
The Georgian pension agency and pension fund were established in January 2019 and the agency began receiving contributions shortly after. Since that point beneficiaries, employers and the state make equal contributions of 2% of gross salary into individual accounts. The new pension scheme is set up as a defined contribution scheme. Pension assets that are credited to individual accounts can be withdrawn at pension age as a lump sum, or through a phased withdrawal. In essence, therefore, the individual participant bears the investment risk in the fund.

The introduction of a funded pension pillar was a major innovation in the Georgian system and the 2019 pension law incorporated experience from other emerging markets that had adopted similar schemes. Mobilizing domestic long-term savings through a contractual scheme could lift the very low national savings rate. It will also diversify the sources of retirement income as population ageing sets in, supplementing the as yet minimal basic pension provided by the state-run redistributive system. There are clear potential benefits for the development of local capital markets, as the pension agency becomes the most significant local institutional investor with a long investment horizon.

Steady participation in the system

Similar schemes elsewhere in emerging Europe regularly came under pressure during economic downturns, when state support or the required contribution rates were reduced. It is therefore encouraging that the number of participants in the Georgian pension fund have continued their steady growth.

Enrolment, opt outs and total participation in the fund



Source: Pension Agency

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While employees in registered enterprises are enrolled by default, participants above 40 years of age are free to opt out. 154,000 individuals, or about 40% of participants exercised such a right in the first four months of the system. Since then opt-outs have been minimal (only about 12,000 in the year to August 2020) and total participants surpassed 1 m in early 2020 (see chart). Compliance by employers, which match employee contributions, is checked based on declarations made to the tax authorities.

Moving towards a more diversified asset allocation

In September 2020 the pension fund had GEL 952 m (approx. USD 287 m) under management and projections, which reflect the current downturn, suggest this amount could double by the end of 2021.

This already considerable capital stock of roughly 2% of GDP is currently invested in cash and GEL denominated cash-like instruments at eight Georgian commercial banks. This has yielded a stable return of 11.1% since the inception of the fund, well above the current inflation rate and the yield on state debt. As several hundred beneficiaries have already received payouts and the growth of individual accounts becomes better understood by beneficiaries, such steady returns should underpin support for the system among the public.

Yet, it is clear that the rapid growth of the pension fund requires a more diversified asset allocation. A first priority was the establishment of a skilled investment office within the agency, and a chief investment officer and deputy have now been appointed. A specialized depository (where the agency's holdings would be registered) is yet to be selected.

The investment policy document, which would formally guide the investment process, is being discussed with the National Bank of Georgia (NBG) which acts as the supervisor of the agency. The pensions law foresees a very conservative asset allocation in the first five years when equity holdings and foreign currency exposures will be capped at 20%. Subsequently, a medium and high-risk portfolio will be offered (the latter including up to 60% in equities), and these are to be managed with investment horizons of at least five years. As participants age, they will be moved into less risky portfolios. Alternative investments which were not detailed in the law may be approved by the NBG on a case-by-case basis. It is expected that about two thirds of total assets will ultimately be allocated to the safest assets of domestic government bonds, cash and deposits.

Priorities beyond the current recession

A more diversified allocation in the medium and high-risk portfolios could bolster returns and support liquidity in the local primary and secondary capital markets. Domestic currency corporate bonds are as yet largely held by local banks, limiting liquidity and maturities. Other investors will still be needed, as the exposure by the pension fund will be limited for each issuer, and each instrument.

Inflation-linked bonds (ILBs) issued by the government could also become an attractive asset class for the pension fund, including at long maturities. In pension schemes in other emerging markets, ILBs are a core holding, and pension funds account for the majority of ILBs outstanding. Defined benefit funds typically seek to match maturities of assets with future liabilities, and ILBs are seen to evolve in line with real wage trends. This would likely bolster political acceptance and public support of an as yet untested source of retirement income.

A further priority should be that the generosity of the state basic pension is not further eroded, and the government adopt the indexation of the basic pension as it has already committed to do. Only those in formal employment are enrolled in the pension fund, and over half of the labour force does not benefit from the matching contributions by the state and the employer. Similarly, incentives for the self-employed to enrol in the pension fund voluntarily could be defined.

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This newsletter is partially based on an assessment of inflation-linked bonds (Policy Study 01/2020). Slides with a summary are available in Policy Briefing 03/2020.

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