

ASIAN DEVELOPMENT BANK

TAR: KAZ 31100

TECHNICAL ASSISTANCE

TO THE

REPUBLIC OF KAZAKSTAN

FOR

CAPACITY BUILDING FOR

PENSION REFORM

November 1997

CURRENCY EQUIVALENTS

(as of 1 November 1997)

Currency Unit	—	Tenge (T)
T1.00	=	\$0.0132
\$1.00	=	T75.55

ABBREVIATIONS

MIS	-	Management Information Systems
MOF	-	Ministry of Finance
NPA	-	National Pension Agency
NSC	-	National Securities Commission
PAYG	-	Pay-as-you-go
SPPC	-	State Pension Payment and Collection Center
TA	-	Technical Assistance

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this Report, "\$" refers to US dollars.

I. INTRODUCTION

1. During the Bank's Loan Fact-finding Mission for the proposed Pension Reform Program in May 1997, the Government of Kazakhstan requested advisory technical assistance (TA) to support pension reform. TA fact-finding was undertaken concurrently with appraisal for the Pension Reform Program from 11-29 August 1997. The TA was discussed with the concerned Government agencies, and an understanding was reached on its terms of reference, cost estimates, and implementation arrangements.¹

II. BACKGROUND AND RATIONALE

2. Kazakhstan is transforming its existing State pay-as-you-go (PAYG) pension system. Under legislation that will become effective on 1 January 1998, the PAYG system is to be minimized, while a fully funded defined-contribution system of individual accounts will be instituted. The legislation also permits additional voluntary private pension schemes. Under the mandatory defined-contribution scheme, it is envisaged that workers will make contributions to their individual pension accounts, to be held either in a State accumulation fund or in privately managed pension funds. Private pension funds will be able to hire the services of professional asset management companies to invest the pension contributions held by them. Contributors will be dependent on the rates of return earned on their cumulative contributions for the main component of their pension payments upon retirement. The Bank proposes to support pension reform in Kazakhstan with a program loan in the amount of \$100 million to be processed in 1997.

3. The new pension system will be based on centralized collection of contributions and payment of benefits by the State Pension Payment and Collection Center (SPPC). All activities of the private pension funds will be regulated by the National Pension Agency (NPA), which is a department of the Ministry of Labor and Social Protection. In addition to licensing pension funds, NPA will need to maintain close coordination with SPPC and the State accumulation fund (to be managed by the assets management division of the Central Bank). For this purpose, NPA will have to establish adequate data bases, appropriate accounting and reporting requirements, and a computerized system involving the development of specialized software that will be compatible with the systems being introduced in the Central Bank and in SPPC. Moreover, the installation of these systems in NPA, and NPA's capabilities in administering them, will need to be developed in coordination with those of the other principal actors of which SPPC will initially be the most important. SPPC's requirements for hardware and matching software are being met from the Government budget and from assistance being provided by other multilateral and bilateral agencies.

4. NPA is expected to receive substantial assistance from the State budget for its computer hardware needs. It is also expected to receive assistance from the United States Agency for International Development to strengthen its division for licensing and regulation. However, it currently lacks an appropriate accounting and monitoring framework, the related skilled human resources, and the software required to operationalize its functions under the new pension system by 1 January 1998. In addition, NPA will require additional assistance following the introduction of the new pension system in order to review the effectiveness of its operational structures in the light of experience. Unless NPA is able to develop its capacity to carry out its functions in a timely manner, the Government will not be able to exercise the regulatory oversight over the new pension system according to the schedule mandated by law

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The TA first appeared in *ADB Business Opportunities* in June 1997.

and as agreed upon under the proposed Pension Reform Program to be supported by the Bank.

5. Currently, financial markets in Kazakhstan are limited in the range of financial intermediaries available, and in the range of financial instruments. More than 95 percent of the assets of the financial sector are accounted for by banks. Moreover, the financial sector lacks depth and liquidity. In this context, an encouraging development has been a series of Government measures designed to initiate trading activity on the stock exchange. A central feature of these measures is the preparation of a number of "blue chip" State-owned enterprises for public offering.

6. The Government's Pension Reform Program is expected to have major positive effects for the development of capital markets and instruments. The accumulated savings held by the new pension funds will provide significant incentives and opportunities for the development of long-term financial instruments that are suited to the needs of workers saving for their retirement. The issuance of indexed securities, including indexed Government bonds, can play an important role in providing pensioners with real rates of return that protect their retirement incomes. Additionally, an important issue to bear in mind is that contributors to pension funds will have the right to switch between funds and that the latter can switch asset managers. This means that secondary markets will need to be rapidly created so that asset fund managers can respond to the demands of investors relatively easily. In this context, a major objective of the Government's overall reform strategy is to enhance financial market development and reduce volatility by stimulating greater private financial intermediation and increasing the array of financial instruments available.

7. However, the availability of large pools of finance in the new pension funds will not automatically lead to the emergence of large-scale financial markets, as the latter require sufficient numbers of investors with diverse interests. The development of a greater range of financial institutions such as asset management companies, insurance companies, etc. will be an important step toward developing broad markets for financial securities. While a more diverse financial structure can be expected, in turn, to lead to a deepening of capital markets, this outcome is likely to be closely linked to the implementation of a transparent and stable, legal, and regulatory regime for the financial sector. It will also be linked to the development of investor confidence in the legal and regulatory structure based on practical experience. In this connection, a careful strategy will need to be formulated to provide the appropriate mix of Government regulation and incentives for the development of financial institutions and instruments.

8. A critical related issue is that of the adequacy of insurance markets, as these will play a fundamental role in supporting the pension reform envisaged in Kazakhstan. Under the system of defined-contribution pension plans, individual contributors will need access to well-functioning insurance markets in the accumulation phase—i.e., during their working lives as they accumulate savings in their individual accounts—in the form of provision for term life and disability insurance to protect their families in the event of death or disability of income earners. In the decumulation phase, that is upon retirement, retirees and their immediate families will need protection from the risk of outliving their savings. This need can be met by the provision of annuities and related products by insurance firms.

9. Insurance companies play a pivotal role in the development of capital markets as well as in the successful implementation of pension reform. The primary function of insurance

companies is to provide financial protection to companies and households from losses caused by uncertain but predictable events. Because their operations generate large reserves to fund their claims and obligations, insurance companies also play an important role as institutional investors. While insurance markets play an essential role in supporting pension reform, conversely, the shift to a defined-contribution national pension plan can provide a significant boost to insurance markets through making available large pools of savings for investment.

10. The insurance industry in Kazakhstan is small, with 56 firms, of which only 2 are life insurance companies. While there has been significant growth in the industry in the last two years, its total charter capital and reserves amount to only T30 billion. The ratio of annual premiums to gross domestic product in 1996 was less than 0.001 percent; this compares with a ratio of about 4 percent in the United States and 1.3 percent in India (calculated for 1994).

11. The insurance industry must operate within a framework of stable regulation that provides incentives for efficiency, allows companies to innovate, and promotes competitive markets. Recognizing the need to develop a modern insurance industry, the Government has taken a number of supportive steps. A department for the regulation and supervision of the industry has been established under the Ministry of Finance (MOF), and a body of regulations has been issued. The department of regulation and supervision has moved vigorously to implement the regulatory requirements for the issuance of licenses and has established a system for the monitoring of performance and the imposition of sanctions.

12. While these steps have been generally in the right direction, a number of significant constraints to the growth of the insurance industry need to be addressed. A major issue is that of the regulatory philosophy to be adopted. Currently, the insurance industry faces regulations regarding the setting of tariffs—applicable for mandatory insurance—and requires approval to introduce new products. These regulations have been designed with a view to protect the interests of consumers and ensure stable and orderly markets. Nevertheless, they are likely to also result in effectively constraining the rapid development of new products and innovations. A more effective approach to regulation would involve monitoring the solvency of insurance companies through focusing on the measurement of financial strength and through implementing detailed rules for capital adequacy.

13. However, in the context of Kazakhstan, supervisors are likely to meet with a number of constraints in adopting the solvency approach to regulation. In determining the adequacy of technical reserves, supervisors will need to have confidence in the appropriateness of their assumptions and in the accuracy of their calculations. The incompleteness of data is likely to pose a particular problem in this regard. Similar problems are likely to be encountered in regard to the evaluation of liquidity and in determining the market value of assets. These problems are fundamentally the result of the lack of familiarity with the technical skills required to adequately monitor the financial performance of insurance companies.

14. The central component of the Bank's country strategy for Kazakhstan is support for the transition to a market-based economy. An important element of this is the shift from the existing PAYG pension system to a fully funded defined-contribution system. This TA is part of a comprehensive package of Bank assistance to support this transition. The package of assistance includes a proposed Pension Reform Program in the amount of \$100 million, expected to be presented for Board consideration in December 1997. Two small-scale TAs have already been provided to prepare the policy framework and to assist in the design of key

administrative mechanisms respectively.¹ The current TA is designed to assist the Government in meeting key objectives under the proposed program loan in the areas of (i) enhancing the administration and management efficiency of the pension system through strengthening operational capacity relative to computer-based information systems, (ii) creating an enabling legal and regulatory framework, and (iii) developing key investment and market instruments in support of the financial sustainability of the new pension system. The TA both supports the proposed program loan and is in turn complemented by TA that will accompany the loan and will provide capacity-building support relative to financial institutions including asset management companies.

III. THE TECHNICAL ASSISTANCE

A. Objective

15. The objective is to strengthen the Government's institutional capabilities in three areas critical to the successful introduction and implementation of a fully funded mandatory system of pensions based on individual pension accounts. The TA will (i) strengthen the capacity of NPA to rapidly implement an effective accounting and reporting framework that will allow it to regulate and monitor the operations of private pension funds and of the State accumulation fund; (ii) help formulate a strategy for the development of long-term capital markets including a market for indexed Government bonds; and (iii) assist the Government to draw up a strategy for the development of an efficient, competitive insurance industry that is capable of providing the insurance products that will be required to support the needs of pensioners under the new pension system.

B. Scope

16. The scope of the TA will include (i) an evaluation of the accounting and reporting framework to be installed by NPA, (ii) assistance in adapting this accounting and reporting framework so as to be consistent with that of the banking system, and (iii) coordination with the Central Bank to ensure compatibility of reporting methods relative to monitoring the operations of the State accumulation fund. The TA will also assist NPA in acquiring software to support its operational functions, installing and running the software, and ensuring that it is compatible with that of the other agencies responsible for the collection and payment of benefits as well as for regulation. Workshops for NPA staff, and appropriate in-country and external training will also be provided under the TA.

17. The TA will evaluate the policy and institutional framework needed to promote markets for long-term bonds and equities. Particular attention will be given to facilitating the development of a market for indexed Government bonds.

18. The scope includes the provision of consulting services, workshops, and in-country and external training for staff of the Department of Regulation and Supervision of Insurance Markets in MOF. The TA will review the existing structure of the insurance industry, evaluate the regulatory framework with a view to the identification of the major constraints to the development of an efficient and competitive insurance industry, and formulate a strategy to develop the industry.

¹ TA No. 2780-KAZ: *Pension Reform*, for \$100,000, approved on 16 April 1997; and TA No. 2829-KAZ: *Enhancing Pension Management and Information System*, for \$100,000, approved on 23 July 1997.

C. Cost Estimates and Financing Plan

19. The total cost of the TA is expected to be \$1,265,000 equivalent. It is proposed that the Bank provide, on a grant basis, a total of \$1 million equivalent comprising \$925,000 in foreign exchange costs and \$75,000 equivalent in local currency costs. The TA will be charged to the Bank-funded TA program. The Government will provide the remaining \$215,000 of foreign exchange costs—consisting primarily of purchases of computer hardware for NPA—and the remaining \$50,000 equivalent of local costs consisting primarily of the cost of office space and counterpart staff, for a total of \$265,000 equivalent. The detailed cost estimates and financing plan are provided in Appendix 1.

D. Implementation Arrangements

20. The TA will be implemented over a nine-month period commencing in January 1998. The international consultants will provide a total of 20 person-months of consulting services and will consist of experts in accounting/reporting frameworks for pension administration (6 person-months; team leader), management information systems (1 person-month), securities and capital markets (4 person-months), insurance (6 person-months), and commercial law (3 person-months). Three full-time translators/interpreters will be recruited locally to assist the international consultants (one translator will be attached to the international consultants working for NPA; one will assist the international securities market expert; and one will assist the international consultants working with MOF). A domestic legal/insurance expert (3 person-months) will be recruited to assist the international commercial law expert. Detailed terms of reference are provided in Appendix 2. Other domestic consultants will be recruited as necessary. All international consultants will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants* and other arrangements satisfactory to the Bank for the engagement of domestic consultants. Procurement of computer software financed by the Bank will be undertaken in accordance with the Bank's *Guidelines for Procurement*. An important component of the training activities will involve the development of performance/competency benchmarks, which will establish the capability levels expected to result from training. These benchmarks will be developed prior to implementation of training programs on the basis of consultations with the Bank and the Government.

21. MOF will be the Executing Agency, with NPA, the National Securities Commission (NSC), and the Department of Regulation and Supervision of the Insurance Industry in MOF being the implementing agencies. The accounting/reporting frameworks for pension administration and management information systems experts will be attached to NPA; the securities expert will be attached to NSC; the insurance and commercial law experts will be attached to MOF. The Government will designate full-time counterparts, who will work with the international consultants. The Government will provide adequate office space and access to international telephone/fax.

IV. THE PRESIDENT'S DECISION

22. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance, on a grant basis, to the Government of the Republic of Kazakhstan, in an amount not exceeding the equivalent of \$1 million for Capacity Building for Pension Reform, and hereby reports such action to the Board.

COST ESTIMATES AND FINANCING PLAN

(\$)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing			
1. International Consultants			
a. Remuneration	400,000	—	400,000
b. Subsistence and Per Diem	150,000	—	150,000
c. International Travel	40,000	—	40,000
2. Domestic Consultants	—	20,000	20,000
3. Report Preparation	10,000	—	10,000
4. Contract Negotiations	5,000	—	5,000
5. Communications	20,000	—	20,000
6. Transport	—	20,000	20,000
7. In-country workshops	—	5,000	5,000
8. External Training	40,000	—	40,000
9. Equipment (computer software for NPA)	150,000	—	150,000
10. Translation	—	20,000	20,000
11. Contingencies	110,000	10,000	120,000
Subtotal (A)	925,000	75,000	1,000,000
B. Government Financing			
1. Office Support	—	20,000	20,000
2. Equipment (computer hardware for NPA)	200,000	—	200,000
3. Counterpart Staff	—	20,000	20,000
4. Contingencies	15,000	10,000	25,000
Subtotal (B)	215,000	50,000	265,000
Total	1,140,000	125,000	1,265,000

— = magnitude zero.

Source: Staff estimates.

(Reference in text: page 5, para. 19)

TERMS OF REFERENCE FOR CONSULTANTS

A. International Consultants

1. Assistance to the National Pension Agency

a. Expert on Accounting/Reporting Frameworks for Pension Administration (6 person-months)

- (i) In the context of the pension reforms to be implemented from 1 January 1998, and given the expected role of the National Pension Agency (NPA), review NPA's needs for an accounting, auditing, and reporting framework.
- (ii) In the light of the above evaluation, and also on the basis of consultations with staff of NPA, the Central Bank, and other relevant agencies and organizations, devise an accounting and reporting framework for NPA.
- (iii) Ensure that the accounting and reporting framework is compatible with those in the Central Bank, State Pension Payment and Collection Center (SPPC), the State accumulation fund, and other State agencies whose activities are required to be coordinated with NPA.
- (iv) In collaboration with Government Working Group, evaluate off-the-shelf Financial and Accounting packages for Pension funds.
- (v) Liaise with the management information systems (MIS) expert in NPA concerning the establishment of the appropriate data bases and the installation of software systems to make the accounting and reporting framework operational.
- (vi) Assist NPA in installing the new accounting and reporting systems.
- (vii) Assist NPA on an ongoing basis in fully operationalizing its accounting and reporting system.
- (viii) Assist NPA in fully coordinating the operations of its new accounting and reporting framework with those of SPPC, the State accumulation fund, and other relevant regulatory agencies.
- (ix) Evaluate the training needs of staff of NPA to effectively manage and operate the accounting and reporting system.
- (x) Based on consultations with the Bank and the Government, provide a series of workshops to train NPA staff in the effective operation of the accounting and reporting system.
- (xi) In consultation with the Bank and the Government, prepare a short program (no more than 10 days) of external training for staff of NPA.

- (xii) Relative to the training, in consultation with the Bank and the Government, develop a set of performance/capability benchmarks that will represent the skill levels or capability enhancement to be achieved under the training programs.

b. Management Information Systems Expert (1 person-month)

- (i) Assist NPA in establishing data bases and install the software required to operate its accounting and reporting system.
- (ii) Liaise with the accounting/reporting frameworks for pension administration expert in installing the data bases and software.
- (iii) Provide a series of workshops to NPA staff to train them in the effective use of the data bases and software installed to support the accounting and reporting system.
- (iv) Relative to this training, in consultation with the Bank and the Government, develop a set of performance/capability benchmarks that will represent the skill levels or capability enhancement to be achieved under the training programs.

2. Assistance to the National Securities Commission— Securities and Capital Markets Expert (4 person-months)

- (i) Evaluate the structure of capital markets and provide a qualitative and quantitative analysis of its development; the analysis will include, but will not be limited to, an evaluation of
 - (a) diversity of financial institutions,
 - (b) range of available financial instruments, and
 - (c) liquidity and depth of financial markets.
- (ii) Identify potential sources of finance and invisible funds that might play a role in the further development of capital markets in Kazakhstan.
- (iii) Analyze the potential impact of the implementation of the fully funded system of pensions on the development of long-term capital markets. In this connection, evaluate the “blue chip” privatization program and its potential role and contribution to deepening equity and bond markets in Kazakhstan through stock exchange activity.
- (iv) Provide a brief comparative review of the role of institutional investors in developing securities and capital markets in Chile following pension reform, in the United States, and in Japan.
- (v) Review and evaluate the legal and regulatory framework as it affects the development of capital markets, in particular as it affects the development of long-term markets.

- (vi) Identify the constraints to the development of long-term capital markets, in particular to the development of indexed bonds.
- (vii) Assist the Government in formulating a strategy of legal, regulatory, and institutional reforms to promote the development of long-term capital markets including a market for indexed Government bonds.

3. Assistance to the Ministry of Finance

a. Insurance Expert (6 person-months)

- (i) Evaluate the structure of the existing insurance industry, develop measures of its performance and efficiency, and identify the major policy and regulatory constraints to its effective development.
- (ii) Review current and pending legislation affecting the insurance industry. The evaluation should include, but not be limited to, the adequacy and appropriateness of regulations governing ownership, market entry and conduct, the structure of tariffs, fees and commissions, control of reserves and investments, policy towards reinsurance, and access to local markets by foreign insurance companies.
- (iii) In consultation with the Government, the Bank, and the commercial law expert, prepare recommendations for regulations and amendments to legislation with a view to developing a sound and efficient insurance industry along competitive lines that is able to provide both general and life insurance products.
- (iv) Focusing specifically on the need to support the Government's Pension Reform Program, develop recommendations for policy and regulatory reform of the insurance industry with a view to facilitating the development of disability, survivorship, and annuity products.
- (v) Evaluate the existing structure and capacity of the Department of Regulation and Supervision of the Insurance Industry in the Ministry of Finance.
- (vi) Identify problems facing supervisors in both on- and off-site surveillance and determine the technical constraints, if any, in carrying out effective supervision and monitoring of the adequacy of reserves and capital, and in the evaluation of assets. Evaluate the adequacy of current financial reporting requirements faced by insurance companies and make recommendations for more effective monitoring by the regulatory authorities.
- (vii) Identify priority areas for strengthening of the capacity of the Department of Regulation and Supervision of the Insurance Industry.

- (viii) In consultation with the Government and the Bank, prepare a training program to meet the immediate needs of the Department in carrying out its regulatory and supervisory functions.
- (ix) Present workshops to staff of the Department on a regular basis on (a) the basic principles underlying the operations of insurance companies, and (b) basic functions and skills required for effective regulation and supervision.
- (x) Identify the key skill deficiencies observed in insurance companies and make recommendations on the optimal measures required to strengthen these skills.
- (xi) Prepare a short program (no more than 7 days) of external training for staff of the Department of Regulation and Supervision of the Insurance Industry.
- (xii) Relative to the training, in consultation with the Bank and the Government, develop a set of performance/capability benchmarks that will represent the skill levels or capability enhancement to be achieved under the training programs.
- (xiii) Prepare a report to be presented to the Bank and the Government containing the evaluations and recommendations made and all activities undertaken.

b. Commercial Law Expert (3 person-months)

- (i) Review the existing legal framework in detail as it applies directly and indirectly to the insurance industry. Evaluate the Insurance Law, relevant provisions of the Civil Code, the Law on Bankruptcy, the laws on joint stock and limited companies, tax laws, and other relevant laws.
- (ii) Provide detailed recommendations on changes required in the legal framework to promote a competitive, efficient insurance industry according to best international practice.
- (iii) Assist the Government in drafting laws and regulations relating to the insurance industry.
- (iv) Assist the Government by reviewing drafts of laws relevant to supporting an efficient insurance industry.

B. Domestic Consultant— Legal/Insurance Expert (3 person-months)

- (i) Assist the commercial law expert in evaluating the legal framework in Kazakhstan as it applies directly and indirectly to the insurance industry.

- (ii) Analyze the relevant laws and provide inputs as requested by the commercial law expert.
- (iii) In preparing drafts of legislation and regulations, advise the commercial law expert on legal terminology appropriate to Kazakhstan.

C. Reporting Requirements

Except for the MIS expert, each of the international experts will present an inception report within four weeks of commencement of services, a midterm report halfway through the term of their services, and a draft final report two weeks from the termination date of services. A final report will be presented to the Government (six copies) and the Bank (three copies) within two weeks of having received the Bank's comments on the draft final report.