ASSOCIATION OF EUROPEAN BUSINESSES
IN THE RUSSIAN FEDERATION

AEB Insurance and Pensions Conference

Long Term Savings and Private Pensions: Answers to Questions You Never Dared to Ask

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December 1, 2009
Swissotel Krasnye Holmy, Moscow

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IN THE RUSSIAN FEDERATION

Long Term Savings and Private Pensions: Answers to Questions You Never Dared to Ask

Opening Remarks

Chris BARRETT

Chairman of the AEB Insurance and Pensions Committee,
Partner, PricewaterhouseCoopers

December 1, 2009
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Session 1

Changing Expectations but Continuing Challenges

Moderated by Leonid Zubarev, Partner, CMS International

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Some legal pitfalls of private pension provision

- Capital guarantee
  - Does it exist?
- Insurance reserve
  - Formation
  - Portability
- Pension contributions on individual accounts under group contract
  - Vesting
  - Portability
- Exit options and surrender values
  - For member (employee)
  - For contributor (employer)

AEB Pension Conference

Tax and Legal Framework of Corporate Pension Provision in Russia

1 December 2009

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Types of Pension Plans for Consideration

Non-State Pension Funds (NSPF)

Insurance Companies

Voluntary State Participation

Non-State Pension Funds – Taxation

Employer’s contributions are subject to social security contributions (which replace Unified Social Tax since 1 January 2010) and Accident Insurance Contributions.

Contributions are deductible for profit tax purposes for employer within the following and other limitations:

- contributions (with other types of pension provision and insurance) should not exceed 12% of the payroll fund per year;
- contributions should be accounted on personal accounts;
- the relevant contracts should provide for pensions payable for the life term (or minimum 5 years for NSPFs) and untill there are no funds on the personal account of individual.

Contributions made by employer are not taxable for an employee. Pensions are subject to personal tax when paid.

An individual is allowed to reduce his / her taxable income by the amount of documented expenses associated with **personal** contributions (up to limit RUB 120,000 per year).

Insurance Companies – Corporate Taxation

Premiums made by employer are subject to social security contributions (which replace Unified Social Tax since 1 January 2010) and Accident Insurance Contributions.

Premiums are deductible for corporate tax purposes if they do not exceed 12% of payroll costs of the company and are payable to properly licensed insurance company by an employer of insured individuals.

Life insurance:

- Insurance agreement for a period longer than 5 years;
- No payments in any format in the first 5 years.

- Pension insurance:
  - the relevant contracts should provide for pensions payable for the life term;
  - only after the insured person reaches statutory pension age.
- Premiums become non-deductible for profits tax purposes if significant changes to the contract with the provider are made, or its term is reduced, or it is cancelled (with the exception of cases of *force majeure* events).

Insurance Companies – Personal Income Taxation

Personal income tax obligations arises for an employee when the employer contribution is made in favour of the employee. The employer is obliged to withhold personal income tax.

Future payments are tax exempt, if certain conditions are met (such as term of contract, level of payments, etc.)

An individual is allowed to reduce his / her taxable income by the amount of documented expenses associated with **personal** contributions (up to limit RUB 120,000 per year).

Voluntary Pension Contributions to the State Pension System

The Federal Law (# 56 – FZ from 30 April 2008) allows individuals to make voluntary contributions to the saving component of the **state** pension and receive matching contributions from the National Welfare Fund (in the amount from RUB 2,000 to RUB 12,000 and up to RUB 48,000 for people at retirement age).

Employers could also participate and their contributions are deductible for personal income taxation and social security contributions (up to RUB 12,000 annually per person and not exceeding 12% of payroll costs of the company (with other types of pension provision and insurance).

Taxable base for personal income tax of individuals can be decreased by the amounts of these contributions (up to RUB 120,000). Social deduction is accessible via filing an annual tax return.

There is a number of practical difficulties that employers face while implementing assistance with such a scheme.

Let us try to put “Pensions at work”

Dr. Guglielmo Callipari
Managing Partner
In2Matrix Group

What is "Retirement" ?

Objective definitions of retirement include:

1. Permanent detachment from the labor force
2. Significant reduction in hours worked per week
3. Receipt of a pension

Questions to the audience

- Are Russian subsidiaries or branches of international companies offering retirement programs?
- How many of them are offering such programs?
- What kind of plans are they offering?
- Is the demand for retirement plans steady, reducing or growing?

Answers

- **Are Russian subsidiaries or branches of international companies offering retirement programs?** YES
- **How many of them are offering such programs?** About 25% are offering some sort of supplementary retirement program
- **What kind of plans are they offering?** 80% DC
- **Is the demand for retirement plans steady, reducing or growing?** In the last 5 years the percentage of companies offering retirement programs grew by 400%

Retirement Plans Features and goals

1. Who can participate in the plan?
2. Are employees on average asked to make contributions?
3. How much are employers contributing to the plan?
4. What happens with the contributions paid if/when employees leave the company?
5. How are the benefits paid ?
6. When are the benefits paid ?
7. What is the purpose of running a retirement scheme ?

1. All full time employees after either a waiting period or after reaching a certain age are entitled to participate in the plan
2. Around 2/3 of the plans require employees contributions
3. Employers contribute between 1% and 8% of basic salary, a higher percentage can apply for management
4. Vesting requirements vary from 3 to 5 years
5. Benefits are paid as annuities or lump sums
6. Benefits are paid after normal retirement age (F55/M60)
7. Companies use retirement plans for
   1. Retention
   2. Recognition of longer times of service
   3. Saving tool for employees
   4. Differentiation from competitors

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Purpose of the features of Retirement Plans

1. Vesting
2. Eligibility
3. Employee contributions
4. Normal retirement age
5. The concept of annuity payment

1. Bind the employees to the employer, encourage longer service, reward long term employment
2. Carrot effect, objective necessity, reduce administration
3. Make employees share the costs, make employee appreciate the value, fiscal advantage
4. Serve the purpose of a retirement benefit system, differentiate from short term incentives
5. Benefits paid as annuities take the risk of longevity away from the employees, the weakest factor in the equation, and ensure peace of mind after retirement

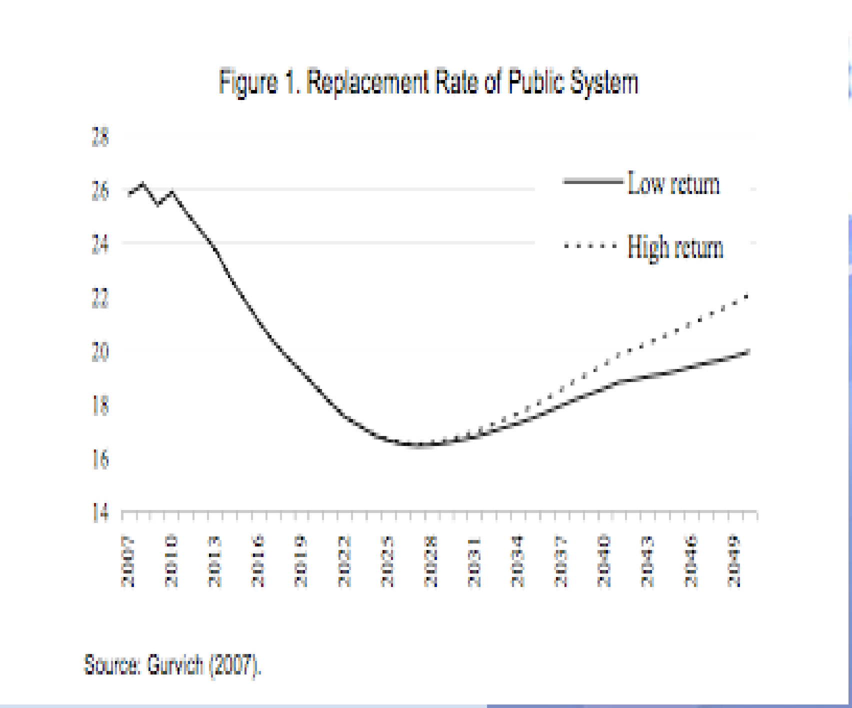
The expectations

- The Russians
- The International Monetary Fund
- The Industry
- The political powers
- In2Matrix

The Russians

HSBC's latest annual survey on the Future of Retirement of older people's work and retirement reveals a positive picture of how people see their prospects and lifestyles in retirement. However, the survey shows a degree of pessimism in Russia with regards to financial security and living standards in old age. The majority of people pre-retirement expect their standard of living to get worse in retirement. And the majority of people post-retirement feel that their standard of living is worse than it was before.

Replacement ratio in Russia



- Replacement ratio in the Public Pension System is falling dramatically in the next years
- The family as security-net is not any more a solid alternative

The International Monetary Fund

The existing pension system is ill-prepared for this challenge. In a no-reform scenario, the replacement rate of the public system is projected to decline to about 17 percent in 2030. This is far below the current level of about 26 percent that is already widely perceived as inadequate and implies that many state pensions are below the subsistence level. As Russia's per capita income rises, Russia's replacement rate will increasingly be out of line with international benchmarks as compared to countries of similar income level, as already 26 percent are lower than in any OECD country today.

What do you expect?

How can we all create a positive trend towards developing a proper and equitable retirement system in Russia

Forum creation vs. Competitive environment

The political powers

I believe, that the issue is being discussed with the most serious intentions of finding a good way out of the current situation

What are the alternatives ?

It is unlikely that voluntary private pensions will be sufficiently large to compensate for the drop in the replacement ratio of Russia's public pension system, thus creating a contingent fiscal liability.

In2Matrix

We believe, that the proper time to work together with all stakeholders to develop a good and well funded corporate pension environment is now.

This activity will contribute positively to the development of the new Russian reality, if sustainability and equitability of the measures taken will remain in the focus.

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Corporate retirement plan vs. corporate bank deposit (book reserve)

Plan Features	Corporate retirement plan	Bank deposit
Plan administration	Partially lays on the policyowner in terms of maintenance of the list of the insured, determination of the contributions, etc.	Fully lays on the policyowner – list of the insured, individual balances, beneficiaries, investment returns placement, vesting, benefits calculations, communication to the employees, etc.
Payment of surrender values and benefits	Performed by the provider directly to the employee	Performed by the policyowner through returning of the funds to the policyowner's account – taxation issue

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Corporate retirement plan vs. corporate bank deposit (book reserve)

Plan Features	Corporate retirement plan	Bank deposit
Contract term	Can be set for any period – until retirement age of employees, for 5,10,15 years, etc	Usually set for the period from 2 weeks to 3 months; have to be re-negotiated after.
Security of the plan at the bankruptcy of the Policyowner	Secure – surrender values are paid to the employees or continued as individual plans	Funds are used as Policyoner's asset at company bankruptcy

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Corporate retirement plan vs. corporate bank deposit (book reserve)

Plan Features	Corporate retirement plan	Bank deposit
Payment of benefits in case of employee's death	Paid directly to the beneficiary or assignee based on the beneficiary or assignee nomination form.	Paid by the policyowner through returning of the funds to the policyowner's account – taxation issue; beneficiary form even if present may be disputed in court by legal heirs.
Taxation	Premiums are tax-deductible in the amount of 12% of total wages.	Can not be tax deducted, paid from net profit

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Corporate retirement plan vs. individual bank deposit paid by the company

Plan Features	Corporate retirement plan	Bank deposit
Taxation as income – PIT	PIT is not withdrawn at contributions payment	PIT is to be paid at the deposit placement
Limited access of the participant to the funds until retirement / resignation	Fully provided	Extremely hard or impossible to implement

ER Needs & Available Solutions

<table>
<tr><th colspan="2">ER Goal</th><th>ER Additional Requirements (other than early termination option with a surrender value guarantee)</th><th>Source of Funding (usually)</th><th>Preferable Legal Framework for relevant solution</th></tr>
<tr><td>Middle-term incentives:</td><td>to guarantee EE lump-sum benefit by a fixed term (5-10 years)</td><td rowspan="2">Flexibility at maturity: Single cash benefit or annuity option by request of the EE (life-long pension or fixed-term annuity)</td><td rowspan="2">ER only</td><td rowspan="2">Fixed-term saving policy from insurance company (guaranteed maturity benefit is established in the insurance policy).
Policy term can be linked to reaching Normal Retirement Age</td></tr>
<tr><td rowspan="3">Long-term incentives:</td><td>to guarantee EE certain fund at retirement</td></tr>
<tr><td rowspan="2">To pay certain contributions building up provisions for EE retirement</td><td>Flexibility at retirement: Single cash benefit or annuity option by request of the EE (life-long pension or fixed-term annuity)</td><td rowspan="2">ER + EE together</td><td rowspan="2">Pension Insurance Policy (from insurance company)
or
Pension Provisions Contract (from Non-State Pension Fund)</td></tr>
<tr><td>No flexibility at retirement: No single cash benefit at retirement, only life-long annuity</td></tr>
</table>

Concept of Insurance or NSPF arrangement: What an insurance/pension contract is about

Life Insurance Industry

- Insurer and the client must agree

  1) on future liabilities of the Insurer (called sum assured or annuity benefits)

  2) on the insurance premiums (=contributions) payable by the client to insurer for that liability.
- Maturity benefits (lump-sum or annuity) have to be 'insured' or 'guaranteed' by the Insurer and explicitly indicated in the policy.
- Insurer is not obliged to invest contributions (possible to keep 100% in cash) but it has to invest, in order to build funds adequate to meet future liabilities.
- Regulator has certain guidelines on how such funds (built by Insurer to meet its future liabilities) should grow in time, depending on the nature of liabilities and contributions schedule.
- The guidelines include mathematical formulas and guaranteed interest rate (usually between 2% to 4% p.a., selected by the insurer)

Non-State Pension Funds

- Future liabilities of NSPF (maturity benefits) may not be guaranteed, and usually they are not indicated in the pension agreement between the client and NSPF.
- The client can pay any contributions to his pension account. Contributions must be invested by NSPF in a broad range of assets in accordance with statutory allocation requirements (not possible to keep 100% in cash)
- The law has vague wording about capital preservation guarantee. Most of NSPFs read the law conservatively, i.e. they decide that at least 0% interest rate has to be accrued on the balance of pension account.

Can the client select how contributions to be invested & how investment return is shared

Life Insurance Industry

- Investment options are hardly possible, taking into account the insurer's commitment to guarantee certain benefit at maturity or at retirement.
- Inevitably, the investment strategy has to be conservative and the insurer has to reserve the right to manage investments by itself.
- The insurer has the right (but not obliged by law) to accrue 'investment bonus' = interest in excess of the guaranteed one, thus increasing guaranteed maturity values.
- Investment bonus is accrued by decision of the insurer's actuary, based on the actual investment performance, the forecasted one, and the insurer's cost base (admin expenses and cost of capital contributed by its shareholders to maintain its statutory solvency margin).

Non-State Pension Funds

- Investment options are possible, if both the client and NSPF refuse capital preservation guarantee.
- Investment options are hardly possible, if capital preservation guarantee is required by the client, because then the nature of liabilities is similar to those under the insurance solution.
- Return on investment of the clients funds (pension reserves) is calculated by the year end and, by law, at least 85% of that must be distributed to the benefits of the clients (i.e. only 15% of the investment return can be withheld by the NSPF to cover its expenses).

Provider's current liabilities: what happens if the arrangement is terminated before maturity (before Normal Retirement Age)

Life Insurance Industry

- The law prohibits to pay more than mathematical provisions calculated by the insurer in accordance with statutory guidelines.

Non-State Pension Funds

- The prohibits to pay more than the balance of the Member's pension account.

- Definition of surrender value and surrender charge are matters of agreement between the Provider and its clients at the moment of pension contract conclusion.

Could accumulated funds be converted into annuity (eg. at retirement)

Life Insurance Industry & Non-State Pension Funds

- Annuity amounts (eg. monthly pension) are to be explicitly indicated in the relevant insurance or pension agreement between Insurer or NSPF and the beneficiary (individual receiving the benefit).
- Available annuities include: term pension, life-long pension, guaranteed payment period option, spouse pension option, annual inflation adjustment, etc.

Providers' fees and charges

Life Insurance Industry

- The law does not require them to be explicitly indicated in the insurance policy and does not establish any cap on them. So, the levels of fees and charges and their indication are matters of agreement between the client and the insurer.
- Contrary to mature markets where the main admin fee is charged from assets under management, in Russia it is conventional to charge contributions only.

Non-State Pension Funds

- The Law demands full transparency of fees and charges related to contributions. The charges must be indicated in the agreement between the client and the employer.
- The parties can agree that contributions are charged before invested, then charge is capped by 6%, of which

  up to 3% can be charged to cover admin expenses and cost of investment guarantees, if any, and

  up to 3% can be charged to build up the so called 'insurance reserve'.
- The parties can agree upon any charges (called 'dedicated contributions') on top of pension contributions, then such charges are not limited.
- Also, up to 15% of investment return can be acquired by NSPF but it is prohibited by law to raise admin fee from assets under management

What complicates selection of a particular solution

Life Insurance Industry

- Lack of investment options
- Under a fixed-term saving policy specifying a lump-sum benefit at maturity, the Regulator requires that at least some (small) death cover to be added to the main saving component.
- Otherwise, the insurance policy would look like a bank deposit.
- Change of premiums -> change of liabilities -> has to be effected under endorsement to the insurance policy.

Non-State Pension Funds

- Limited investment options
- Often requirement by NSPF for the client to contribute into the Insurance reserve (statutory solvency margin) established at 5% of values on pension accounts.
- It is economically senseless for NSPF founders to sponsor this solvency margin, so it is usually financed from the clients (as a deduction from their pension contribution and/or a dedicated contribution on top of their pension contribution)

Statutory Allocation Requirements

	IC	NSPF
Portfolio share managed by specialized AMCs under trust management agreements	≤ 20%	≤ 100%
Federal Government Bonds	≤ 100%	≤100%
Regional and Municipal Government Bonds	≤ 30% & 15%	≤ 70%
Bank deposits	≤ 40% ≤ 20% in 1 bank	≤ 80% with or without AMC ≤ 25% in 1 bank
Units in Unit Trusts	≤ 10%	≤ 70%
Foreign assets (n/a)	≤ 20%	≤ 30% via AMC
Real Estate	≤ 20%	≤ 20% but via mortgage certificates only, through AMC
Private companies' bonds	≤ 20%	≤ 70% via AMC
Equities	≤ 15%	≤ 70% via AMC

Tax Environment

Parameter for comparison	Saving Insurance Scheme	Pension Insurance Scheme	NSPF
Deductibility of employer contributions for the purpose of Corporate Profit Tax	Yes, ER contributions are tax deductible if they in total do not exceed 12% of the company's annual payroll		
Social Insurance Contributions corresponding to employer's contributions	ER contributions are recognised as a part of taxable income for SIC. However, under 0% tax rate from any income in excess of 415 k RUR p.a., effectively no tax shall apply to middle and high income earners		No tax
Personal income tax from benefits corresponding to employer's contributions	Only benefits (at maturity or retirement or cash surrender values) are subject to Personal Income Tax (13% flat)		
Personal income tax re employee's own contributions and benefits	No tax refund from member's own contributions. At maturity or at lapse date, only 'gains' (difference between the benefit and contributions increased by Central Bank of Russia's refinancing rate) is taxed by Personal Income Tax	Income Tax from the member's own contributions can be refunded by submission of annual tax declaration, but no more than $500 per year (=120 000 RUR x 13% : 31 RUR/$). Pension benefits are tax free but early cash benefit is taxed (refunded tax amount is to be withheld by provider together with personal income tax from the difference between the benefit and contributions	

GENERAL PORTRAIT OF A CORPORATE CLIENT

Moscow
2009 December, 1

Content

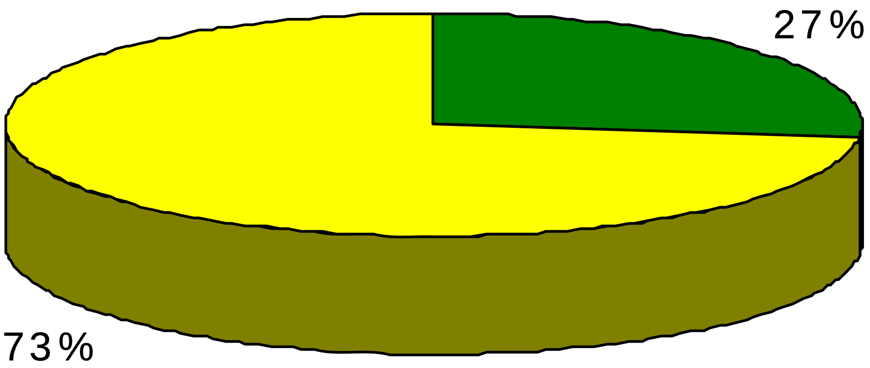
- Raiffeisen Pension Fund
- Origin (foreign/domestic)
- Industries
- Participation eligibility
- Financing schemes
- Vesting types

Raiffeisen Pension Fund

- Founded in **1994** (as NPF Dobroe Delo)
- Shareholder: **Raiffeisenbank** since 2004
- Assets under management: **RUB 2,3 billion** (USD 77 million)
- Full range of pension products:
  - 2nd pillar – **25 000** insured individuals
  - 3rd pillar corporate – **111** companies
  - 3rd pillar retail – **37 000** individuals
- Distribution via **266 branches** of Raiffeisenbank all over Russia

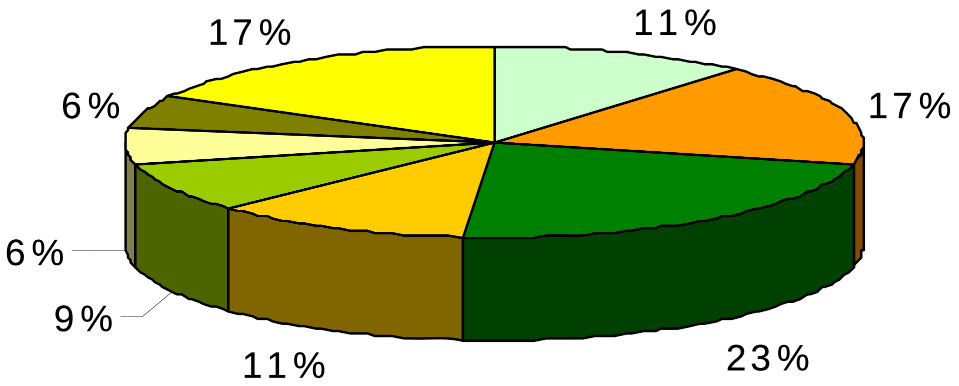
Origin (foreign / domestic)

- Foreign companies – **73%**
- Domestic companies – **27%**



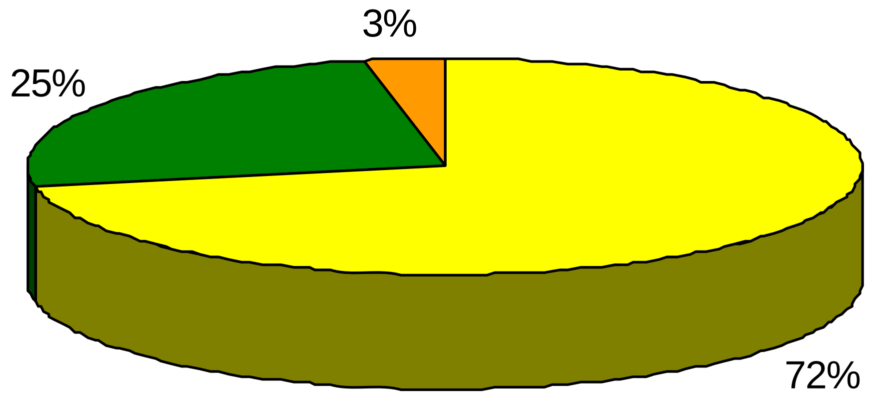
Industries

- Electronic – **11%**
- Finance – **17%**
- FMCG – **23%**
- Oil & Gas – **11%**
- Transport – **6%**
- IT – **6%**
- Pharmaceutical – **9%**
- Other – **17%**



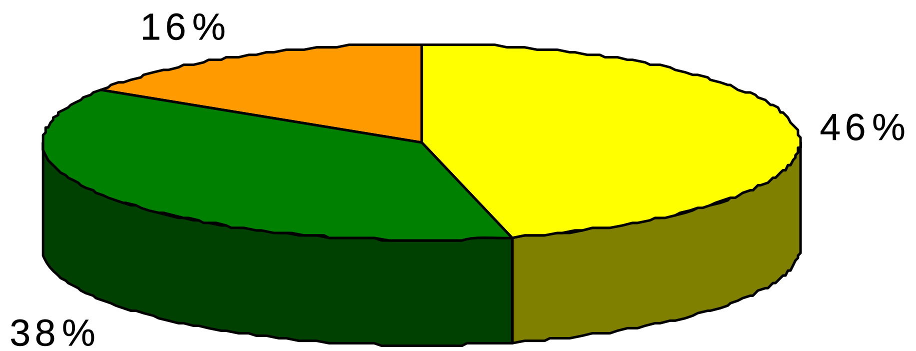
Participation eligibility

- All employees – **72%**
- Defined groups of employees (e.g., depending on the length of services in the company, status, age of the employee and so on) – **25%**
- Only top management of the company – **3%**



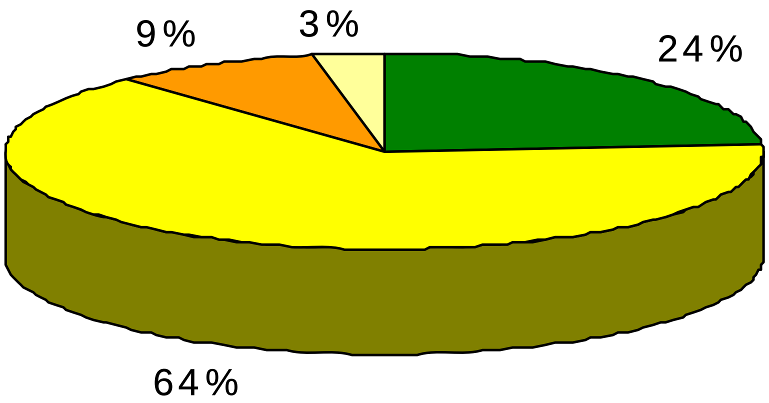
Financing schemes

- Only employer's contributions – **46%**
- Joint financing – **38%**
- Combined financing (basic employer's contribution + additional joint financing) – **16%**



Vesting types

- Fixed – **24%**
- Graded – **64%**
- Immediate – **9%**
- Reverse – **3%**



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