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5
THE PRIVATE PENSION REFORM **EXPERIENCE IN TURKEY**

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MACROECONOMIC CONTEXT

One of Turkey's key macroeconomic weaknesses over the last fifteen years has been its wide current account deficits. Turkey's growth model in the post - 2001 period has relied heavily on external financing to bridge the gap between its investment spending and domestic savings (Figure 5.1). The average growth rate of 6.8% in the 2002-07 period has been associated with a 3.7% current account deficit. Following the global financial crisis-led contraction in 2009, the strong recovery generated even higher levels of deficit.

Turkey's domestic saving rates are low and have been declining.[1] The high levels of current account deficit are mirrored in the low levels of domestic savings in the 2000s. The average domestic saving rate declined from 16.4% in 2002-08 to 14% in 2009-14. Figure 5.2 shows that the decline in overall saving rates in the first half of the last decade was driven by a sharp drop in private savings, which more than offset the rise in public sector savings, which more than offset the rise in public sector savings — a result of fiscal consolidation in the early 2000s. Within private savings, household saving rates seem to have pulled down overall savings as measured by the data from the household budget survey.[2] Since 2009, saving rates seem to have stabilized.

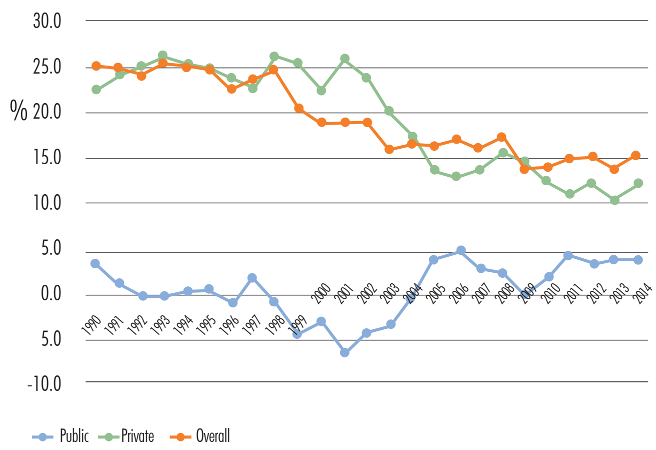
Figure 5.1
GDP Growth (%) and Current Account Balance (% of GDP)
Growth and Current Account Balance

Source: World Development Indicators

[1] A new GDP series for Turkey was announced after this chapter was written. In addition to a 20 %increase in the level of GDP, saving rates were also significantly revised, however, further research is required to understand the revision to the composition of GDP.

[2] Decomposition of private savings by corporate and household sectors were not available through national accounts data at the time of the writing of this chapter. The household saving rates presented here are calculated using the household budget survey from TUIK.

Figure 5.2
Turkey's Domestic Saving Rates
Public, Private and Overall Saving Rates



Source: Ministry of Development

Reaching Turkey's higher growth targets would require higher domestic savings. Low domestic savings adversely affect Turkey's growth prospects in two ways. First, domestic saving finances investment and the impact on growth: cross-country data—especially for developing countries—suggest a positive association between saving, investment, and growth.[3] Second, low domestic saving increases dependence on foreign financing, fuelling a rise in the external current account deficit and increasing vulnerability of the growth process. Increasing domestic savings to bring it closer to the 19% targeted in Turkey's 10th national development plan, and thus narrowing the structural current account deficit, would put Turkey's growth process on stronger footing to move from a middle-income country to one that is high-income.

Moving towards this goal, and to complement the existing first pillar pension scheme, Turkish policy makers introduced the voluntary private pension scheme in 2003. The rest of this chapter provides an assessment of Turkey's experience in establishing the private pension system and policy initiatives aimed at expanding the coverage of the system. Section 2 provides further background by describing Turkey's social security landscape and its demographic profile. Section 3 opens the door for discussion of the private pensions in Turkey and covers Foundation (employer linked) private pension schemes. Section 4 sets forth the experience of Turkey as regards the individual pension system, and includes details on the new auto - enrolment pillar legislated in August 2016 and being introduced from 2017.

[3] World Bank (2012). "Sustaining High Growth: The Role of Domestic Savings." Turkey Country Economic Memorandum.

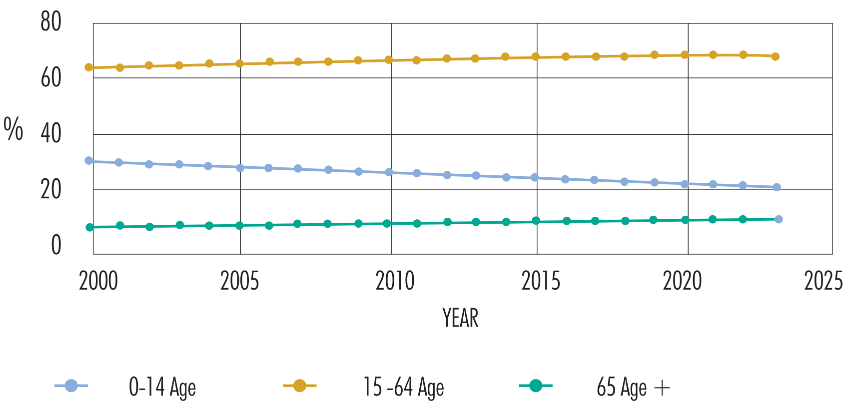
TURKEY'S SOCIAL SECURITY SYSTEM AND **DEMOGRAPHICS**

Turkey's First Pillar Social Security System is a pay-as-you-go system. Social security premiums of workers finance healthcare services of existing and retired workers as well as pension benefits of retirees. There is an income transfer from those who are currently employed to those who are retirees. As of 2016, the active/passive ratio is 1.91 which should be ideally 4 by international standards. The Social Security and General Health Insurance Law (No. 5510) introduced in 2008 unified the administration of social security benefits under a single agency known as the "Social Security Institution" (SSI – SGK in Turkish). Eligibility for retirement became stricter with the new law. The retirement age increased to 65, (it is 55 for women and 60 for men), and the replacement ratios or generosity of the benefits were cut – albeit from levels that are among the most generous in the OECD.

A. DEMOGRAPHIC PROFILE

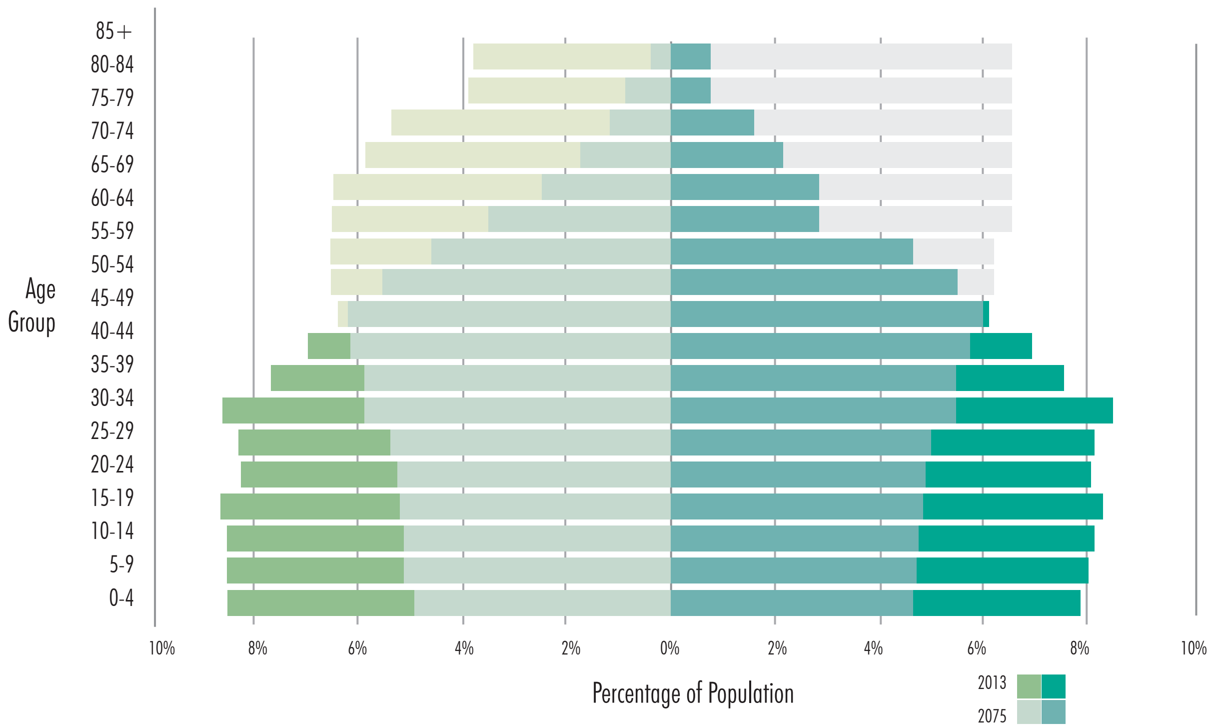
Different age groups have different retirement requirements due to the phasing in of the higher retirement age. The proportion of the 15-64 age group in the general population in 2023 is higher than in 2013 as shown in Figure 5.3. It is expected that the ratio of people aged 65 and over to the population will rise to 10.2% from 8.3% over the same period.

Figure 5.3
Share of different age groups in Turkey, 2000-2025



Source: TURKSTAT (Turkish Statistical Institute)

Figure 5.4
Population Pyramid of Turkey by Age Groups and Gender in 2013 and 2075



As depicted in Figure 5.4, the percentage of the population aged 65 and over in 2013 in Turkey is between 2.5% and 3% on average for each five year age band in 2013 – compared to around 8% in each five year age band from 0 to 35. This is set to change dramatically when the share in each five year age band above 65 is generally around 6% in 2075 with the younger age bands falling to around 4.5%-6% on average. In other words, the elderly population will increase and there will be a decrease in active/passive ratio – with the population pyramid 'inverting'[4]. Therefore, Turkey's social security structure will be adversely affected due to the decrease in the number of active workers.

B. MANDATORY SOCIAL SECURITY SCHEME

The first pillar retirement system is compulsory for all employees and is provided by the state. Before 2008, private sector employees were covered under Law No. 506; traders, self-employed individuals, and those who are active in agricultural activities were covered under Law No. 1479; and state employees were covered under Law No. 5434. As highlighted above, these three different groups began to receive social security service under a single law and from a single institution from 2008 – the SSI – under Law No 5510.

[4] For more details of this phenomenon in Turkey and other countries in Europe and Central Asia see Schwarz and Arias (2014).

Table 5.1
Insured, Retired Members, and Active-Passive Ratio Table (2015)

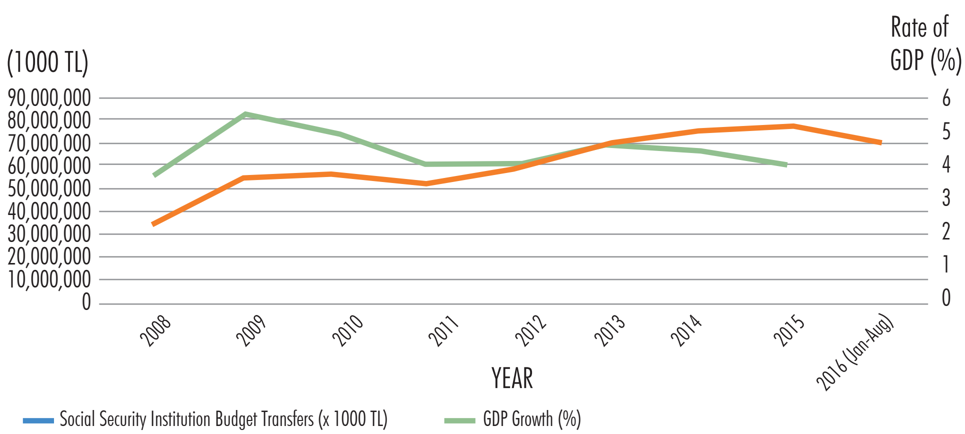
	Insured (i)	Pensioner (p)	Insured/ Pensioner Ratio (i/p)
4-a (Employee)	14,577,287	7,044,708	2.07
4-b (Self employed)	2,785,917	2,558,374	1.09
4-c (Civil servants)	3,042,243	2,026,541	1.50
Total	**20,405,447**	**11,629,623**	**1.75**

Law No. 5510 applied in general to new entrants to the labour market who become insured for the first time under this Law. The rights of those who had been already insured before the Law were generally protected, with some transition conditions applying. This means, the very generous provisions of the earlier laws have a long transition period before they finally disappear.

As of 2015, 85.5% of the population has been covered by the First Pillar Pension System The ratio of insured people to pensioners and dependents is 45%.

As the ratio of active workers to pensioners and dependents is low, an increase can be expected in the share of transfers from the general budget to the social security system. The amount of transfers to SSI has been increasing since 2008.

Figure 5.5
The Population covered by SSI, 2004-15
Social Security Institution Budget Transfers (TL)



Source: Social Security Institution

Increasing the premium rates, extending the scope and limits of earnings subject to the premium, extending the number of working days and the number of days for premium payments, expanding the labour force, decreasing unemployment and unregistered employment could help reduce the budget transfers. Some specific policy measures that have been aimed at promoting the fiscal sustainability of the system are:

- Social Security and General Health Insurance Law No. 5510 changed the retirement age and the premium payment periods to 65 and 9000 days, respectively. Also, the replacement rates were decreased although they remain generous relative to other OECD countries.[5]
- The upper limit of the daily earnings subject to insurance premium increased from 6.5 times of the daily gross minimum wage to 7.5 times,[6] with an expected 15% increase in premium collection.
- In order to increase labour force participation, free courses and job placement services are provided, which are financed by the Unemployment Insurance Fund.

PENSION REPLACEMENT RATE

The pension replacement rate can be calculated over the gross and net wage. In OECD countries, the replacement rate calculated over the average gross wage is 57%. It can also be defined as the ratio of the pension amount to the average wages earned during the working life.

There are three pension allocation systems in Turkey: The period before 2000, between 2000 — October 2008 and after October 2008. The pensions before 2000 were calculated over the earnings of the last 10 years of working life. In the systems after 2000, the pension has been calculated over the updated earnings multiplied by the CPI and GDP growth rate concerning the whole period of employment.

For workers following Law No. 5510 since 2008, it is possible for individuals, who begin their working life at 18, to receive a maximum replacement rate of 94%. This is because of the annual accrual rate of 2%. (65-18 = 47 years x 2% = 94%). They receive pension equal to 90% of the updated average earnings at the maximum instead. Since a 47 - year - working life does not seem possible given the circumstances in Turkey, if we assume that the average working life is 30 years, 60% (30 years x 2%) of the average earnings during the working life will be the average replacement rate.

On the other hand, the pension allocated to an individual who paid premiums over the upper limit for 30 years before the year 2000, equals to 65% of the average of the earnings, updated according to CPI. For the same individual, the corresponding percentage for his or her working life before the year 2000 is 65%, it is 72.5% between the

[5] See OECD Pensions at a Glance 2015

[6] Article 8 of the Law on Amendments to Certain Laws and Public Finance Management and Control Law, Numbered 6761, adopted by the Grand National Assembly of Turkey on November 16th 2016.

year 2000 and October 2008, and it is 60% after October 2008. If he or she has worked 10 years in each of the three periods, the replacement rate is 65.8% = (0.65 x 10 + 0.725 x 10 + 0.60 x 10) / 30.

The pension replacement rate for an individual who became insured before October 2008 for the first time and worked in the public sector for 30 years would be 80% of his or her salary when he or she retires. However, after October 2008, according to Law No. 5510, those who start working as government employees for the first time have a pension replacement rate of 60%.

Thus, replacement rates for the new entrants to the work force will be much lower than their pre - 2008 levels. In order to address this income gap during retirement, a number of initiatives have been taken in Turkey, which will be discussed in the upcoming sections.

C. 'FIRST PILLAR' OR SOCIAL SECURITY FOUNDATIONS

Some large employers – such as banks, insurance, and reassurance companies established Pension Foundations that were required to provide benefits as generous, or more so, than the Social Security System. So they are effectively part of the First Pillar of Turkey's pension system. There is a range of practices –with some matching the pension and health coverage of the SSI and some exceeding it. The members subject to these foundations are not required to pay social security contributions to SSI. Enrolment in such schemes are compulsory for the workers employed in the institutions that were allowed to offer these schemes. (i.e. banks, insurance/reassurance companies, and chambers of commerce).[7]

As of today, there are 17 Foundations, 10 of which have a relatively bigger size. By the end of 2015, there were approximately 250,000 members in total, approximately 150,000 of whom were active members while 100,000 were passive. At the end of 2015, the total assets under management (AUM) in these Foundations were approximately USD 3.5 billion.

These 'first pillar' Foundations are monitored by the Ministry of Labour and SSI. They have wide freedoms as to where to invest their assets. This allows well-run Foundations to design efficient portfolios – but it also allows a high degree of self-investment – for example,the employer can invest in his buildings.

EMPLOYER SPONSORED **PENSIONS**

In addition to the 'First Pillar' or Social Security Foundations there are a range of complementary pension plans that were established over the years to provide benefits in addition to Social Security. They were all established before the introduction of the

[7] Such Pension Foundations are schemes that were established before the introduction of the Social Security Law in 1974, and are allowed to be exempt from the provisions of the Social Security Law as long as they provide the minimum benefits required by the SS Law.

voluntary individual pension system in 2003. Many will become increasingly 'legacy' organizations, with some already transferring their members into the voluntary private pension system described in Section 4 below – a process that is likely to continue with the introduction of the new auto - enrolment pillar described in Section 5. However, some will endure – in particular OYAK (Army Solidarity Institution) which is the pension fund for the armed forces.

OYAK was founded in 1961 by Law no. 205 and its members were also compulsory members of the Social Security Institution. OYAK had 320,000 members at the end of 2015, and coverage had been rising steadily over the years, bringing its assets under management to USD 7.4 billion at the end of 2015.

Another complementary pension foundation defined by the law is the Union of Coal Miners. (Amele Birligi).[8] The Union has been operating as an institution under the Ministry of Labour and Social Security since 14th December 1982. In this foundation, members contribute 2% of their salary and members who leave the Union can continue as voluntary members. It is a small size fund that has an AUM of approximately USD 10 million.

There are around 80 other Foundations set up by a range of employers – from large conglomerates such as the Koc Foundation to institutions such as the Central Bank. By the end of 2015, there were 266,844 members in total, 191,021 of whom were active and 75,823 of whom were passive. The total AUM amounts to approximately USD 7 billion. These institutions are subject to audit and have to register in the list of Pension Providers kept by the Undersecretariat of Treasury. They prepare an Actuarial Audit Report and send it to the Undersecretariat of Treasury. The actuarial requirements have recently been strengthened by regulations developed by the Treasury.

Transferring funds from such schemes to the individual pension system became possible in 2007 through Provisional Article 1 added to the Law on Individual Pension Savings and Investment System No. 4632. So far, 13 institutions have undergone transfers that accelerated after 2011. The sum of assets transferred to the system in this way was USD 601.2 million by the end of 2015. The time frame allocated for such transfers ends as of December 31st 2017.

THE INDIVIDUAL PENSION SCHEME (BES)

A. INITIAL DESIGN

As highlighted above, Turkey has a large First Pillar – and some employer based coverage for certain groups or companies – but before 2001 it did not have an individual voluntary pension system – known as a 'third pillar' in World Bank terminology. This was an

[8] In the past, institutions similar to OYAK and AmeleBirligi such as MEYAK (Civil Servants Solidarity Institution) for civil servants and İYAK (Labours Solidarity Institution) were proposed. However, although MEYAK Law entered into force and a deduction of 5% from the civil servants' salary was implemented for a while, it did not become permanent and IYAK remained only as an idea

important gap that had to be filled in the multi - pillar framework. The initial reform efforts aimed to promote domestic savings to generate additional resources that could be invested in productive assets via the capital markets. This was done for another advantage, which was to increase the stock of domestic assets by providing a new channel for saving, with the aim of providing additional resources that could be invested in productive assets via the capital market. The third pillar pension system, i.e., the Individual Pension System, (BES in Turkish)was established by the Law on Individual Pension Savings and Investment System No. 4632, which came into force on 7th October 2001. Following the finalization of the secondary legislation and the necessary operational framework, the system became operational on 27th October 2003. The system is based on voluntary participation.

The contributions collected by the pension companies are invested in pension mutual funds founded by the pension companies. Members make their own decisions as to which fund or funds to allocate their contributions in accordance with their risk or return expectations. Pension mutual funds are managed by portfolio managers. It is possible to change the allocations up to six times a year.

Members' accumulations are held under an individual account opened in Takasbank (the custodian bank). Thus, members are not affected by the pension company's solvency and enjoy the benefits of a custodian in terms of fraud prevention.

The individual pension system is a Defined Contribution system based on individual pension accounts. Withdrawals at retirement age can be in the form of phased withdrawals or a lump sum. Early withdrawals are also allowed although with certain penalties, based on the duration of stay within the system. Early withdrawals have been used very extensively, with the average duration of holdings in the individual accounts being only around three years. At the retirement age of 56, assets can be withdrawn without any penalties – but can be left in for longer. In order to retire from the individual pension system, members have to stay in the system for 10 years and complete the age of 56.

As of November 2016, there are 6.6 million members in the individual pension system. The total assets are USD 17.2 billion – made up of USD 15.17 billion dollars directly from members,with additional funds from a state matching subsidy (explained below) totalling USD 2.04 billion. Both the number of members in the system and pension accumulations are rising steadily. So far, 43,114 members have retired from the system. Other primary indicators regarding the system are shown in Table 5.2.

Table 5.2
Basic Indicators of the Individual Pension System (30.11.2016)

Total Number of Members		**6.566.391**
Total Amount of AUM (USD)		15,165,161,044
Total Amount of AUM (State Matching Funds) (USD)		2,041,858,832
Number of Retired Members		43,114
Number of Contracts	Individual Pension Contracts	5,665,437
	Employee's Group Contracts	1,542,608
	Non contributory Group Contracts	506,154

B. INTRODUCTION OF MATCHING INSTEAD OF TAX-RELIEF IN 2013 TO EXPAND COVERAGE

The individual pension system membership grew quickly in the first 10 years of operation, but there was a desire to explore ways to expand coverage further. Hence, in 2013 the incentives to contribute were changed from a traditional use of tax-relief to the innovative use of state matching concept. For the case of Turkey, state matching has the potential to be more effective than tax relief for many reasons. First of all, it is easier to understand for many when compared to tax-relief. Also, it doesn't require any additional operation from the member (such as having to submit the proof of pension contribution on a monthly basis in order to enjoy tax relief etc.). Moreover, it allows non - tax payers to receive incentives – and hence can be less regressive than traditional tax relief. Indeed, before the move to matching, only 33% of the members were able to make use of the tax relief. Thus, after 2013, the incentive structure changed into a direct cash contribution by the government (state matching contribution) at the rate of 25% of the contributions paid by members. Within the context of the new structure, all member contributions can benefit from state matching contribution within the statutory limits. The calculation of the state match is performed automatically by the system and no statement or notification from the member is required. The cap for the state match in a calendar year is for that year. So, the max. amount of state match that a member can receive annually is equal to 25% of the annual gross minimum wage.

THE IMPACT OF STATE MATCHING CONTRIBUTION ON INCREASING COVERAGE IN THE SYSTEM

The state match incentive system was extensively publicized before its initiation. As a result, in 2013, the number of new members increased by 64.6% compared to 2012, adding about 1.5 million people to the system in 2013. The number of members entered into the system in 2014 and 2015 was 1.5 and 1.7 million respectively. As set out in Table 5.3 this represented a very significant increase on the growth rates before the policy change.

Table 5.3
Annual New Entrants

Year	New Members (Gross#)	Cumulative Members at the end of the year	Rate of Increase According to Previous Year (%)
2010	604,441	2,281,478	-
2011	730,619	2,641,843	15.8%
2012	925,418	3,128,130	18.4%
2013	1,523,409	4,153,055	32.8%
2014	1,551,298	5,092,871	22.6%
2015	1,704,813	6,038,432	18.6%

Sources: PMC Annual Progress Reports, 2010 - 2015

State matching has also resulted in an important increase in the level of contributions. An analysis of contracts that made at least one payment in the year reveals that the average payment per contract rose from 186 TL (USD 103)in 2012 to 205 TL (USD 108) in 2013. The growth rate in contribution size rose from 6.9% in 2012 to 10.2% in 2013. Contributions then stabilized around this higher level – see Table 5.4.

Table 5.4
The Average Contribution per Member (Regular Contributions)

Year	Members' Average Monthly Regular Contributions (TL)	Rate of Increase according to Previous Year (%)	Rate of Inflation - Consumer Price Index (%)
2010	165	-	-
2011	174	5,5	10,5
2012	187	7,5	6,2
2013	205	9,6	7,4
2014	204	-0,5	8,17
2015	213	4,4	8,81

Thus, the state matching reform proved to be effective in increasing participation in BES. However, further reform was still needed to reach the desired levels of private pension coverage in Turkey. It was in this context that preparations were made to develop the new auto - enrolment reform introduced in 2016. This reform is explained below – after a discussion of the history of fees in the individual voluntary system that was another driver for the auto - enrolment reforms.

FEES AND RETURNS

As set out above, contributions paid in the Individual Pension System are invested in pension mutual funds chosen by members. Members' savings value is determined by the gains or losses of the assets included in the preferred funds. The system initially allowed a wide range of fees and deductions:

- **Entry fee:** An entry fee is a charge for the first contract of a member executed with a pension company (non-contributory group contracts excluded). Entry fees may be collected in advance or deferred (i.e. collected in case of early exit). It may also be collected in instalments provided to collect the advance payment within a year at most.
- **Administrative Expenses Fee:** Administrative expenses fee may be charged over members' contributions paid to the individual pension account.
- **Additional Administrative Expenses Fees charged in case of a suspension:** If a contribution is not paid within three months following the due date of the contribution, the contract is deemed as a suspended contract. An additional administrative expenses fee may be charged from member's savings throughout the period of suspension.
- **Fund Management Fee:** A fund management fee may be deducted from the fund.

These deductions have undergone several changes since the system was introduced. This was done to ensure a reduction in the members' costs in order to encourage increased participation in the system and thus improve retirement income adequacy.

When BES was initiated, the entry fee was capped at the amount of the gross minimum monthly wage from the date of entry to the system, and the administrative expenses fee was capped at 8% of contributions. The fund management fee was limited to 10/100000 per day, calculated over AUM, (3.65% on an annual basis). In the event of suspension, an extra deduction was possible that was capped at 25% of the minimum monthly wage.

In 2008, the suspension fee was limited to only the fixed expenses paid by the pension company to the Pension Monitoring Centre and the Custodian/Takasbank.

In 2013, with the introduction of the state matching contribution system, certain amendments were made in all the fee items. The amount of entry fee was not changed, however, options of advance or deferred collections were brought in. It was stated that the advance part of the entry fee may not exceed 10% of the monthly minimum wage effective on the signing date of the proposal. It was indicated that the sum of the entry fee collected in advance and deferred form may not exceed certain percentages of monthly minimum wage effective on the signing date of the proposal as follows;

a. 75% for those members opting out or transferring within three years as of the effective date of contract,

b. 50% for those members opting out or transferring before six years of contract after fulfilling three years as of the effective date of contract,

c. 25% for those members opting out or transferring before 10 years of contract after fulfilling six years as of the effective date of contract.

However, it was also regulated that no deferred entry fee may be collected from those members who exit the system due to death, disability, or retirement.

There were also reductions in the fund expenses fee cap. Thus, the annual fee cap for: Capital Markets (cash-type) funds was reduced to 1.09%; government and private sector bonds and T-bills funds, international bonds and bills funds, precious metals funds and index funds was reduced to 1.91%; and equities and other equity-like funds was reduced to 2.28%. The suspension fee was reduced to a maximum of 2 TL for each complete month of suspension. Moreover, the administrative fee cap was reduced to 2% from 8%.

By a legislative amendment in 2016, new caps based on the contract tenure were introduced for all fees to be charged from members (including Entry Fee, Administrative Expenses Fee, and Fund Management Fee). A new legislation introduced in 2016 limited fees further in the Individual Pension System. In the first five years of the contract between the years 2016 - 2021, the total amount of entry fee and administrative expenses fee shall not exceed 8.5% of monthly gross minimum wage applied in the first six months of the respective calendar year for each contract year. On the other hand, on and after the sixth year of the contract, no entry fee and administrative expenses fee may be charged.

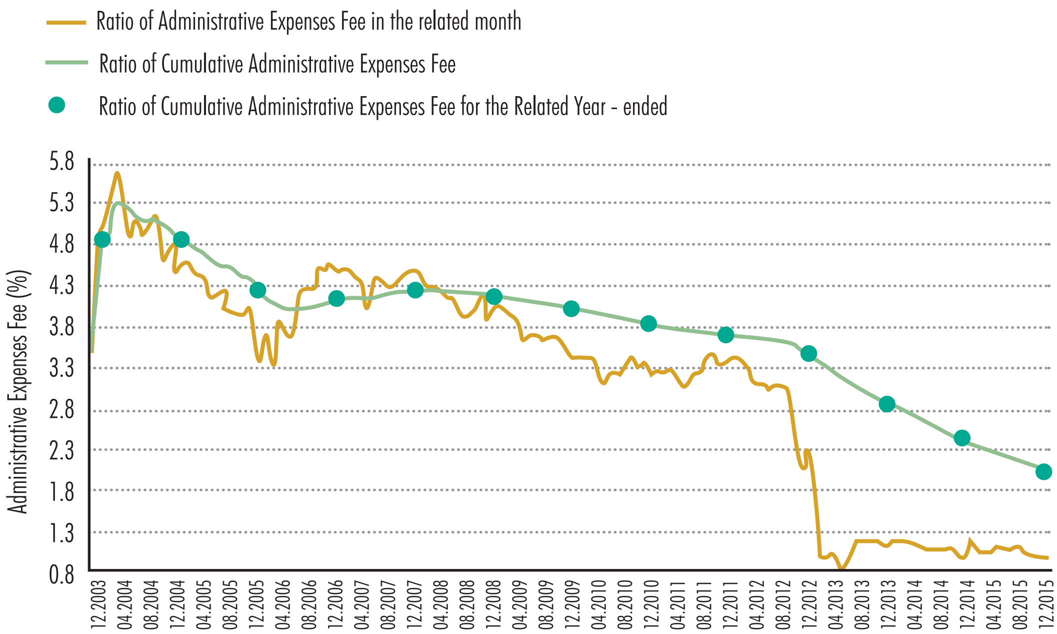
However, the part of such fixed amounts corresponding to the period until the end of the fifth year of the respective contract and yet uncollected by the respective pension company may be deducted as a deferred entry fee from a member's savings at his individual pension account for those members opting out or transferring without fulfilling five years of the contract period. (Getting out of the pension system due to death, disability, or retirement are exceptions).

In addition, there is only a fund management fee in the practice of the automatic enrolment system to be applied to the large masses of employees, and it was indicated that maximum yearly fund management fee (FMF) for all funds will be applied at a maximum of 0.85% and in all conditions.

It was stated that in the event of exceeding some specified performance thresholds together with a total fund expenses fee, in the automatic enrolment practice, it will be possible to charge an additional FMF equaling to the 25% of the amount over the threshold. However, it was added that, any additional fee to be charged may not exceed the rate of 0.85%. All these arrangements aim to reduce the costs of the individual pension system for members.

The administrative expenses fee is taken from the contributions made by the participant. In an examination of these fees in terms of administrative expenses fees, it is observed that the administrative expenses fees charged on the collections made by the end of 2015 were 2.09% cumulatively. However, members who entered the system after 2013 saw this fee around 1 percent.

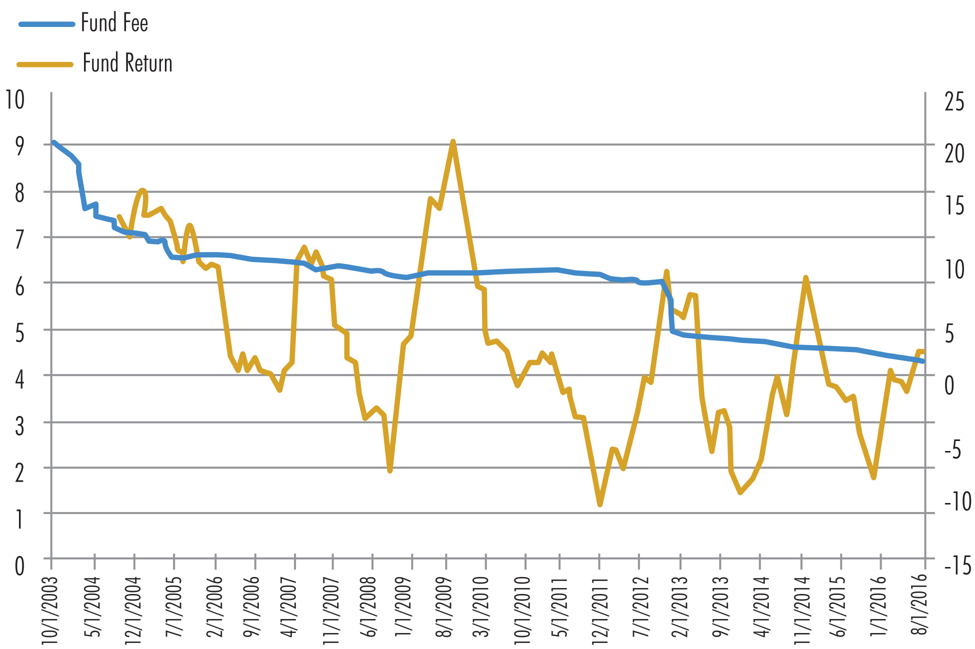
Figure 5.6
History of Administrative Expense Fees



Source: PMC Annual Progress Report 2015

As Figure 5.7 shows there is no correlation between higher fees and higher returns – with returns driven by market movements. This matches the evidence shown in Chapter 18 on cost.

Figure 5.7
Relation between Fund Management Fee and Fund Return (%)



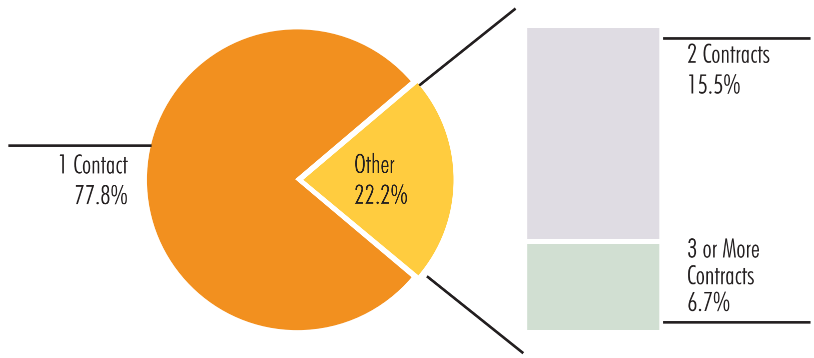
Source: www.egm.org.tr

C. DATA AND CITIZEN IDS

The collection of data and recordkeeping are very crucial aspects for the effective functioning of the Turkish private pension system. A member in the individual pension system might have more than one contract in the same or different pension company. Members are identified based on the Republic of Turkey ID number while contracts are identified on the basis of contract numbers given by pension companies. In this case, it is possible that there will be more than one contract number under an ID number. Pension companies can access the information of whether members have contracts in other companies through the Pensions Monitoring Centre (PMC). The PMC provides the daily supervision of pension companies' activities in order to ensure the safe and efficient operation of the individual pension system and the protection of members' rights and returns. The PMC has functions such as monitoring and supervising of the pension companies' daily activities, keeping the information of members, informing the public and members, producing, and reporting statistics,etc. In this context, pension companies send data to the PMC each day and the PMC consolidates this data. The PMC requests pension companies to send data defined as "Enhanced Monitoring Activity Data". They are sent on the basis of member,contract,and various other legislative subjects. The PMC consolidates the data and gives feedback to pension companies about errors in it,with the aim of collecting error-free data.

When a member wants to retire, the oldest contract's enforcement date is considered as entrance date to the system and this is how time-dependent rights emerge. The member needs to merge savings in all pension contracts into one contract at the time of retirement. The operation is initiated when the member communicates his/her request to retire to one of the pension companies with which he/she has a contract.

Figure 5.8
Distribution of Members According to Number of Contracts Owned



Source: PMC Annual Progress Report of 2015

IT AND ADMINISTRATION

The Law on Individual Pension Savings and Investment System No. 4632 includes provisions for monitoring that are in compliance with the EU regulations and ensure high standards. The detailed framework for monitoring and supervising the system was established by the Regulation on Procedures and Principles Regarding Monitoring and Supervising Insurance and Private Pension Sectors based on Law No. 4632. The individual pension system includes a versatile and comprehensive supervision mechanism.

Aside from the Circulars, Notifications, and Resolutions published during the continuity of the system, all pension companies that will carry on business in the individual pension system are constantly monitored and audited by:

- Republic of Turkey Prime Ministry - Undersecretariat of Treasury
- Capital Markets Board of Turkey
- Independent external audit
- Company internal audit units
- Company actuary units.

D. SUPERVISION

A pension company's pension activities are subject to supervision by the Undersecretariat of Treasury. The Undersecretariat of Treasury has prepared the "Individual Pension Procedures Audit Manual" in order to set out the minimum auditing areas and subjects without limiting the framework of the audit during the on-site audits conducted by the supervisors. This manual is updated in the scope of the new regulations when necessary.

The Undersecretariat of Treasury has commissioned to the PMC for daily monitoring of the system as highlighted above.

AUDITING BY THE CAPITAL MARKETS BOARD

The following are regulated by the Capital Markets Board of Turkey: the organisational structure; internal and independent auditing; accounting, documentation, and recording system of the private pension mutual funds; principles concerning fund member disclosure, principles pertaining to fund types, and portfolio limitations; issues on valuing and safekeeping of assets in the fund portfolio; rules for consolidation; and transfer of funds.

INDEPENDENT EXTERNAL AUDIT

Pension companies are subject to audits by independent auditing firms at least once a year. In addition, accounts and transactions of pension funds are subject to an independent external audit on a quarterly and yearly basis (Law No 4632, Article 21).

It is essential that independent audits conducted at pension companies' requests are bound by a written audit contract. A copy of the contract is submitted to the Undersecretariat of Treasury by the pension company to be audited.

INTERNAL AUDITING

Internal auditing of pension companies is intended to ensure: reliable information flow; integrity and attaining on-time information on financial and administrative issues; improving productivity; and provision of pension companies' activities in compliance with the legislation. Pension companies are required to put in writing all policies and procedures concerning the internal auditing system. Execution of these activities by pension companies in compliance with internal auditing procedures is audited by pension companies' auditors.

Internal auditors of pension companies are obliged to act as whistle blowers in the case of any critical issues. In such cases, the relevant report should be to the board of directors of the relevant pension company, and a copy of the report should be submitted simultaneously to the Undersecretariat of Treasury.

THE NEW **AUTO ENROLMENT PILLAR**

The existing Individual Pension System (BES) allowed individual or group pension contracts. Group contracts set up via employers are often a way to significantly increase scale or reduce costs. Around 20% of the 6 million BES contracts were group contracts of one form or another. But this development, whilst useful, has not fundamentally changed the coverage of private pensions or their costs. Similarly as described above there were important changes to incentives and fee caps which led to significant improvements on the original design of the BES, but the government wanted to go further. Moreover, the ultimate aim of the government to improve coverage of private pensions, as well as its policy aim to increase the supply of domestic assets for investment and to reduce dependence on foreign sources of investment funding have inspired the Undersecretariat of Treasury to investigate new ways to improve coverage, reduce costs, and increase returns.

Initial studies for the feasibility of auto - enrolment reform began in 2014. A pilot project was conducted in 2014 with seven employers that revealed that making use of inertia could work in Turkey. This was important because a fully mandatory approach was not considered likely to be successful due to unfavourable experiences in Turkey in 1980s and 1990s with compulsory saving schemes. A 'FIRST' funded project with the World Bank was launched in 2014 to investigate different options regarding the design and supervision of the system.

The aim was to use the best international evidence tailored to the specific circumstances of Turkey. This suggested that parts of the existing private pension system could be used but that significant improvements would be needed as well. For example, it would be possible to use the individual account structure and the investment in private markets, but the employer would become the main channel into the pension system and be the one to make a choice of the pension provider to remove the costs and complexity for members of the individual/ sales agent model. Default funds would be needed to ensure that members who were not investment experts would have a well-designed asset allocation. Also, the fees needed to be reduced further to ensure a rise in the net of fee returns in order to help boost pension adequacy. The fees could be reduced further because the design of the new auto - enrolment pillar removed some significant elements of costs – although this will require some other investments as set out in more detail below.

Law No. 6740 laid down the framework for the reform. The law was enacted in August 2016 to be effective as of 1st January 2017. According to the law, all employees under the age of 45 are required to be automatically enrolled into the individual pension system by the employers. The contribution, which can be raised upon the employee's request, is equal to 3% of the gross salary. There is no mandatory employer contribution. Whilst this is unusual compared to other examples of auto - enrolment and employer pensions more generally, it was decided in the context of a recent 30% increase in the minimum wage, which had already imposed significant costs on employers.

The Council of Ministers has the authority to increase the minimum contribution rate from 3% to 6%. There is an opt-out period of two months. However, early withdrawals are also allowed after the opt-out period – a feature that ideally would be revisited in the future to help keep assets locked in for longer and allow longer term and more illiquid investments to be targeted. The employers choose the pension company, whereas the funds will be chosen by the employee among five different investment options. The fund management fee is limited to 0.85% of the AUM on an annual basis. Also, there are short and longer term performance benchmarks for the funds managed with possible performance rewards or penalties.

The total number of employees that are subject to auto - enrolment is around 14.1 million. The employers will be enrolled between 2017 and 2019 according to the number of their employees.

There are many governmental incentives to induce people to stay in the system. First, even if they are already receiving matching contributions in the BES, automatically enrolled workers will receive an additional 25% state matching subsidy for their new auto - enrolment pension contract. Furthermore, employees who do not exercise their right of opt-out and continue to stay in the system will be granted an extra state subsidy (welcome bonus) of 1,000 TL (275 USD). When individuals reach the retirement age of 56 (assuming they have been in the system for at least 10 years) if they convert their savings into an annuity contract payable for a minimum of 10 years, they will be granted another supplementary state subsidy of 5% of their total assets. All of these incentives aim to decrease the opt-out rate, roll-out private pensions to the masses, and encourage them to take their pension as a stream of annuity income rather than as a lump sum.

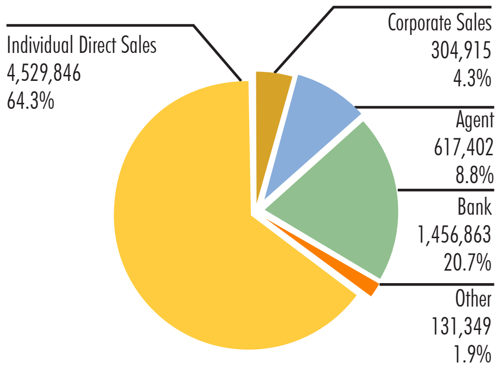
The auto - enrolment pillar is expected to lead to an additional assets under management of USD 30 billion dollars in the next 10 years. Such a scale-up will benefit the pension companies in numerous ways:

- Reduction in expenses
- Facilitation of simpler processes
- Provision of services to more members with existing infrastructure
- Convenience of cross-sales
- Decrease in brokerage commissions

There may be some additional costs but the net effect will be to reduce costs and increase scale – and hence it is acceptable to reduce the fees further compared to the BES. Since, in the automatic enrolment system, employers are the sole decision makers in terms of sales, corporate sales channel will be part of the deal. Corporate sales units will have to encompass individual sales. Instead of individual pension brokers soliciting members generally on an individual basis in the existing system, in the new system the activities of marketing, promotion, and brokerage will be focused on workplaces. This, in turn, will make substantial changes in the number of brokers and variations of distribution channels in the near future.

This will be a very significant change. At the end of 2015 most contracts were still arranged through the individual sales distribution channel even though corporate or group plans were possible. As a result of the increases in corporate sales distribution staff by pension companies due to the automatic enrolment system, the number of contracts executed through corporate sales will increase.

Figure 5.9
Contracts according to Sales Channel



Source: PMC Annual Progress Report 2015

PAYOUT PHASE

In Turkey, under the BES, generally, each of the three traditional payout methods is utilized for the payout period. The methods used at retirement may be specified as:

1. Lump sum payment
2. Phased withdrawals (income drawdown)
3. Annuities

1. **Lump sum payment:** This is the most frequently used method for the payout phase before and after the enactment of the BES in Turkey. Currently, the majority of total payouts in the BES are made as lump-sum payments. According to the BES Progress Report 2015 by the PMC, 92% of members leaving the system at retirement at the end of 2015 took their entire savings as a lump sum payment.

2. **Phased Withdrawals (income drawdown):** In Turkey, this option is usually deemed suitable for retirees wishing to receive payments as certain amounts for a specified period. In phased withdrawals, the member's contract in the BES is transferred to the retirement income plan in the chosen pension company, and she/he may receive the payments monthly, quarterly, biannually, or annually. While receiving the payments, the rest of the total sum of savings continues to earn interest in pension funds chosen by the retiree based on the pension investment fund options in her/his retirement income plan. The retiree is entitled to change the distribution of the funds in which her/his savings are invested depending on the performance of the funds and her/his preference. The retiree is also entitled to cash out the savings remaining in her/his account any time. Also, it is compulsory to pay out the total accumulation as

a lump sum benefit to the beneficiaries upon the death of the retiree. In this context, there is no provision in the legislation for the transfer of phased withdrawal payments to widows and orphans. With phased withdrawals, the only cost element is the fund management fee which is charged daily on the AUM.

3. **Annuities:** Annuities are currently not pervasively used in Turkey. Before the BES system started in 2003, "endowment life insurance" policies were offering a lump sum payment or an annuity option at the end of the insurance period. Most insured chose lump sum payments instead of the annuity because fund balances were low, payouts were not considered to be very generous, and the life insurance companies were not eager to provide annuities either. Comprehensive legislation on annuities entered into force in October 2015. According to the legislation, the pension and life insurance companies were licensed by the Undersecretariat of Treasury before offering any annuity products. The Insurance Tariff, technical principles, and special conditions of the policy were not subject to any approval by the authority, but submitted to the Undersecretariat at least 15 days before the launch of the product. The mortality tables used to price and under-write the liabilities were limited and subject to the approval of the authority, and any charges/fees were also limited (withdrawal/surrender fees).

Currently, there is legislative segmentation for the offering of annuities. For the retirees aged 56 and over, only traditional single premium immediate lifetime annuities are allowed with a maximum of five-years deferral period. The annuities should be offered as inflation indexed annuities.

For the retirees under the age of 56, the product range is much more diverse.

Demand for annuities and phased withdrawals are expected to grow as members start to retire from the BES. One of the most significant motivations for people to participate in the BES in Turkey is the person's desire for adequate retirement income that will allow them to be independent financially from their families during their retirement. In addition, the bequest motive is also quite strong. A combination between a phased withdrawal product and a deferred annuity product, which is activated well past retirement could be optimal. See Chapter 20 for more discussion on payouts.

The government has also enacted laws on the taxation side in order to stimulate demand for the annuities. In this context, Single Premium Annuity products sold upon retirement are excluded from income tax. In addition, as highlighted above, individuals who choose to convert their accumulations to an annuity from the new auto – enrolment pillar will receive a supplementary state match of 5% on their total amount of savings.

However, despite these positive developments, there are also factors impeding the growth of a strong annuity market in Turkey:

a. **Measurability and management of longevity risk:** Technical studies enabling the management of longevity risk have recently started in Turkey. Mortality tables specific to Turkish population are recently available and are used by the insurance and pension companies. However, it is essential to update the mortality tables regularly and calculate the mortality improvements in the population – using dynamic mortality tables rather than static or period tables. Efforts in this regard are ongoing.

b. **Investment Risk Management:** Annuities are long-term financial products and should be supported with long-term investment vehicles (like 30 or 50 - year - long government bonds, treasury bonds or alternative investment vehicles). Currently, 30- or 50 - year - long financial investment vehicles do not exist in Turkey. However, the Undersecretariat of Treasury has stated that it will issue long-term investment vehicles (state bonds and bills) with the intention of promoting progress in this area. Accordingly, the Undersecretariat of Treasury published a CPI Indexed Annuity Government Bonds Investor Guidance on Annuities in December 2015. In this context, the required financial assets to back annuity sales will start to be supplied but this will be a long-term effort. The development of the economy, an increase in the savings rate and investment product ownership and improved products will hopefully lead to an acceleration in the size and viability of the annuity market.

c. **Reinsurance supply:** Insurance companies will need to make the necessary reinsurance agreements before the launch of annuity products. These arrangements were not well-developed before but should grow in the future as more people begin to retire from the BES and, in the future, from the new auto - enrolment pillar.

CONCLUSION

Turkey has continuously aimed to develop a more diversified pension system, so that private pensions work alongside public pensions. The aim was to increase the welfare of the working population at retirement, as well as increase the domestic savings rates. The development of the BES system generated a fund size of around USD 17 billion in around 13 years. Introduced in an inflationary environment, it was initially launched with a relatively high cost platform.– Since then, and reflecting changing economic environment, there has been an active process to improve upon the voluntary system: primarily its coverage, fairness, and cost-efficiency. These have yielded some positive results and include one of the most successful examples of the benefits of matching compared to tax relief in the world. But to go further, and ensure coverage beyond 30% of the workforce, a bold step has been taken to introduce an auto - enrolment pension system. In addition, it was important to use this development to change the model of enrolment into pensions – using the cost efficiency and governance benefits of having the employer as the primary route into a pension scheme. This increases coverage and allows cost savings that can be passed on to members in the form of lower fees and higher net returns. It should also be noted that prior efforts in building a governance body like the PMC and creating unique citizen IDs have significantly facilitated this transition. Going forward, outreach into the informal sector will be the next big challenge. For this purpose, Turkey may consider creating a platform for broad-based coverage that could be cost efficient to informal workers – using the relatively sophisticated and broad based financial inclusion and payments infrastructure in Turkey.

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