June 7th, 2017

AIDE MEMOIRE

GEORGIA

POLICY LOAN-PRIVATE SECTOR COMPETITIVENESS

Appraisal mission - May 15-18th, 2017

The French Agency for Development (AFD - Agence Française de Développement) is a public financial institution that has worked for seventy years to alleviate poverty and foster sustainable development in the developing world and in the French Overseas Provinces. AFD implements the French government's development aid policies.

AFD operates on four continents via a network of 75 offices. It finances and supports projects that improve living conditions, promote economic growth, and protect the planet. In 2016, AFD earmarked € 9.4 billion to finance projects in developing and emerging countries and in the French Overseas Territories.

I. MISSIONS' CONTEXT AND OBJECTIVES

After having been authorized to intervene in the South Caucasus in 2012 within the framework of a mandate aiming at promoting a green and inclusive growth, AFD opened a regional representative office in Tbilisi in December 2016 in order to closely monitor its growing portfolio and strengthen its cooperation in the region.

After initial discussions held during the first quarter of 2017, the Ministry of Finance of Georgia (MoF) officially requested AFD in March 2017 to consider the possibility to cofinance the ongoing Development Policy Operation (DPO) of the World Bank (WB) for an amount of 60M€. Following exchange with WB team, AFD agreed in principle to cooperate with the WB on the *Private Sector Competitiveness* DPO, tranche 2 (DPO 2). Given AFD and more globally French expertise in the field of pension reform and management, AFD has decided to focus more especially the policy dialogue on the implementation of the forthcoming reform of the pension system in Georgia, which is one of the core actions to be set up under the DPO 2. In this regard, AFD is also considering extending a grant in addition to the policy based loan in order to finance technical assistance and capacity building dedicated to this reform.

An AFD mission of the Health and Social Protection department was carried out in Georgia from May 15th to 18th 2017, together with WB team in charge of the Private Sector Competitiveness DPO 2. The objectives of this mission were (i) to assess the implementation of measures contained in the policy matrix agreed with the WB under the DPO 2 and (ii) to identify the components of the technical assistance to be funded by AFD to support the implementation of the reform of the pension system in close collaboration with the donors already involved in the preparation of this reform (WB, Asian Development Bank and USAID).

AFD team was composed of Mr. Nicolas Le Guen, Project Manager, Mrs. Aurore Lambert, Project Manager, Mrs. Alexandra Vassiliades, Country officer (all based in Paris), Mrs. Gaelle Assayag, Head of AFD representative office for the South Caucasus and M. Hugo Bérard, Project officer (based in Tbilisi). The Mission met with the Ministry of Labor, Social Affairs and Health (MOLSAH), representatives of the Ministry of Finance, the World Bank, the Asian Development Bank (ADB), USAID, International Monetary Fund (IMF) and the French Embassy. The list of persons met by the mission is attached in the Annex 1.

AFD mission wishes to express their sincere thanks to all the persons met and particularly the World Bank team for their kind welcome, hospitality and availability, and for the high quality and operational value of the discussions.

This Aide-Memoire summarizes the main outcomes of the mission.

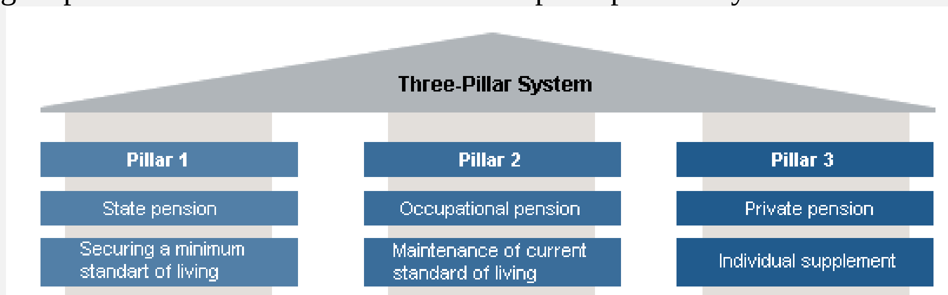
II. PENSION REFORM CONTEXT AND CALENDAR

MAIN FEATURES OF THE GEORGIAN PENSION REFORM

The current Georgian pension reform aims to address three main issues :

- Providing a minimum and fair income for elderly people ;
- Ensuring the financial sustainability of fiscal budget and
- Coping with the demographic shift in the population.

The Georgian pension reform is based on the three pillar pension system.



The first two pillars are the main focuses of the Georgian pension reform :

- **Pillar 1 - A universal social pension** available to all Georgian citizens who have reached specified retirement age is financed since 2004 through the general budget revenues and serves as a strong poverty alleviation mechanism for the elderly people. The Ministry of Labor, Health and Social Affairs (MoLHSA) is responsible for allocating this state pension. The pension reform will index the social pension to inflation to keep it over the minimum subsistence level ;
- **Pillar 2 - A private pension system** will be introduced by the pension reform. Contribution rates will be shared between the employer, the employee and the state. The proposed private pension scheme lays out a 2% + 2% + 2% system for legally employed workers. The state contribution will be capped at 2,000 GEL per month per employee. To encourage the savings, the government will give strong financial and tax incentives: contributions, investment returns and pay-outs will be tax exempt. The funds will be administered by a non-profit pension fund set up by the Parliament. At the first stage of the reform, this long-term individual pension saving scheme will be available to employees of the formal sector, around 15% of the population.

A Pension Reform Unit (PRU) has been created under the Ministry of Economy and Sustainable Development (MoESD) to design the pension reform strategy.

The mission allowed clarifying the context and the content of the ongoing pension reform along with the current situation and the next steps for the approval of the law and the implementation of the reform:

Expected calendar of the pension reform implementation 2017-2019

2017	2018	2019
May: Final draft of the law **June - July:** Public Consultation **October:** Approval by the Parliament	**1st Quarter :** Pension Agency implementation / first employees hired **Communication campaign**	**First Contribution collection**

1. A **new draft of the law**, the ninth one, has just been finalized. This draft should be submitted for public consultation from June to July 2017 for a two-month period and then be introduced to Parliament in September for final approval in autumn 2017. The law has to be submitted to the Parliament with all complementary/secondary legislation that will be impacted by the pension reform ;

2. A **communication strategy** has been drafted with USAID technical assistance and reviewed by the Ministry of Economy and Sustainable Development (MoESD). This strategy should be rolled out after the law is approved ;

3. An **operational roadmap** for the implementation of the reform is going to be elaborated with the Asian Development Bank (ADB) technical assistance. This master plan will include the different operational aspects: IT systems, cooperation between ministries, operational processes for contribution collection, investment policies, governance issues, etc. First contribution collection could take place in early 2019.

The pension reform is a long process and key issues are still under discussion among the stakeholders both on the policy design and on the operational set-up:

1. Policy Design

(i) As of May 2017, the **Pension Agency regulatory body and governance** could be organized as followed **:**

1) The National Bank of Georgia (NBG) who supervises all the financial sector seems to be the most relevant regulatory authority for the future Pension Agency ;

2) The Pension Agency will have a Supervisory Board composed by the following ministries: MoESD, Ministry of Labor, Health and Social Affairs (MOLHSA), Ministry of Finance (MoF). Representatives of employers and employees are not currently included in this Supervisory Board but could adequately facilitate dispute issues if they were in the future. However, discussions with employers and employees representatives had already been organized and allowed to agree on the general design even if specific guarantees have been requested by the trade unions.

3) The Pension Agency should have an independent Investment Board composed of five or six industry professionals. The Investment board should oversee the investment activities and might include foreign professionals. The government expressed a concern on the cost of mobilizing foreigners in the Investment Board. The World Bank has already identified key professionals that could be interested to participate on a voluntary basis such as the former Chairman of the NEST.

(ii) **Investment policy.** The investment policy should *protect participants from excessive investment risks*, while on the other hand allowing investment allocations to be designed in such a way that it allows the system to *generate sufficient long-term returns* to ensure fair pensions to the contributors. Investment allocation principles including types of asset classes, investment caps, diversification limits, etc. will need to be defined either :

i. In the law approved by the Parliament ;

ii. In the regulation set by the regulatory authority, the NBG ;

If the Pension Agency could also be a powerful tool to boost the Georgian economy through local capital market development in a country with current very low saving rates, limits should be included on local or international investments to ensure sufficient assets liquidity and protection against currency depreciation risk. Maturity of local markets needs to be assessed to take evidence-based decisions. No decision has been taken so far regarding the future investment limits and their inclusion in the law or regulations. Georgia currently counts with limited expertise in the asset management area.

(iii) If MoESD had the ownership of the reform at its start, MoF and MoLHSA will be closely involved in the consultations and operational set-up phase. **Cooperation between the different ministries** and all relevant stakeholders (NBG, Revenue Service…) is key to the success of the reform and should be insured during the implementation stage.

2. Implementation of the reform and operational design

As of today, most of efforts around the pension reform have been invested into the policy design and there are still pending issues to solve in order to clearly the future operational design. The Pension Reform Unit (PRU) at the MoESD in charge of the implementation of the reform only counts with one full-time person and the Pension Agency will only be set-up once the law is approved by the Parliament. A few specific issues have been raised during the mission such as:

(i) At first, the Revenue Service was identified as the entity responsible for the **contribution collection** but finally the MoF has decided to set up the collect a different way through a dedicated IT system. The collect will be done automatically when the salaries are paid by bank transfer. This process should be clarified to identify more clearly risks and benefits ;

(ii) The Pension Agency Monitoring and Information System (MIS) should also be bought or developed in-house with sufficient dedicated time given its key role in the Agency operations.

The whole operational design will need to answer many organizational questions, such as: how contributions will flow into the system? Who will keep the individual records? How reliable information on contributing employees will be collected? What penalties will apply for non-paying employers? How the opt-out option will be handled? When will the Agency be able to cover its administration costs without government support? How could independent workers be contributors? Etc.

Key aspects of the reform also include the **Pension fund participation and reform acceptance**. Incentivizing participation is a key challenge of pension reform in general but especially for Georgia where negative experiences on savings (pension crises) are still fresh on people's minds. Trust and credibility are key for the success of this project, all the more since the benefits will take substantial time to realize. The acceptance of the pension reform depends on different aspects:

1) **Enrollment options (Compulsory/Voluntary):** the finally chosen model is a mix of compulsory system for all employees and opt-out option for people over 40 years old after three years or three months of contribution (final delay to be decided). Compulsory enrollment could be a source of dissatisfaction in particular for people over 40 years old.

2) **Ownership of the Pension Agency (Public/private):** different stakeholders pointed out during the mission the deep distrust of the population towards public institutions in Georgia. Hence, it is considered that the private non profit status of the Pension Agency should participate in a positive perception of the reform ;

3) **Ownership of the reform** : the Prime Minister, Giorgi Kvirikashvili, former Minister of Economy and Sustainable Development who benefits from a high level of trust, has promoted the pension reform since its start and could be therefore an important spokesman for the reform ;

4) **Collection of the contributions (taxes/benefits):** to enhance acceptance of the reform, contributions should be considered as future benefits and not as taxes ;

5) **Guarantee of the contributions**. In the current draft, there is no particular guarantee of the funds by the government. Guarantees could be provided only for a part of the contributions, such as the employees contributions.

⇨ Discussions have already started with key stakeholders over the last three years and more participation will be made possible during the public consultation. However, the communication campaign toward the general population will be critical (hotline, mailing, tvs spots, decision-makers speeches, etc.) to enhance acceptance and therefore ensure the success of the reform.

III. TECHNICAL ASSISTANCE

1. Technical Assistance main focus

During the mission, the World Bank organized a donor meeting on May 17th. The objective was to ensure that each donor support would take into account and complement other donors' initiatives. Three main donors have been providing technical assistance (TA) for the pension reform: the World Bank, the Asian Development Bank (ADB) and USAID.

The World Bank has mainly focused its TA on drafting the Law and designing the regulatory framework.

Summary of donors main areas of technical assistance for the pension reform 2017/2018

	World Bank	**ADB**	**USAID**
	2018- 2020 : 400K USD TA over 3 years on pension reforms	*2018 TA budget to be determined in July 2017*	*To be determined*
Legal	Planned : regulatory and supervision support with exchanges from Kosovo.	Support for drafting the law with two international and one local lawyers ;	Support for discussions with MPs about the final draft / elaboration of simplified policy papers on the reform ;
Communication			Preparation of the communication strategy (finalized) ; Planned (to be confirmed): *Participation in the outreach system (TV adds, website, etc.)–*

			Budget still to be defined.
Operational set-up		Support for the IT system with one international and one local IT specialists Support for the actuarial study for the calculation of the financial arrangements. Planned (confirmed) : one-year consultant contract to draft a roadmap for the operational set-up	

AFD is willing to provide financial and technical support **to prepare and operationalize the pension reform.** Considering (i) the above table summarizing the different existing and expected TA supports, (ii) the discussions held with the donors and (iii) the strong French expertise areas, the AFD TA could focus on the following items:

Specific areas identified for which TA could be provided :	Relevant French Expertise
- Support the implementation of the **communication strategy,** specifically to develop : o tools such as the calculator of the future pension that will create transparency and trust ; o grievance mechanisms such as hotlines.	The French National Pension Fund has recently developed various web based tools for contributors to simulate their future pension levels, retirement age, etc.
- Support the definition of the investment policy in the regulation or at the Pension Agency level.	Private French authorized institutions managing pension funds.
- Support the Pension Agency operationalization: o Processes and procedures (contribution collection, standard forms, individual records handling, etc.) o MIS (Monitoring and Information System) ; o Finance, etc.	The French National Pension Fund could provide pension scheme operations TA with a specific focus on individualized records handling.
- Pension Agency staff capacity building in different areas : o Investment ; o Finance ; o Legal o Pension fund management, etc.	

This table gives first proposals on how the AFD TA could be mobilized. The communication strategy drafted with USAID support and the roadmap for the pension reform implementation to be elaborated with ADB support will be key documents to identify more specifically AFD technical assistance.

Those proposals will be discussed with the TA beneficiaries in particular the Pension Reform Unit of the MoESD, the MoF and eventually with the Pension Agency staff once it is set-up.

The **timeframe of the TA** will hence depend on the pace of the reform operationalization. Indeed, specific operational TA support should be only provided once the Pension Agency staff has been hired to ensure appropriation and capacity building. Considering the existing support for the preparation of the law, the consultation period and the submission to the Parliament, AFD TA could start in January 2018.

A TA plan could be drafted after consultation with the donors and the government officials based on needs and realistic timelines for the operationalization of the reform. A portion of the TA, x days of international or local experts, could be however left for later allocation and not be earmarked.

AFD TA should mainly be used for technical assistance and not for investment in any kind of assets (hardware, building, furniture). AFD TA should be a mix of French expertise and local or other international experts. Activities could include documents drafting, capacity building sessions, advising services, etc.

2. Technical Assistance - operational modalities

AFD will provide peer-to-peer technical assistance by mobilizing French public sector expertise on specific issues. Depending on the needs identified, AFD could also provide local expertise on the specific areas identified.

AFD confirms that grant resources will be mobilized to provide technical assistance and contribute to build capacities of the Pension Agency. A specific grant facility agreement (separate from the credit facility agreement) will have to be concluded between AFD and the MoF once the components of the TA have been discussed and commonly agreed with all relevant Georgian stakeholders. AFD internal process shall lead to release funds by the end of the year and the technical assistance may therefore start early 2018 for 12 to 16 months.

IV. NEXT STEPS

- According to AFD internal process, the budget support to support private sector competitiveness funded by a 60M€ loan should be submitted to an internal committee in June 2017and presented to AFD board by the end of September 2017. The policy matrix of the DPO 2 will be updated and shared with AFD prior to the board's presentation as agreed with the World Bank

- A draft financing facility agreement will be provided by AFD to the MoF by the end of July 2017.

- Terms of the financing agreement (legal aspects, financial terms and conditions) between AFD and Georgia will be discussed during the first fortnight of September, if possible during the week of September 11th 2017.

- AFD consider to sign its respective credit facility agreement and to make a single disbursement before the end of the year 2017.

- Regarding the TA components: AFD would welcome any comments/questions or suggestion from the MoF and MOESD on the preliminary proposals made below. A specific mission to further exchange and define the components should be organized at the beginning of September (probably in parallel to the mission dedicated to the credit facility negotiations). The grand facility agreement could be then signed by the end of the year.

- Finally, AFD would like to confirm its interest to further consider the opportunity to provide a second policy loan in 2018 based on ongoing policy reforms. A new policy matrix targeting social protection and social services could be elaborated in close collaboration with the World Bank according to the policy reforms to be conducted in this sector. During the next mission (September 2017), specific components of a new policy matrix could be drafted jointly with the World Bank.

ANNEX 1: List of Persons met by AFD Mission

Ministry of Labor, Social Affairs and Health
Davit Sergeenko, Minister
Nutsi Odisharia, Head of Social Protection Department

Ministry of Finance
Nikoloz Gagua, Deputy Minister
Mzia Giorgobiani, Deputy Head of Public Debt and External Financing Department
Giorgi Mamatelashvili, IT manager

World Bank
Geneviève Boyreau, Economist Social Protection and Labor Global Practice, Tbilisi
John Gabriel Goddard, Lead Economist for Southern Africa, Pretoria
Anita Schwartz, Social Protection and Labor Global Practice, Washington DC

USAID (Growing for Growth in Georgia)
Natalia Beruashvili, Chief of party

Asian Development Bank
Mariam Rusishvili, Project coordinator

International Monetary Fund
François Painchaud
IMF representative in Georgia