

Private Pension Fund Scheme in The Turkish Law

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Recently, neither the working population nor the retired throughout the world are satisfied with retirement systems, organized and operated by government, throughout the world due to several reasons, including but not limited to the current changes in the demographical composition, human life getting longer, reduced number of birth, chronic unemployment problem and economic crisis, because more severe conditions are imposed for being retired and the allowances granted to individuals and the retirement pay are getting far from being satisfactory. All these negative facts require the introduction of a second system which operates upon voluntarily participation of the employees and is based upon fund providing basically complementary retirement allowance to the employees, in addition to one-leg social security systems, organized and operated under the warranty, inspection and surveillance of the state and based on "pay as you go" principle and compulsory participation of the employees. This new system is called private pension regime.¹ Most remarkable attribute of this regime is, further to providing complementary retirement pay, to enhance the capital market through private pension funds and to improve the GNP and employment opportunities.^{1a} In today's worlds, this system is basically the choice of industrialized

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¹ See *C. Tuncay*; on Private Pension Regime, Cement Employer, March 2000, 3 etc; *S. Uğur* Place of Private Pension Programs in Social Security Systems and its Development (TISK), Ankara 2004, 83 etc

^{1a} see *C. Ergenekon*, Financing the Pension, Suggestions for Turkey under the Highlight of Global Private Pension Fund, Istanbul 2001, 89 etc

Western countries, which constitutes third leg within existing social security systems in such countries.

The private pension or retirement based on private fund system is a system established under the lead of the state, operated under its inspection but by private sector, being dependent on the requirements of the concerned, established by their individual contributions, through which the social security needs of individuals are met from a fund operated on insurance technique.^{1b} This retirement system of complementary nature, based on individual savings, which is becoming widespread in EU member countries while it is already used in the USA and Japan for long years, constitutes the basis of social security system applied in some countries, such as Chile.^{1c} Due to decrease in birth ratio in the European countries, increasing old population, consequent loss of assets-liabilities equilibrium and increased share of social security expenditures within the GNP (which is 14% in Italy), special pension fund programs as complementary to public social security system, based on pay as you go principle, are regarded as a solution. Within this context, legal application was initiated in Sweden since 2001, in Germany since early 2002 and in Italy since early 2003.^{1d}

I. Act on Private Pension and Principles of its Execution

Low retirement pay by all Turkish social security institutions for a long time, difficult living conditions, retirement at young age are the main factors forcing retired people to continue working actively. Though the Act number 4447, passed on August 25, 1999, ceased the application of young retirement to a great extent and provided increase in premiums paid, the amount of pension could not be raised satisfactorily. Thus, with the purpose to ensure additional income for the retired people in addition to the public social security system, on one hand, and to transfer the premium to be paid by the participants to the capital market and invest-

^{1b} *Tuncay*, on Private Pension Regime.

^{1c} See *C. Tuncay*; on Private Pension Funds – Lessons to be taken from Chile Case (ISE), Istanbul 1998, 81 etc. See also paragraph 4 1 7 above.

^{1d} See *The Economist*, Pensions, Feb. 16, 22002, 4 etc; *The Economist*, August 3, 2002, 23. Although business place private pension programs are widely used in the USA, recently some restrictions are made regarding allowances due to financial and economic problems or the companies try to cover their losses using the accrued contributions in private pension funds, which resulted in great financial scandal in the country. (see, *The Economist*, January 8, 2205, 63).

ment areas through private retirement companies to be established, on the other hand, and consequently to make contribution to the national development, the Act numbered 4632 on Private Pension Savings and Investment System has been passed on March 28, 2001.

The new pension system can be outlined under headings hereinbelow.²

1. Complementary retirement program: Private retirement system, based on individual savings, is not an independent system, like private funds, or an alternative social security system for the public social security system, but provides *complementary opportunity for being retired* for the individuals who are employed being subject to any social security institution. As a matter of fact, those who are not recorded at any social security institution or have cancelled the records may participate in the system. The Act does not contain any provision in the contrary. Private pension fund system constitutes a complementary retirement system, based on voluntarily participation, (3. leg) in addition to minimum income level provided by the public social security institutions (1. leg) and monthly pension, proportionate to income level, provided by volunteer or compulsory social security institutions, established at the discretion of private sector (2. leg).³

At top of the corporate organization chart, there is Private Pension Consultative Committee to make suggestions on measures to be taken in order to set forth the policies on private pension system and to make these operational. The Committee, chaired by the Undersecretariat for Treasury, consists of four members, serving at least as General Manager, to be appointed each by the Ministry of Finance, the Ministry of Labour & social security, the Undersecretariat for Treasury and the Capital Markets Board (CMB) (Section 3).

Although private pension system is operated beyond the public social security system, it is applied under the inspection and surveillance of the state authorities.⁴ Accordingly, the Undersecretariat for Treasury acts as the organization responsible for the foundation, operation and auditing of pension companies, while the Capital Markets Board is charged with

² See, Y. Alper, *New Step for Social Security Issue: Private Pension*, Cement Employer, Mach 2002, 12 etc; S. Uğur *Private Pension System from Legal Point of View*, Legal İşH. ve Sos. GHD, number 2, 2004, 513 etc; same author, *TİSK*, 154 etc.

³ Y. Alper, *Private Pension*, 13-14; Uğur (*TİSK*), 152 etc.

⁴ Uğur, 514; same author (*TİSK*) 182 etc.

observation of allocation of contributions collected by pension companies and the pension investment funds in compliance with the applicable rules and audit the custody and settlement services of portfolio management companies.

2. Volunteer participation: The system is based on volunteer participation and it is not a requirement. Participation in the system is realized upon execution of a "retirement contract" to be signed by and between the participant and the pension company. Individuals with the capacity to use civil rights may participate in the system (Section 4).

The Regulation on the Private Pension System is announced to regulate the principles and methods for the pension contract to be signed by the pension companies with the participants who wish to be included in the private pension system established on the principle of volunteer participation and defined contribution.⁵ With this Regulation, a great many matter not contained in the Act have been set out. Pursuant to the Regulation (Section 5), the pension contract is the contract which regulates the participation in the system, leaving the system, being retired, payment of contributions, payments to participants and the parties' rights and obligations, where a third party intending to execute the contract on behalf and in the name of the participant, if any, becomes a party thereof. Matters, principles and methods to be contained in the contract shall be determined by the Undersecretariat for Treasury. Participation in the contract as a group is available, as well. "Group pension contracts" may be signed with a business with minimum or less than 10 personnel, a professional establishment with legal entity, association or similar establishments or groups, covering all the employees or members thereof.⁶ Such contracts shall be concluded by and between the professional establishment, association or any other similar organization and the pension fund company.⁷ It should be noted that a participant may sign pension contract with more than one company or more than one contract with one company.

Upon payment of the contribution or initial membership fee, completely or partially, by the participant who duly completes and signs the offer form or by a third party on behalf or in the name of the participant,

⁵ Official Journal dated 28.2.2002, number 24681.

⁶ Regulation on Private Pension System, Section 16, 17.

⁷ See *C. Tuncay*, Group Pension Contract for Employees, MERCEK, October 2003, 83 etc.

the contract shall be deemed as executed if the company does not reject the offer within 10 business days (Regulation 11/1st). Upon countersigning of the pension contract by the company and presentation thereof to the participant, the contract shall come into force as from the date of crediting the company's account for the contribution fee. The date of effectiveness, mentioned in the initial pension contract, shall be deemed the date of participation in the private pension system.

Section 11 of the Act numbered 4632 contains the intermediary persons for the private pension. According to the Regulation on the Intermediary Persons for Private Pension, issued pursuant to Sections 11 and 26 of the Act, "intermediary persons" are those who mediate for the companies on permanent basis, based on a separate agreement, for the execution of pension contracts or who conclude such contracts in the name of the company. Such persons render several services to individuals who wish to participate in the private pension system, including but not limited to company selection, presentation, information, marketing and sales of pension plans offered. Intermediaries are required to be registered at the Undersecretariat. The Regulation contains provisions on the requirements to become an intermediary, their qualifications, examinations to be taken, their rights and obligations and the working conditions.

3. Contribution fees: The system shall be financed through the contribution fees to be paid by the participant to the pension account within the framework of principles set forth in the pension contract signed with the company. In other words, the system shall be operated upon evaluation of the funds, to be formed through contribution fees to be paid by individuals to the system, through investment tools traded on the capital market. The pension to be received shall be high in proportion to the contribution fee paid. The company shall define the amount of minimum contribution fee to cover the management and fund operating costs of the pension fund schedule. The participant may allocate the contribution fee among the funds included in the pension fund schedule. The company may demand membership fee from as new member, in addition to the contribution fee. Membership fee may be paid in instalments within maximum one year.

Furthermore, the company may withhold fund operating cost or management costs from the contribution fee, fund revenue or fund assets (Section 7). Membership fee is not compulsory, and its collection and

amount shall be defined by the competition between the companies.⁸ Membership fee is paid only for once, thus it shall not be paid at participation in another company's program. At practice, membership fee is paid in instalments and calculated in accordance with the applicable minimum wage amount. Amount of contribution fee and due dates shall be defined in the pension contract. Neither the Act number 4632 nor the Regulation on the Private Pension System contains any provision on this matter. Payment periods for contribution fees shall be determined on monthly, quarterly and annual basis according to the pension schedules and contracts.⁹ The company must use the contribution fee for investment within 2 business days upon receipt. Otherwise, default penalty equal to twice as much of the last monthly return of the participant's fund shall be added to the participant's account.

The participant may suspend the payment of contribution fee. In such a case, the time-period granted shall not be taken into account for the calculation of 10 years, necessary to deserve retirement. However, the participant may, at its sole discretion, pay the contribution fee against the suspension period and let the suspension period be added to the ten-year period.

Since the amount of contribution shall be defined with the contract to be executed by and between the participant and the company and pension depends on the yield of funds which the contribution fees are invested in, it is obvious that the system depends on "defined contribution" but not on "defined benefit".¹⁰ As a matter of fact, Article 1 of the Act number 4632 on the subject, it is expressly stated that the private pension fund system shall depend on the principle of defined contribution. Programs based on defined benefit depending on the principle of definition of level pension at the beginning are encouraging long office term at the same business place. In the contrary, pension programs based on defined contribution has become recently the preferred system due to facility for transfer of accrued savings from one company to another, provision of opportunity to get high return on investment tools and of opportunity for individuals to manage their own retirement.¹¹ Latest reform movements in Italy, Germany, Sweden, USA, Canada, Ireland and Japan are in this way.¹²

⁸ Alper, Private Retirement.

⁹ Uğur, 519; same author (TİSK) 176 etc.

¹⁰ For these subjects, see Ergenekon, Private Pension Funds, 5 etc; Uğur, (TİSK) 89 etc.

¹¹ Ergenekon, Financing the pension, 103 etc.

¹² The Economist, Pensions, Feb. 16, 2002. 13.

4. Retirement Investment Fund: Retirement investment fund is an asset obtained by the company within the context of pension contract and established in order to operate the contribution fees kept in private pension accounts, in the name of the participants, based on the principles of distribution of risk and trustful property. The fund has no legal entity. The fund is established upon permission by the Capital Market Board and shall not be used for any purpose other than defined by the Act; the fund assets shall not be pawned, be presented as guaranty, be sequestered by third persons and included in bankrupt's assets. The funds consist of values including but not limited to cash, domestic or international marketable securities, gold, Treasury bill, bonds and foreign exchange. The fund to be established may not be less than 1/20 of the company's paid-in capital (Section 16/1). A company is obliged to establish minimum 3 separate funds, provided that each shall have different portfolio composition and be selected from among those determined by the Capital Market Board (Section 17). If the company fails to apply to CMB within latest three months after obtaining the operation licence or if the application will be rejected, then the permission for foundation or operation licence will be automatically void and null.¹³ Fund portfolio shall be managed by the portfolio managers pursuant to the Act on Capital Markets (Section 18). Establishment of pension funds, transactions regarding fund assets and funds, portfolio management, evaluation of contribution fees, transfer of savings to another pension fund company and similar acts are subject to the supervision of the CMB. The investment fund shall issue an internal statute, which is a joint contract executed by and between the participant and the company, trustee and portfolio manager with the subject of custody of the fund portfolio by the trustee according to trustful property and management according to the provisions of power of attorney, containing general terms and conditions for transactions (section 15/3). Assets in the fund portfolio shall be kept with a separate trustee in order to keep the participants harmless against insolvency, bankruptcy, dissolution of the company sand similar cases. In practice, this responsibility is borne by TAKASBANK.

5. Transfer among pension fund companies: The participant is entitled to demand the transfer of accrued amount at his/her private pension account to another pension company. In order to demand such transfer the participant has to wait for minimum one year, this condition applies

¹³ Regulation on Foundation and Operation Principles of Pension Fund Companies, Section 10.

for each new transfer. If the company fails to meet the demand within 7 business days, it shall be deemed to be in default. In such a case, the monthly default interest shall not be less than twice of last monthly return of the fund (Section 5). The participants are entitled to change the pension schedule maximum for times a year.

6. Age for private pension is set as 56 years: Any participant shall be entitled to become retired upon completion 56 years of age, provided that he/she is a member of the system for at least 10 years (Section 6). It is obvious that the limits of age for private pension is lower than that set for public retirement (which is 58-60 years) in order to make the system attractive and there is no distinction made between men and women.

It should be noted that the condition to be member of the system for ten years is not necessarily be uninterrupted. As mentioned earlier, payments may be suspended.¹⁴ Because there may be some times when the participant becomes unemployed, the potential to make expenditures becomes diminished and strives to pay the contribution fee. Since ten-year period has to be completed to fully benefit from pension, age limit of 56 years may be exceeded.

7. Pension: Pursuant to the pension contract, the company shall notify the date for deserving pension to the participant with a latest one-month notice. The participant may demand either payment of monthly pension or payment of savings all at one, partially or completely. Pension is the sum of contributions accrued in the pension account and the returns thereon. It may be paid on monthly, quarterly, bi-annual or annual basis, in accordance with the annual benefit insurance contract. The participant is entitled to leave the system, anytime it would think fit, upon receipt all savings and returns thereon until the date of leave, without any withholding. In such a case, the savings, together with the returns thereon, shall be paid within latest 7 days. Otherwise the company shall be automatically in default, without further notice. In case of leaving the system before expiration of ten years, some tax advantages will be lost, proportionate to the duration of membership in the system.

In case of death of the participant during the validity of the pension contract, the person designated as beneficiary, and in case of its disability for work, itself can demand the payment of accrued amount. Such payment can be made either in form of monthly pension or all at once.

¹⁴ Regulation on System, Section 18.

8. Tax advantages: In order to encourage potential participants, some amendments have been made in the Act number 193 on Income Tax and Act number 5422 on Corporations Tax which offers some tax facilities and tax exemptions.¹⁵ For example, 26% of payments to be made to those entitled to become retired and those leaving the system due to death, disability or dissolution, and 10% of payments to be made to those leaving other insurance companies due to aforesaid reasons shall be exempted from income tax (Act no 4697, Section 1), and the employer's contribution paid to the pension companies on behalf of the employees and the premium paid by the participant for itself or its family members shall be deducted from tax base. The amount to be deducted shall not exceed 10% of the salary of the month concerned and annual sum of minimum wage, on annual basis (Act number 4697 Section 4). Furthermore, earnings yielded by pension investment funds are tax-exempted, pursuant to Act number 5422 on Corporations Tax and it is anticipated that they shall be free from withholding, pursuant to the Act on Income Tax (Act number 5422, Section 8/1). On the other hand, payments made by pension company to those leaving the system without paying premium or contribution to system for ten years shall be subject to income tax, with the aim to dissuade early leave (Act on Income Tax, Section 75/15). With the aim to encourage maintaining membership in the system, tax burden on those leaving the system after long time is less than that imposed on those leaving before expiration of the time-period.

¹⁵ See Act number 4697 dated 28.6.2001; published in Official Journal dated 10.7.2001 number 24458; *Uğur* (TİSK) 181 etc.