TOWARDS A MORE LIBERAL PENSION FUND MECHANISM IN THE EU?

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In connection with the discussion over pension reform in Slovakia there are often heard voices also concerning the safety of pension fund resources and to what extent the state should, or should not ensure their protection. In this context quality legislation is desirable that would eliminate risks connected with this form of collective investment. This article sets itself up the goal of indicating answers to questions as to what are the principles of this form of investment and how all pension funds operate in the EU, whether they too work in a limiting regime, or have completely liberalised conditions.

Basic investment principles of pension funds

In comparison with other financial institutions pension funds have a great advantage in particular in the fact at they have long-term funds with a limited need for liquidity. Their cash incomes are known in advance, since they represent a fixed percentage of the incomes of employees, from which it results that they may be determined with some precision. On the other hand nor is it too difficult to forecast the need for payouts in cash.

The administrator of a fund, in investing, must follow certain criteria while complying with the principles of prudence. The basic criteria to which a pension fund adheres in its investing are: liquidity, risk and rate of return.

The investment strategy in pension funds must adhere to several restrictions:

• Minimum level of liquidity – a fund must ensure the availability of assets in the amount necessary to settle pensions, which may relatively precisely be estimated on the basis of contracts and demographic tables.

• Investment horizon – with regard to the fact that pension funds have long-term money, they can purchase also long-term assets (various forms of bonds), the scheduling of which may be easily set to ensure the necessary cash flows.

• Sensitivity of individual assets to inflation – specifically this concerns interest-bearing assets, fund managers may however hedge these assets in the form of, for example, swaps, or through purchasing assets with a variable yield.

• Tax and accounting regulations – in the case of certain assets it is very difficult to determine their market price, in particular when they are not regularly traded, or are not quoted on an exchange, where these assets may provide an interesting yield. An important fact is also that the overall yield is influenced also by the tax rate.

Pension fund assets

Pension funds invest primarily in various types of securities, which take account of the above-mentioned investment criteria. The most common assets are:

• Shares – they have a better rate of return than other types of long-term assets. They have low trading costs. A great disadvantage is however the high volatility of their prices, which is expressed also in the instability of incomes from the these assets. A similar situation is also in the case of foreign shares purchased by pension funds. These shares however have higher trading costs, but on the other hand pay a higher rates of return, particularly in a period of economic expansion. It is necessary to take heed on of the fact that in the case of foreign shares other risks also come into play, namely: currency risk, political risk, tax disadvantages, etc. Consequently, they are more risky assets, and are represented in pension funds to varying degrees depending on whether it is a private or public fund. Private pension funds have a comparably greater proportion of shares than pension funds controlled by the government.

• Government and foreign bonds - mainly those which have a high continual yield, providing coverage for the payment of benefits with zero or fixed growth, from which it ensues that pension plans have a fixed amount of benefit payout, whereby they limit the risk of loss in the case of inflation. In the case of foreign bonds pension funds take advantage mainly of the benefits of various interest rates and as well as the easy tradability of these bonds in individual states. With regard to the lower degree of risk of such securities they are represented to a greater degree in the portfolios of public funds than in private funds.

• Corporate bonds – these bring for pension funds potentially higher yields, bearing a lesser or greater

investment risk. They are however securities with lower risk than shares and therefore are significantly represented both in the case of private as well as public funds. The basic condition for pension funds in purchasing corporate bonds is that the issue should fulfil the condition of general tradability with low costs.

• Investments in property - these represent purchases of real estate mainly via real-estate agencies. They bring significant advantages, mainly in real long-term yield, prices do not exhibit such a high degree of fluctuation, and in consequence of this the yields are relatively stable. Conversely, in comparison with other assets, real-estate prices in the case of inflation exhibit growth, thus in the case of real estate there is always forecast a positive growth of prices as well as yields. It is however necessary to add that these investments have a low degree of liquidity, very low risk, which is also reflected in the lower rate of return compared to shares.

• The cash of a pension fund represents from the fund's aspect short-term cash or a "working deficit", in order that all transactions can be realised. The cash of pension funds is placed mostly as a deposit at low short-term interest rates.

Investment limits and rules of prudent conduct for pension funds around the world

The liberalised, but also secured system in the USA

Investments of pension funds around the world are today regulated either by rules of prudent business conduct, or by a quantitative restrictions for individual types of assets in the portfolio. The rules of prudent business conduct apply in particular in pricing assets at market value, or at nominal value. Conversely, quantitative restrictive measures apply in particular to more risky assets such as shares.

Private pension funds in the USA do not have any investment limits from the side of the state. They are governed only by the strict rules of the ERISA Act, which obligates fund managers to comply with the rules of prudent business conduct. In the asset structure of US pension funds real estate (offices, industrial, retail and family premises) feature largely. They focus mainly on real estate in attractive localities and cities. In 2001 pension funds controlled a 39% share of the property market in the USA, where the internal rate of return was around 10 – 12%.

At the beginning of the 1990's pension funds in the USA also changed their strategy, becoming more aggressive. The reason was a lower rate of asset appreciation than had been expected. With regard to the decline in yields, in particular on interest-bearing assets, they shifted assets from bonds, especially those with a fixed coupon, into company shares and pension funds began to invest more abroad. In an effort to avoid exchange rate risks they also turned their attention to investing in foreign shares and less in bonds. The increased attractiveness of shares for pension funds led to the situation where at the turn of the century their portfolios held more shares than other assets. Financial scandals and the collapses of large businesses connected with a sharp decline in share prices led to pension funds beginning to have problems in achieving their forecast appreciation. Large American companies had to put huge amounts of money into their pension funds in order to comply with the statutory pensioner protection conditions*. In consequence of the fall in the value of pension funds the enterprises had to use resources that should have served for a recovery and expansion of production to compensate the decline of the fund. A significant loss for American funds was brought about also by the situation when together with a fall in the market price of shares, interest rates declined, causing a shift into interest-bearing assets, and thereby also a fall in the rate of return. While in 1999 78% of pension funds (registered by the S&P 500 index) reported a positive rate of return, by 2002 this figure was only 26%. A serious problem in investing of pension funds is also becoming the fact that the current level of accounting standards induces doubts in the minds of investors as to whether at all a company's financial results is truthful or artificially inflated.

At this point it is however necessary to mention that a system of reinsurance operates in the USA, realised by the Pension Benefit Guarantee Corporation agency under the Ministry of Labour. This agency takes over the responsibility that in the case of a pension fund crash, benefits will be paid out by this institution. The funds of this agency come from contributions paid by individual fund administrators and are determined in detail. This clearly bears witness to the fact that pension funds with defined benefits are reinsured and in the case that the agency would not have sufficient resources for paying out benefits, it will be subsidised by the state. In 1999 the agency covered around 42 million employees and pensioners in more than 44 000 pension funds with defined benefits.

A conservative but safer system in Europe?

In the European area there have so far (with the exception of Great Britain and Ireland) applied quantitative restrictions in pension fund investments. Investment limits relate most to domestic and foreign

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*The law prescribes that companies must contribute to a fund, if its reserves fall below 90% of its liabilities over three years.

shares. Some countries have stricter investment conditions in the case of unlisted shares (Belgium, France, Finland). Restrictions may concern also other assets. For example in Switzerland they may invest 50% in real estate. Higher limits for investments in real estate compared to shares are also found in Finland. Investment limits may also exist for other financial instruments, for example some countries, such as Austria, Belgium and France, have limits also for bank deposits. Germany and Portugal have limits also for corporate bonds and mortgage bonds.

Most countries have created upper investment limits, but there are also countries that have lower investment limits for their pension funds. Austria, for example, has set a minimum limit for mortgage bonds in the amount of 35% of assets, in France a minimum of 50% of assets may be government bonds of EU countries. In Denmark funds must invest 60% of their resources in domestic bonds.

Investment restrictions may feature also in the case of investments in one enterprise. There may be set an upper or lower limit. For example, in Sweden and Spain the lower limit is 5%. Upper and lower limits are used also in the case of investments in foreign currencies. For example funds in Denmark, Finland, Germany and Portugal have it defined that 80% of their assets shall be in the domestic currency. In Belgium the restriction for funds applies that in investing in shares, at maximum 65% of these may be foreign.

At present arguments exist for and against these limits. Supporters of limits are of the opinion that this concerns the savings of future pensioners, who need to be protected against the risks of the capital market. On the other hand opponents claim that with the above restrictions the investments aims of pension funds are lowered, in particular in their approach to capital. An oft-used argument of the opponents is also the fact that countries such as Ireland and their farms have achieved an average appreciation to date of 12.5%, while for example in Denmark, where tough restrictions are in place the performance of funds stands at only 6.15%. In countries, where tough restrictions operate employers as well as employees must hand over greater contributions for covering pension incomes, because the funds achieve a lower yield.

Investment restrictions create even today difficult conditions for the functioning of pension funds in the EU. The concept of a single capital market in the EU has the aim of providing investors easier access to capital. The establishment and control of pension funds is still in hands of member states with markedly complicated and non-transparent legislation. In the framework of the EU, where there exists the free movement of labour, the situation is made the more complicated by the fact that a uniform pension system does not exist, complicating the transfer of pension savings between states. The economic advantages that would accrue from economies of scale are lost also through the fact that resources are handed over into various pension funds, replicated in various countries.

Since 2002 discussions have been under way at the highest level of the EU as to whether there will be a uniform pension system in the EU. Discussions have also been held on whether the investment restrictions on pension funds are necessary and whether a liberal system would not be more appropriate. Some member countries are however of the opinion that this approach would merely help Great Britain, since capital would shift to the London Stock Exchange due to the better appreciation.

Changes in the framework of the EU

At the end of November 2002 the Council of Ministers of the EU agreed on the basic principles of a new directive on pension funds. Directive 2003/41/EC of the European Parliament and Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision is based upon the Action Plan for Financial Services and has the aim of creating a single European framework for the operation of these institutions. This Directive should be implemented into the legislations of individual member states by the end of 2005. The aim of this Directive is to ensure for members of supplementary pensions schemes higher yields, freedom of choice in investing and concurrently also a higher standard of protection. This Directive now contains the issue of transparent business conduct as well as supervision, and even the term "prudent person" as the basic principle of capital investment. The most important elements and principles of the Directive are:

- Contributors into a fund (as well as employers, in the Directive they are termed sponsoring subjects) must be strictly separated from the fund management company in terms of both property as well as legally. If a fund management company becomes insolvent, it may not touch members' funds, from which it results that there must be set at least minimum standards of prudence for the protection of members.
- Public supervision is required, which determines also the professional moral quality of fund managers, the rules for the precise calculation of a funds assets and liabilities and rules for the functioning of fund management companies.
- Funds must prepare an audited financial statement and annual report, and provide them to their members. Funds must provide at regular 3-yearly

intervals a detailed report on their investment strategy and the manner of managing risk. This information shall be available not only to the supervisory authority, but also to fund members. The role of the supervisory authority will be to examine compliance with this strategy.

• It is necessary to provide all information for the needs of the supervisory authority. Inspections shall be carried directly in situ, where it has the possibility to perform an inspection in the auditing firm that carried out the audit.

• The basic obligation of funds is to ensure the fulfilment of its liabilities in the form of paying out pensions. For this reason a prudent calculation of the insurance reserves pursuant to insurance mathematics is essential, where the highest interest rates should be selected prudently according to the respective intrastate rules. With regard to the fact that also other risks exist, which can differ from state to state, the Directive gives the possibility to incorporate into the calculations also other rules that are not included in it.

• Supervision methods and practice differ in individual member states and the Directive gives member states a certain freedom in particular as regards the precise rules of investing.

• The Directive is based also on the fact that funds are investors with low liquidity risks and it is not necessary to restrict them in investing in risk-capital markets. They should exploit the advantages of international diversification, invest into shares and other currencies in accordance with the rules of prudence.

• In the case that a fund operates across borders, the respective authorities of the host state can require that the fund applies limits on investing, for example, in unregulated markets, or in investing in other currencies, but only provided that these limits relate also to domestic subjects.

né orgány hostiteľského štátu žiadať, aby fond uplatnil limity na investovanie napr. do akcií na neregulovaných trhoch, resp. i pri investovaní do iných mien, ale iba za predpokladu, že sa tieto limity vzťahujú i na domáce subjekty.

Rules of prudent investing

It may be said that some rules are of a general nature and the role of the respective national institutions will be to adapt them also to national conditions. Other rules specifically define the conditions and limits for investing. What are the rules for investing?

1. In accordance with the “prudent person” rule, assets must be invested in the best interest of fund members with regard to the portfolio’s safety, quality, liquidity and profitability. Assets are invested prevailingly on regulated markets, the remainder simply in accordance with the rules of prudent business conduct. The rules allow investment also in derivative instruments, but under the condition that they contribute to reducing investment risks or facilitate efficient portfolio management. Their pricing however must be governed by the rules of prudent conduct. The main idea of investing is to exclude excessive risk through the greatest possible diversification, i.e. to not focus attention only on certain assets. From this there ensues also the requirement that assets of the sponsoring subject - the employer - may not exceed a 5% share in the portfolio. In the case that such a subject is a component of a large whole, for example consolidated groups (the Directive uses the term “large groups”), then investments in the portfolio for the group as a whole may not exceed 10%. This condition need not apply to state bonds.

2. A member state in whose territory a fund is established may prohibit the fund from providing credit and loans, or to feature as a guarantor on behalf of third parties. On the other hand, however, member states may permit certain loans for liquidity purposes.

3. Member states shall not require that institutions in their territory invest in certain categories of asset.

4. For institutions in their territory member states may set more detailed rules, including quantitative restrictions, provided that they are justified on the basis of prudence.

5. In accordance with the Directive it is also possible to:

a) invest up to 70% of assets covering insurance reserves or up to the amount of the whole portfolio in systems in which members bear investment risks in shares, tradable securities (shares, corporate bonds) on regulated markets. The decision on the weighting of these instruments in a given portfolio is the right of the given subject in accordance with the rules of prudent investing. Member states may also apply a lower limit in the case of those funds whose pension products are tied to the guarantee of a long-term interest rate,

b) invest up to 30% of the assets covering insurance reserves in assets denominated in currencies other than those in which the liabilities are expressed,

c) invest in risk-capital markets.

6. Member states do however have the possibility of requiring from institutions operating in their territory stricter investment rules, provided that these are required on the basis of prudence. This relates however only to the part of those assets of the fund that pertain to the respective state.

7. For institutions already operating in the territories of several states, these states may require stricter rules, but in accordance with the rules in the given state for domestic subjects.

a) An institution may invest at most 30% of assets in shares and debt securities tradable on unregulated markets (over-the-counter markets), or 70% of assets in shares and debt securities tradable on regulated markets (stock exchanges).

b) The maximum 5% limit relates to shares, bonds and other financial and capital market securities of one issuer, an investment in the group of which the issuer is a part, may reach at most 10%.

c) At most 30% may be invested in assets denominated in assets denominated in currencies other than those in which the liabilities are expressed.

The draft new Directive has created room for the functioning of pension funds to develop their activities freely in the framework of the whole euro-zone, and thus following Slovakia's entry, also in the territory of the SR. From this ensues the possibility also that large funds may establish branches abroad (including in the SR) and conversely, contributors to domestic funds will in the future be able to shift their resources between funds in the EU. In the end the real economy should also profit, as the funds should ensure a greater transfer of capital and its efficient allocation.

Opening up the European market should be reflected for the pension funds in a better diversification of portfolios and higher yields. Higher yields are essential to the fate of pension reforms. In the case of an average net growth on an investment of 2% annually (e.g. government bonds) a contributor would have to put aside annually 20% of their wages for the pension to be comparable to their wages, while in the case of a 6% yield it is sufficient to put aside 5% of wages. Such an effect may be achieved only by investing in shares. Despite the fact that member states still have the possibility, resulting from the Directive, of imposing quantitative restrictions, it is logical that development will gradually lead towards greater liberalisation of the system in the EU.

Mainly the portion of shares in investments and investments abroad will increase. The Directive admits the possibility of investing up to 70% of resources in shares and 30% in foreign securities. The quality and professionalism of fund managers should ensure that diversified portfolios will be created so that risk is eliminated to the greatest possible extent. The rules of prudent business conduct which today relate to the banking sector, stockbrokers shall become the basis of business conduct also for the efficient functioning of pension funds in Europe.

From this aspect it will be essential to increase also the functionality and effectiveness of national supervisory authorities, which is now reflected in the Directive EU 2003/41/EC, dealing, besides investment possibilities, also with the problem of supervision over these institutions. The indicated development, including the EU, is leading toward a greater degree of liberalisation. It is however today questionable whether in the future it will be necessary, similarly as in the USA, to build also a system of reinsurance, since gambling with this form of investment is at present a very precarious matter.