

Developing Strong Pension Funds - Financial Market Preconditions, and Local Market Development

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Agenda

What do we mean by “strong pension funds”?

Purpose and objectives of pension funds

Pension fund optimization

Investing pension fund assets

Risk management

Key principles for building “strong pension funds”

Local capital market implications

Objectives of Pension Funds

A pension system must be viewed in the context of the key objectives for well functioning societies:

High national income, economic growth and efficiency

Even income distribution (or “not too uneven” distribution)

Social security and insurance

(Health care, poverty relief, education, unemployment benefits, sickness benefits, childcare, maternity benefits, pensions)

Sustainability (environmental, generational)

The pension system must be “optimized” in the context of all key objectives for the society

→ Funding of pension funds and strengthening the capital market are not among the primary objectives

Examples on Derived Objectives

High national saving

Funding of pension funds

Capital market efficiency

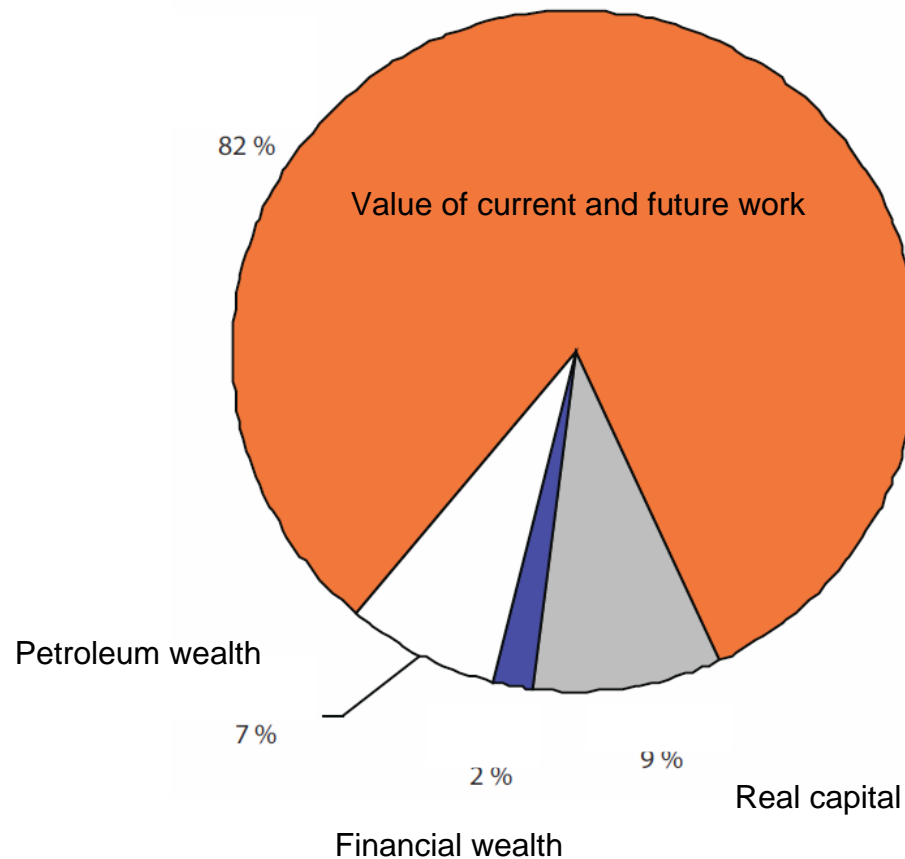
Private choice over pension fund investments

What may be good objectives for a 2nd and 3rd pillar pension system are not necessarily well aligned with the primary objectives for the society

What is paying for pensions is the future working population and their productivity: Size of the workforce, education and competence of the workforce, hours worked, unemployment, quality and relevance of the capital structure etc

Example: Net Wealth in an Oil Rich Economy

Future pension are mainly paid by future work, even in a country like Norway that has significant petroleum wealth (in the ground and in the Oil Fund)



Examples on Conflicting Priorities

Excessive public pension promises that put the bill forward to future generations and limit the growth potential of the economy

Excessive contractual rights on private pensions that limit future supply of labor (e.g. by taking down the actual retirement age)

High pension promises (public or private) that may distort incentives to work

“Free market” for provisions of private pensions? Liberalism, freedom to produce and consume, and competition, can be fine in many markets. But is provisions of pensions such a market?

- Extremely complex products. Easy for producers to benefit from an asymmetric relation to consumers. Principal agent issues
- Delivery is in the future. Past performance is a poor guide
- Herd behavior. Huge losses during cycles even among professional investors
- Often excessive costs

Investing Pension Fund Assets

Preconditions for building pension funds

Own competence and resources to run, farm out and monitor asset management

Market infrastructure: Regulation, supervision, property rights, corporate governance rights, settlement systems, custody etc

Liquidity, breadth and depth of financial instruments

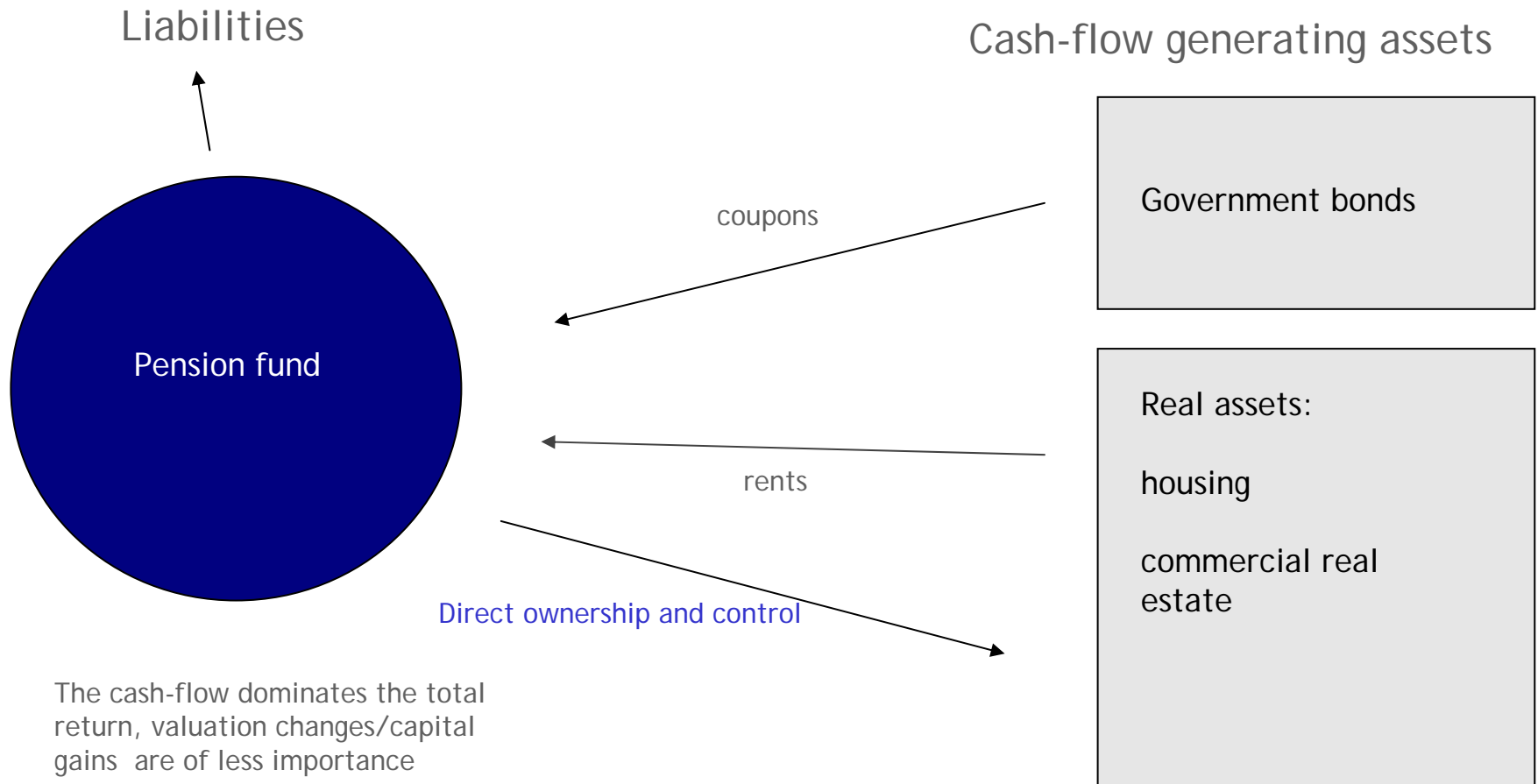
Phases of asset management sophistication:

Invest directly in real assets, e.g. UK University endowments investments in properties several hundred years back

Adding investments in government bonds

Applying a wide spectrum of services offered by the national and international capital markets

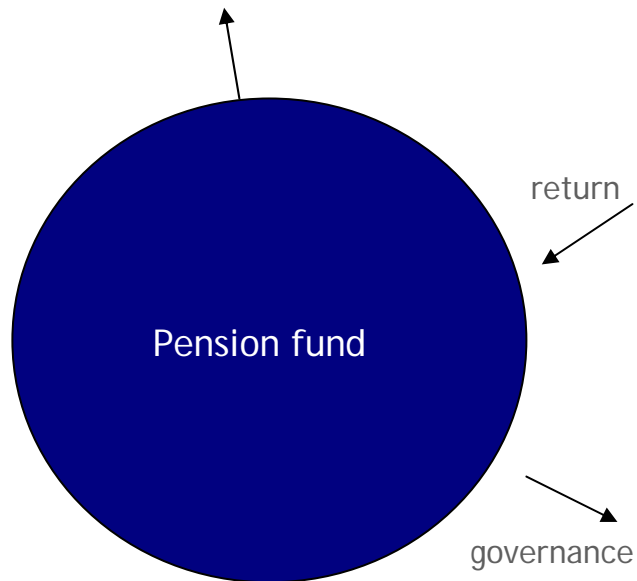
The Old/Classic Pension Fund Model



Example: The asset allocation of the Dutch pension fund ABP was in 1984 92% fixed income, 1.25% equities and 6.25% real estate. The real-estate group was the biggest department measured in headcount

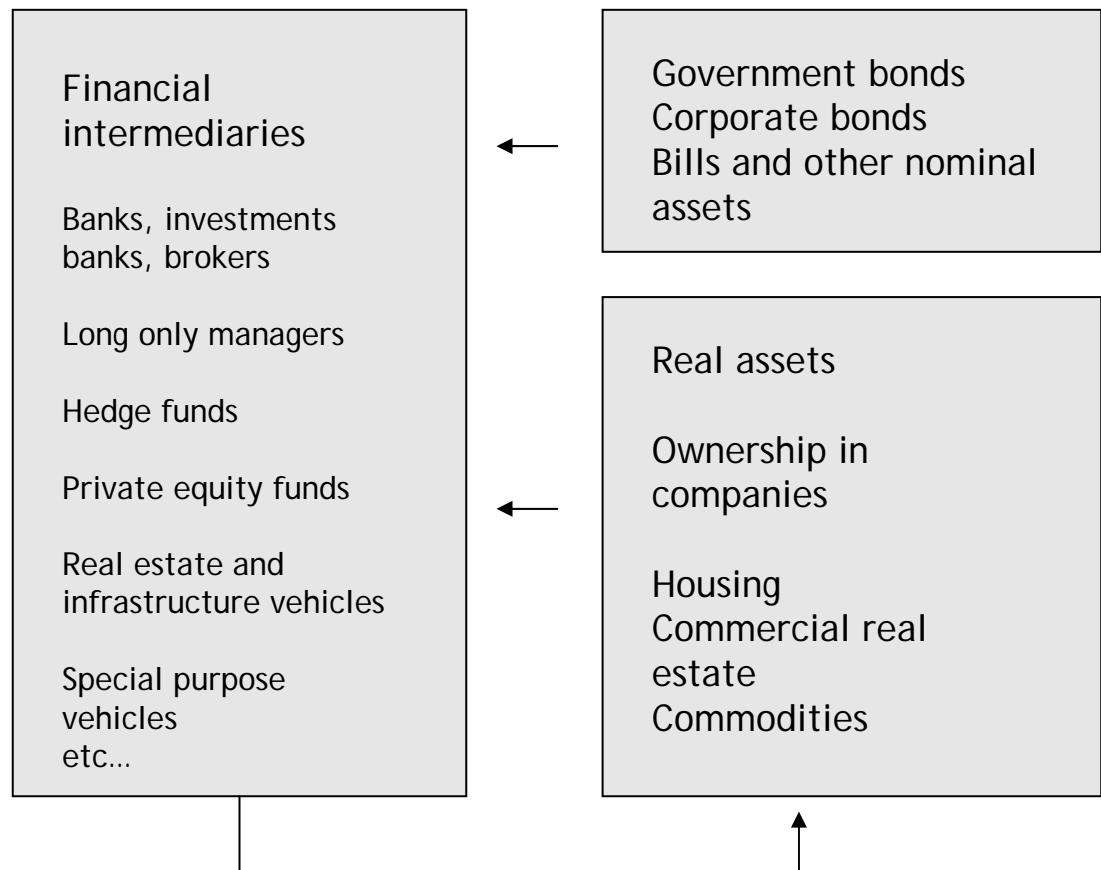
The Current Pension Fund Model

Liabilities



The financial intermediaries claim to provide higher liquidity, enable portfolio restructurings, improved diversification and risk management etc
At the costs of transaction and management fees, less direct control over the cash-generating assets, vulnerability of own agendas / agency issues in the intermediaries

Cash-flow generating assets



The Role of the Capital Market

By applying the capital market, the pension funds can outsource the governance of the cash-generating assets, and in addition achieve:

- liquidity to change portfolio allocation and rebalance
- improved opportunities to diversify
- potential return enhancements by utilizing special skills

The key costs are related to:

- transactions (many types of intermediaries involved)
- management fees
- agency costs and information asymmetry

(between beneficiaries and Board/representation, Board and fund manager, fund manager and external managers)

The move into private markets and the increased application of financial engineering have increased these costs

Investment Objectives

Safeguard long-term purchasing power

- Not appropriate to invest only in “nominal assets” (like government bonds)

- Must include “real assets” (like real estate, equities, inflation protected bonds, infrastructure)

- Prudent diversification

- Controlled counterparty risk

- Low costs

Match profile of future liabilities (ALM)

- Trade off between pension promise (future expenses), contribution rate and risk taking

There are no “free lunches” here: Planning for a high expected return means high risk taking. If you stretch too far, you may be wiped out in the bottom of a cycle (if you cannot pass the bill to future tax payers, like the US public pension funds)

The Main Pitfalls

Insufficient and inappropriate public regulation and supervisory

Must take into account the information asymmetry and agent/principal characteristics of the financial markets (see below)

Procyclical architecture: E.g. Dutch regulation that dictates use of 30 years swap rate for the present value calculations of future liabilities

Lack of competence and countervailing power among the ultimate asset owners

Product complexity: The agents have plenty of ways to enrich themselves

Individuals are easy victims for herd behavior; e.g. taking up the risk at the wrong time, selling assets in “rainy weather”

Even pension funds can be easy victims of the financial industry and impacted by herd behavior

Crony capitalism

A pension asset base can be a tempting target for governments and businesses that care more about own interests than the ones of future pensioners

Example: Italian Municipalities

Investment banks have sold derivative contracts to Italian local governments for an aggregate value USD 35 bn, swapping interest rates on long-term debt to short term variable rate. The deals are packed with fees and complexity.

Milan has raised criminal charges against four banks and 13 individuals

FINANCIAL TIMES

Milan swaps case puts banks in hot seat

By Vincent Boland

Published: March 18 2010 18:50 | Last updated: March 18 2010 18:50

Print

If any European country was going to be a test bed for the raging global debate on the use of complex derivatives, it was Italy.

Not only is the country, at the sovereign level, one of the eurozone's most indebted nations, with a debt to GDP ratio that the Italian finance ministry estimates will be 116.9 per cent this year. It also has heavily indebted local authorities, where the ticking timebombs are really located.



This week one of those time bombs erupted. A judge in Milan on Wednesday levelled charges of fraud against four international banks – Deutsche Bank, Germany's Depfa, UBS, and JPMorgan – and ordered 11 bankers and two former municipal employees to stand trial for their roles in a complex and controversial €1.7bn (\$2.3bn) bond issue that the city claims has hurt it financially.

Alfredo Robledo, the Milan chief prosecutor, sounded almost tentative in his summing up of the seriousness of the case against the banks when the judge's ruling was

Thousands of public authorities across Europe tried to cut borrowing costs in recent years through **derivatives deals whose risks they couldn't measure**. In the U.S., governments and nonprofit organizations have paid more than \$4 billion to Wall Street firms to end such agreements since 2008, according to data compiled by Bloomberg.

Bloomberg, 21 January 2011

Example: Norwegian Municipalities

Norway towns sue Citi over structured note losses

Mon Aug 10, 2009 6:45pm EDT

NEW YORK (Reuters) - Seven Norwegian municipalities and a Norwegian securities broker are suing Citigroup Inc for more than \$200 million in damages after they lost millions of dollars on investments sold by the U.S. bank two years ago.

The municipalities and Norwegian firm Terra Securities claim Citigroup misrepresented certain structured notes as a conservative investment, according to a filing made on Monday in a New York court.

Citi sold the notes, whose return it said was linked to a municipal bond arbitrage fund, in May and June 2007 -- but by May 2008 nearly all the towns' original investment was gone and Terra was in bankruptcy, according to the claim.

The court documents allege Citi sold more than \$115 million of the notes "in order to unload what was becoming significant risk from either its own or its preferred customers' balance sheets.

"We believe this suit is without merit," a spokeswoman for Citigroup said.

Example: Hedge Funds and Asymmetric Information

- It has always been difficult to see which managers are skillful and who are just lucky
- Derivatives provide managers with flexibility to “fake skills” *)
- Lack of mark to market (in many of the vehicles) and the use of complicated structures and instruments has made it difficult for investors to control and follow up the managers
- Managers have incentives to exploit asymmetric distributions for their own benefit
- Much of the perceived alpha has been loading of beta factors
- Low barriers to entry - and to exit - contributes to the (in general) lack of alignment between partners and investors
- 2/20 fee structures means in practice that the funds need an information ratio higher than . 5 to generate any return to the investors
- The market for hedge-funds has “market for lemons” characteristics

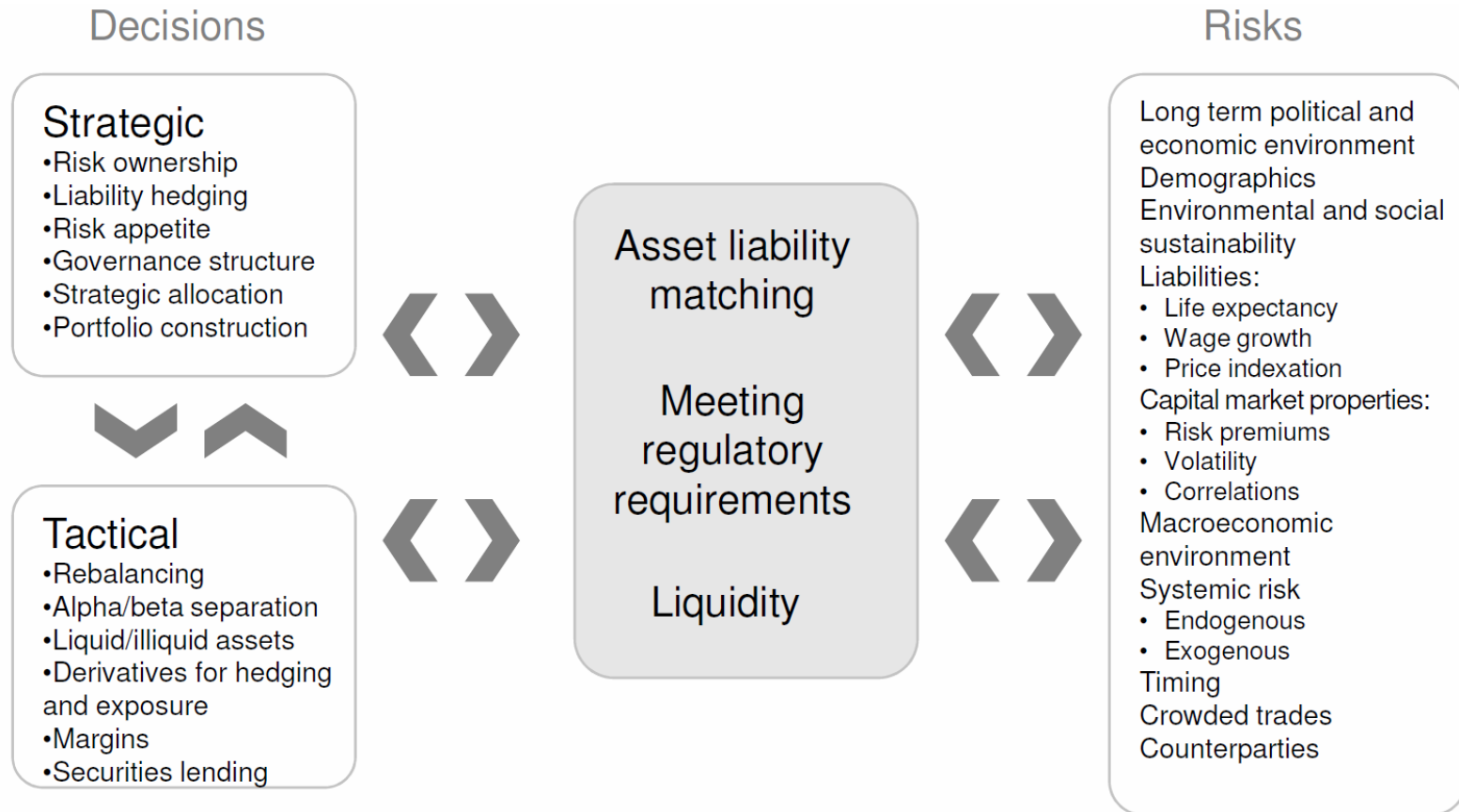
*) E.g. illustrated in “The hedge fund game: Incentives, Excess Returns, and piggy-backing. D. P. Foster and H.P. Young, Discussion paper series, Oxford, 2008



With the “right” fee structure mediocre investment managers may become rich as they ensure that their investors cease to remain so.

Martin Wolf, Financial Times, 18 March 2008

Risk Management of Pension Funds



Strategies that can be optimal for the long-term liability matching, can force dysfunctional actions in the short term, and vice versa.

Example: The role of liquidity management was underestimated before the crisis. Cash needs for capital calls, hedging programs etc. enforced costly restrictions on the execution of investment strategy.

Manage Risk and Live with Uncertainty

Even with more knowledge on the nature of financial markets – and improvements in how we monitor and assess risk, investors will continue to face and live with uncertainty

Proper investment strategy and risk management are about:

Avoiding the biggest mistakes

Building robust decision making systems

Building robust portfolios

Risk factor based asset management

The Biggest Mistakes

- Procyclical investments
- Lack of competence
- Overly complex portfolios
- Lack of consistent risk aggregation

(Not a complete list!)

Procyclical Investments

Inappropriate risk ownership and strategy

Is the purpose of the fund/institution defined clearly?

Is the risk decision taken by the ultimate owner of the risk?

Is the strategy and implementation anchored with the risk owner?

Are the possible consequences understood by the owner?

Typical mistakes:

Risk level is set too high in “good times”, risk owner must take down risk when “bad times” occur

The risk decision is not taken by or anchored with the risk owner, the risk owner blames the manager, takes over control and downscales risk at the worst possible time

Building Robust Decision Making Systems

Acknowledge uncertainty, own limitations and behavioral deficiencies

Establish predefined decision rules

Build institutional clarity, a disciplined structure and professionalism

- Well defined risk ownership, all risk taking anchored with owner

- Complexity in implementation aligned with competence/professionalism and the quality of the monitoring systems

- Empowerment of independent and central risk management functions

- A culture that encourages integrity and diversity and questioning of “authorities” (avoiding group think)

Decision discipline to avoid entering investments / risk exposures at unreasonably high prices / low risk premiums

Building a Robust Portfolio

The expected return and risk of institutional portfolios are dominated by some key risk factors

Even if the investment approach is fundamental bottom up (e.g. stock picking), or absolute return strategies (e.g. hedge funds), the total risk is largely driven by factors

A successful investment strategy must be based on an explicit understanding of what those key factors are

Portfolio construction will in the future shift away from adding together alpha-seeking managers towards a transparent, top down, risk-controlled loading of beta factors - based on efficient use of public market standard instruments and by applying leverage and long/short techniques to achieve optimal diversification of the underlying risk factors

Building Blocks of Portfolio Construction

Understanding factor and strategy exposure

Harvesting risk premiums

Diversifying portfolios based on the underlying risk premium drivers

Separating alpha and beta when possible

Liquidity management

Reconsidering the role of alternatives

Minimizing agency conflicts

Mechanical rebalancing, or even “valuation dependent rebalancing”

Rebalancing: Discipline to Stay Clear of Herd Behavior

Two perspectives:

- discipline to avoid herd behavior and procyclicality
- exploit mean reversions and earning a diversification premium

Rebalancing maintains optimal utility and prevents the asset with the highest drift from eventually dominating the portfolio holdings. Thus, rebalancing ensures diversification and mitigates risk

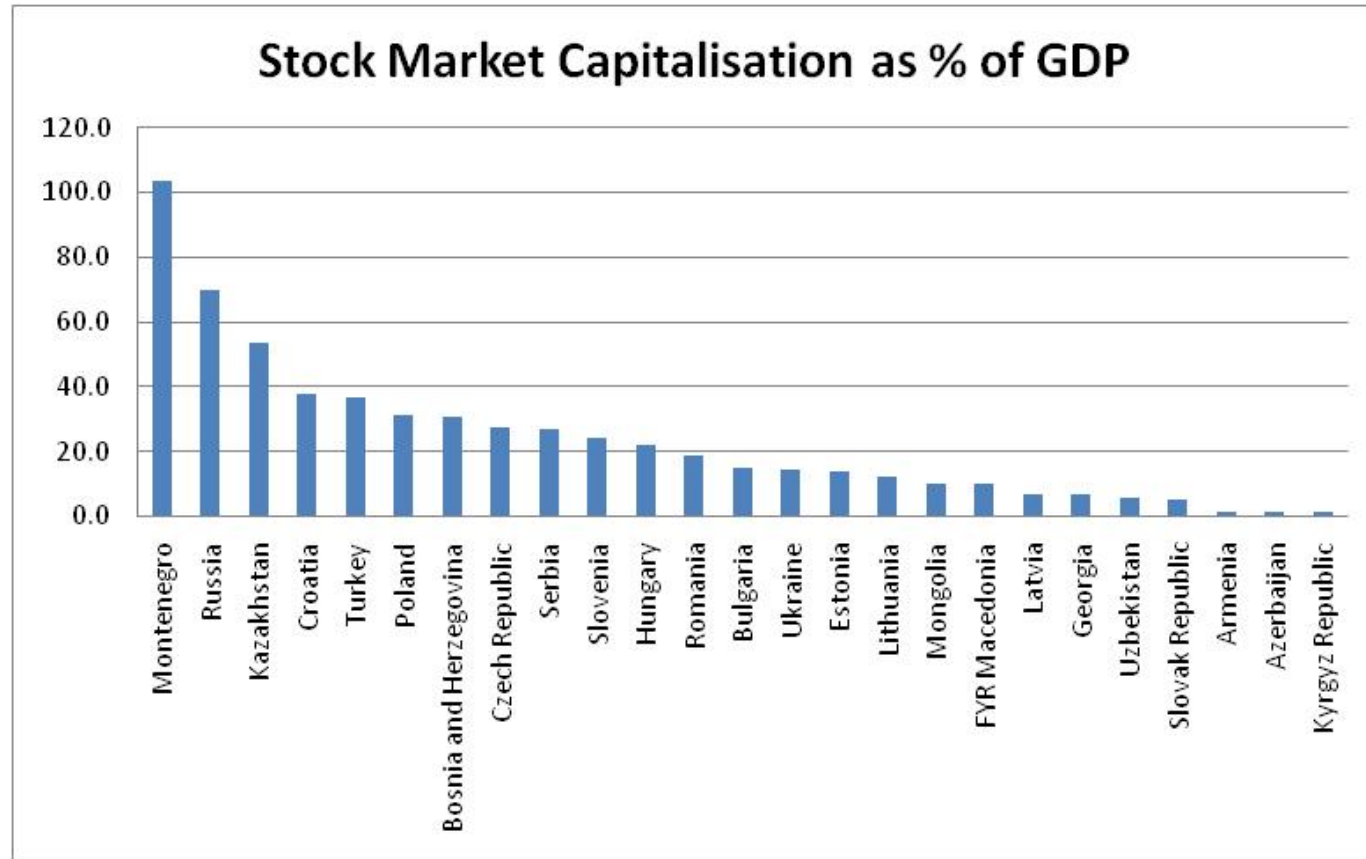
Rebalancing imparts an automatic value bias, buying assets recently declined in price and selling assets with price gains provides liquidity

The big problem is when investors act procyclically. These investors sell assets with poor returns that often have high expected returns going forward and rebalance into assets with low future expected returns

Rebalancing itself also earns a premium even when underlying assets do not have positive expected returns: Booth and Fama's (1992) "diversification return"

Rebalancing should be done at more than just the asset class level: it should also be done within asset classes. This makes market weighting non-optimal

Local Market Developments



Source: EBRD Office of The Chief Economist, S&P, IFC, FEAS, National sources, WEO Oct 2010

Large differences between the capital markets of the EBRD countries

The Role of Pension Funds in the Local Markets

The funds can provide:

- Capital
- Liquidity
- Competence
- Responsibility

Local long-term capital can play important roles in building and strengthening local based business

Foreign capital is complete and often very significant for the provision of liquidity and competence

Capital is not a “commodity”. Capital guided by competence and clear return objectives may play a much more positive role for value creation and economic growth than capital provided with less business minded objectives (like being a long-term investor to strengthen local business)

Capital and Competence

- Equity culture has proven to be an important driver for growth, wealth and prosperity
- A key challenge with the equity model is the structure and culture of ownership – corporate governance:
 - lack of elementary ownership rights: Management/insider driven companies, no real checks and balances. Happens often when the ownership structure is dispersed
 - abuse of power by dominant shareholders / families
- Skilled and demanding owners can make a difference by:
 - shaping the strategy of the firm, ensuring that the real business purpose rules and avoiding that management build empires, enriches themselves and takes excessive risks
 - providing inspiration, ideas, networks
 - keeping the management accountable

The Non-Competent and “Crony” Capital

A public pension fund that has dual objectives; not only future return for pensioners but also to contribute to the development of the local capital market

It can work well!

But it is a high risk that it don't serve any of the objectives: Poor return and negative contributions to business growth

It is hard to make the trustees and managers of a pension fund accountable when their objectives are not clear. That opens up for political influence over the investment decisions. How demanding and competent will the pension fund act as owner when it is not kept accountable itself?

Conclusions

“Developing strong pension funds” is a derived objective

The role and functioning of funded pension systems must be optimized in the context of the primary objectives of a well functioning society

There are probably no “blue print” model. Differences in national preferences, local market conditions, educational level etc will lead to different choices

Financial instruments and markets are very much about complexity and agency issues. Even professional investors can be impacted by herd behavior and run their funds with ambition level that exceeds their competence

Normal market liberalistic approaches does not work for provisions of pensions

However, a funded system that strikes a balance between regulation and market mechanisms, having high integrity versus short sighted political and business interests, and includes educational efforts; may contribute positively to future economic growth by their impact on the local capital markets