THE PERFORMANCE AND RISKS OF PRIVATE PENSION FUNDS - IMPLICATIONS FOR FINANCIAL STABILITY

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Abstract: : Despite the difficulties due to the economic and financial crisis, the private pension funds continued to record a strong growth worldwide and they are to return to the pre-crisis levels. Although the last year's economic and financial indicators have shown signs of economic recovery, the prospects for future developments remain uncertain. In addition, the financial markets are increasingly fed with derivative products which are designed to protect the pension funds against the risks associated with these investments. Thus, the implications of the private pension funds for the stability of the financial system are more and more important. In Romania, the decrease in the economic activity has limited the growth of the revenue from the private pension contributions. Private pension funds have not encountered additional problems in the management of financial cash flows and they do not represent a threat to the domestic financial system of Romania

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The financial crisis, the budgetary pressures as the political tensions have fed the desire of political policy makers to discourage the development of private pension funds. However, at least in terms of investment activity, private pension funds have obtained very good yields and have had a good contribution to stabilize the financial markets.

The economic and financial crisis has led the policy makers to focus their attention on the risks of investment of private pension systems although they represent only a part of the retirement income, most of these revenues not being affected by the risk of investment. Most european countries have recorded, despite the global economic and financial difficulties, a considerable growth of private pension fund assets. If in december 2008, private pension funds in OECD countries recorded a value of 3400 billion dollars, two years later, the market was at a level of 3000 billion dollars. Private pension funds recorded an average growth rate of assets to GDP from 68% in 2009 to 71.6% in 2010, when they recorded an average positive return on investment average of 3.5% in real terms and 5.4% in nominal terms. The countries which recorded the highest revenues were the Netherlands (18.6%), New Zealand (10.3%), Chile (10%), Finland (8.9%), Canada (8.5%) and Poland (7.7%). 1

In contrast, private pension systems in Portugal and Greece have recorded a negative average investment return of 2.4% and respectively 7.4%. For the Greek state, the collapse was due to the negative value of the Athens Stock Exchange and the fall of the bonds of this state. In Portugal the negative return on private pension funds can be explained by the turbulences on the domestic capital market. In Spain, the increase in volatility in the financial markets, particularly in the bonds issued by the public administration, the decrease of the contributions to personal pension plans and options to members of pension insurance contracts and other products that guarantee a certain rate of return have led to a decline in private pension fund assets in 20102.

Because of the financial crisis, the deficiencies on the labour market and the aging of the European population, pension systems in Europe are facing many difficulties. Both the public pay-as-you-go schemes and the funded private pensions have been threatened by this crisis. Under this conditions, many efforts have been made in order to find the right balance between public and private pensions3.

Nowadays it seems that retirement savings are a preferred tool for the governments that want to make up government budget deficits. As governments organize most pension schemes they prefer to gain control over retirement savings instead of making privatizations or reduce spending. We are witnessing governments efforts to take-over private pensions funds. In this sense, Argentina, Hungary, Bulgaria, Poland, Ireland and France are just few examples.

But most OECD countries have seen an increase in assets except some which still have not recovered from their losses. At the end of 2010, the assets of private pension funds recorded ,in Belgium ,values by 10% lower than the level in December 2007, , by 10% lower in Ireland, by 13%, 8% in Japan, with 12% in Portugal, in Spain by 3%, and also by 3% in the U.S. Considering the structure of the asset portfolio, in most countries, the major percentages were held by bonds and equity which represented 50% of the total assets. However, the U.S., Australia, Finland and Chile showed an increase of the shares.

In the countries which are not members of OECD we have also witnessed a performance of pension funds, which showed an average investment return of 9.9% in real terms, more than the double of the average rate of return in the member countries. The fact that countries such as Colombia, Latvia, Ukraine, Peru and Romania, which are not OECD members have recorded a better performance of private pension funds, is due primarily to the fact that their systems are still at the beginning. An explanation for this development is the increase in investment by private pension systems in these countries under the conditions of low prices and a good enough return on market market investment4. (Table 2).

[1] OECD 2011 – Pension Markets in Focus – July 2011 – Issue 8
[2] OECD 2011 – Pension Markets in Focus – July 2011 – Issue 8
[3] Lans Bovenberg, Casper van Ewijk, Private Pensions for Europe, CPB Policy Brief, 2011/07

[4] OECD 2011 – Pension Markets in Focus – July 2011 – Issue 8

Table 2. Pension fund nominal and real 3-year average annual returns in selectd non-OECD countries over 2008-2010 (%)

Country	3-year average return	
	Nominal	Real
Colombia	18,6	13,5
Romania	17,0	9,8
Albania	8,3	5,1
Nigeria	5,9	-5,7
Costa Rica	5,7	-2,9
Pakistan	3,9	-10,3
Macedonia	3,0	0,0
Peru	0,4	-2,9
Bulgaria	-4,4	-9,6
Simple average	***6,5***	***-0,3***
Weighted average	***10,0***	***4,5***

Source: OECD, Global Pensions Statistics

In 2008-2010, the highest annual net income were recorded in Turkey (16.5% in nominal terms, 7.5% in real terms), Denmark (6.8% in nominal terms 4.3% in real terms), Mexico (6.8% in Term nominal 1.8% in real terms), Germany (4.7% in nominal terms and 3.3% in real terms). The countries that have recorded the lowest level of performance were: Spain (-2% in nominal terms, -3.8% in real terms), Australia (-2.8% in nominal terms, - 5.6% in real terms) and Estonia (-3.7% in nominal terms, -7.7% in real terms). The OECD countries that have recorded better performances in 2008-2010, Colombia being on first place with a nominal return of 18.6% in nominal terms, 13.5% in real terms, while Bulgaria had the weakest performance (-4.4% in nominal terms and -9.6% in real terms)[5].

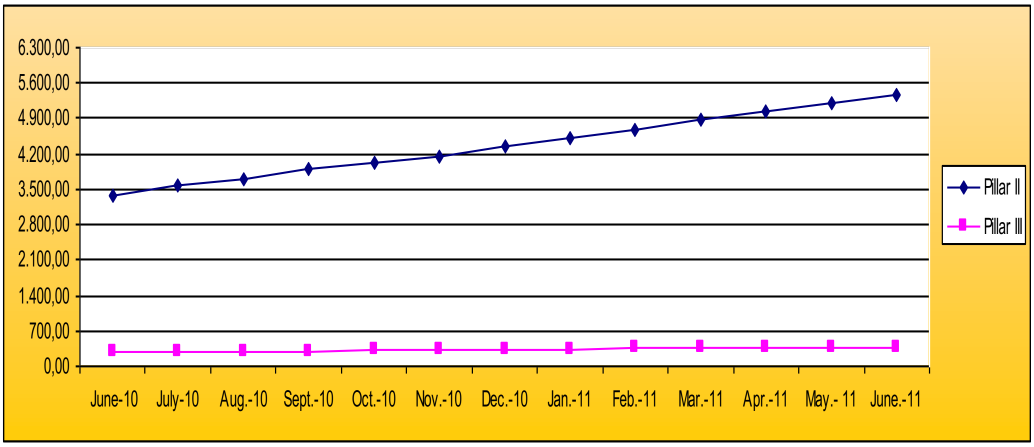
In Romania, in only three years ,the system of private pension funds has become a mechanism that strongly stimulates the investment competition and performance. This system has gained a lot of confidence among the population. Despite the contraction in the economic activity in 2009-2010 and the decrease in number of the persons for whom monthly contributions were transferred, we have witnessed an increase in value of the contributions due to the increase of the contribution rate from 2% to 2.5% of the gross income in March 2010.

While going through a difficult economic crisis, the number of participants in Pillar II has increased reaching 5.32 million at the end of June 2011. The contributions were relatively small (2% of gross wages in 2008 and 2009, 2.5% in 2010 and 3% in 2011) but the value of the managed net assets has steadily grown, these representing 5.4 billion for Pillar II and 385 million for Pillar III at the end of first semester, current year. . Voluntary private pensions have increased a lower growth than the compulsory private pension funds. These levels show, however, a limited capacity of these funds to support the stability of domestic financial markets[6](Graph1).

[5] OECD, Global Pension Statistics, 2011

[6] Supervisory Commission of the Private Pension System, Monthly Bulletin, June 2011

Graph 1. Net asset value (mil.Ron) , June 2010-June 2011

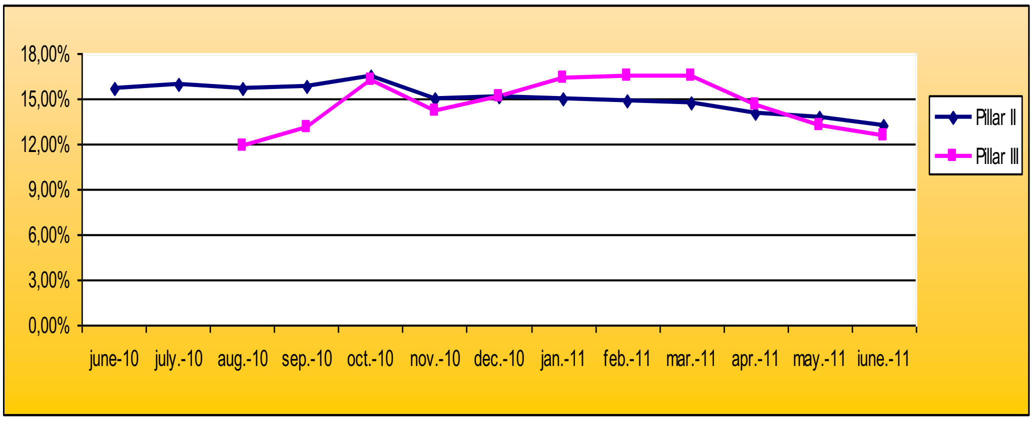


Source: Supervisory Commission of the Private Pension System, Monthly Bulletin, June 2011

In 2010, the highest returns for pension funds were provided by fixed-income instruments. Although investment in Transferable Securities have recorded very small yields, even negative in Pillar III, they did not affect the total return of private pension funds as a result of owning a minor share (less than 9%) in the structure of the portfolio.

The private pension system in Romania has made it possible to obtain a permanent high return rate, well above the annual inflation. For example, at the end of 2010, Pillar II recorded an average rate of return of 15% while the inflation in the same period was of 6.34%. These positive aspects encourage the maturation of this mechanism and indirectly support the economic recovery[7](Graph2.)

Graph 2. Weighted average return of all funds in high risk category



Supervisory Commission of the Private Pension System, Monthly Bulletin, June 2011

The strongest threat to the private pension system comes from the political and legislative power and from the unions. Given the increasing budget constraints, the authorities show less favorable attitudes to private pension systems. Other major risks

[7] Financial Stability Report, National Bank of Romania, 2011

to the private pension funds are represented by the changes in regulation and accounting.

Given the pressure of the failed public pension systems, the european countries face more and more difficulties in efforts to reduce public debt. However, Europe still has sources for increasing its productivity. However, the chronic budget deficits and the rising public debt bring serious doubts on the fiscal sustainability of the most important powers. In addition, the complex legislative frame, the large public sectors with a low productivity as the growth of early retirement make it difficult to set the economic growth in Europe. Thus, the development of private pension systems remains a necessity due to the existence of a bankrupt system of state pensions.

Private pension funds are an important investor because they accomplish an efficient allocation of the economic resources and ensure the completion of the lower and more uncertain state income. Therefore, private pension system provides extra financial stability through a long-term orientation and an increase in liquidity. However, currently private pension funds have a limited capacity to support the stability of the financial markets, most of the resources being placed in government securities. Thus, these funds have a lower risk of investment. They are not exposed to any significant risks of contagion to external financial shocks. Thus, private pension funds currently show a significant dependence on the state ability to meet its payment obligations. The resistance of private pension funds to the financial market risks is strengthened by other factors such as bank deposits and shares.

In Romania, according to the latest Financial Stability Report, over 60% of the resources of private pension funds were invested in government securities. Thus, direct exposure to international risks is low, only 11.4% of Pillar II portfolio and 10.1% of Pillar III portfolio investments abroad represent. However, it is necessary to ensure a proper monitoring of contagion risk of external shocks.

First, we are witnessing an intensification of the search for high returns by buying higher-risk products. While seeking to obtain profitable investments, pension funds can contribute to the intensification of bubbles in asset prices and investment flows.

Today this trend is emerging and investors show a growing appetite for alternative investments such as hedge funds. Even more conservative countries such as Denmark and the Netherlands have registered increases in actual allocations to hedge funds and private equity funds. Private pension funds have sought to reduce the investment risk rate by increasing the percentage of resource allocation to bonds and by increasing the investment period. But we are witnessing more and more actions of engaging these funds in transactions with financial derivatives, and thus to a reduction of pressure on bond yields.

In conclusion, despite the unfavorable economic environment, private pension funds recorded very good yields of the investment activity and they support the stability of the financial system. Although most of the resources of private pension funds are currently invested in government securities and lower investment risk, it is necessary to ensure a careful and constant monitoring of these risks. Despite the difficulties caused by the current crisis, most European countries have recorded significant increases in private pension fund assets.

In Romania, the private pension funds have contributed to stimulate investment competition and performance and have gained more and more confidence among the population. Currently, the main threats to private pension funds come from the

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legislative power and political power. Facing a bankrupt public pension system the development of private pension systems remains a necessity as they complete the income from the public pension system and bring added liquidity, thus helping to support financial markets.

The large share of government securities in the structure of private pension funds, proves a limited capacity to support the financial markets but we are also witnessing a growth trend and portfolio diversification. So we must pay attention to risk management and provide a good framework for the development of private pension funds.

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