PENSION FUNDS AND EUROPEAN FINANCIAL MARKETS

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Overview

- Institutional investor growth established trend
- Pension fund growth in Europe strong but unevenly distributed
- Institutionalisation and EMU are combining to revolutionise EU financial markets
- Some regulatory problems for EU pension fund investments remain unresolved
- Pension reform options not yet widely grasped despite coming difficulties of social security pensions
- Looking ahead, financial stability risks arise for retirement systems, particularly where reform absent

Long term financial developments in Europe

- Growth of institutional investors
- Long term institutionalisation of financial markets
- Large size of mutual funds and life insurance as well as pension funds

Size of institutional investors (relative to GDP)

	1970	1980	1990	1998	Change 1970–1998
United Kingdom	0.42	0.37	1.02	1.99	1.57
Germany	0.12	0.20	0.33	0.65	0.53
France	0.07	0.12	0.52	1.09	1.02
Italy	0.07	0.06	0.15	0.20	0.13

Share of institutions in intermediation

		1970	1980	1990	1998	Change 1970–1998
United Kingdom	Bank	0.58	0.64	0.55	0.46	-0.12
	Institutional	0.28	0.26	0.32	0.40	0.12
Germany	Bank	0.84	0.86	0.83	0.74	–0.10
	Institutional	0.10	0.12	0.17	0.23	0.13
France	Bank	0.94	0.68	0.82	0.66	–0.28
	Institutional	0.05	0.04	0.19	0.29	0.24
Italy	Bank	0.98	0.98	0.95	0.92	–0.06
	Institutional	0.06	0.05	0.11	0.10	0.04

Relative size of institutional sectors, 2000

Percent of GDP	Pension funds	Investment funds	Insurance
Belgium	6	30	42
Denmark	24	20	78
Germany	16	12	43
Greece	4	25	1
Spain	7	30	13
France	7	55	61
Ireland	51	144	45
Italy	3	39	21
Luxembourg	1	3867	117
Netherlands	111	25	65
Austria	12	40	24
Portugal	12	16	20
Finland	9	10	57
Sweden	57	34	90
UK	81	27	107

European pension fund developments

- Growth in prospect: assets Euro 2500 bn in 2000, forecast Euro 3500 bn in 2005
- Shift from bonds to equities underway
- EMU likely to stimulate further pension reform
  - Stability pact and rating agency focus on social security
  - Transparency in costs
  - Reduction in book-reserves to help credit rating
- And improves conditions for existing funds
  - Better risk return trade-off
  - Easing of regulations
  - Competition among asset managers

- Despite reforms in a number of countries, assets and growth remain concentrated in the UK, Sweden, Netherlands and Denmark
- Reforms themselves e.g. in Germany are modest and will not generate a rapid build-up of assets, while elsewhere (e.g. France) no reform on horizon
- Many countries retain restrictive portfolio regulations, hampering performance, although EMU and the Pension Funds Directive will mitigate their effects (see below)
- Investment dominated by domestic banks, which charge relatively high fees owing to lack of competition (also some hidden fees and lack of independent performance measurement)

Portfolio restrictions on EU and Swiss pension funds

BE	>15% in government bonds
DK	rules of the EU's 3rd life insurance directive, 80% currency matching
FR	>50% EU government bonds
DE	<30% EU equities, <25% EU property, <6% non-EU equities, <6% non-EU bonds, <20% overall foreign assets, >80% currency matching
IT	<20% liquid assets, <50% non-listed OECD securities, <5% non-OECD securities, >30% currency matching
PT	<40% in foreign equity
CH	<50% real estate, <30% Swiss equities, <30% foreign loans, <25% foreign equities

European asset manager performance

	Operating profits	Net revenues	Total costs	Memo: % retail funds	Memo: equity fund management costs (bp)
Benelux	19	32	13	53	4.6
France	19	32	13	40	5.7
Germany	9	23	14	31	5.7
Iberia	42	53	11	74	3.7
Italy	35	48	13	94	5.8
UK	11	28	17	21	5.8

Fees for a $100 mn balanced mandate

	Fees (basis points)
Ireland	18
Netherlands	18
Germany	27
UK	27
France	32
Switzerland	40
Memo: US	46

- Meanwhile strong effect on EU financial markets (e.g. in corporate governance) generated by US funds, whose foreign assets are $800 bn
- Research suggests that growth of institutional investors’ share of equity leads to higher dividends and productivity and lower investment
- Given ageing of the population, the effects set out below can only intensify in the future, subject to progress of pension reforms and an appropriate regulatory framework

European pension fund assets 1999

Intersec data	Assets (Euro bn)	Annual % growth 1995-99	% Bonds	% Equities	% Foreign
UK	1367.7	12.3	14	74	27
Netherlands	434.4	7.8	35	45	42
Germany	128.7	2.3	36	25	8
Sweden	96.5	4.5	76	17	6
Denmark	80.5	9.8	52	42	11
France	72.4	2.6	52	12	8
Italy	56.3	-0.2	28	3	3
Ireland	48.3	16.9	24	60	40

European pension fund assets 1999 (continued)

Intersec data	Assets (Euro bn)	Annual % growth 1995-99	% Bonds	% Equities	% Foreign
Finland	32.2	NA	49	22	1
Belgium	16.1	11.1	38	53	47
Portugal	16.1	NA	50	35	23
Spain	16.1	20.6	56	25	23
Austria	8.0	32.6	68	28	16
US	7755.4	16.1	24	63	11
Europe	2719.2	9.8	27	53	27
Europe ex UK and Ireland	1303.3	7.2	39	31	27

Asset manager competition – barriers to entry of markets

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	Foreign	Domestic
Reputation of existing firms	3.63	3.52
Existing firms' relationships with clients	3.69	3.61
Existing firms' distribution channels/selling networks	3.93	3.8
Existing firms' expertise/technical capabilities	3.07	3.39
Existing firms' lower unit costs	2.48	2.82
Capital or marketing costs	2.98	2.95
Existing firms' local information	3.36	2.8
Established investor preferences	3.34	3.22
Regulatory barriers	3.07	2.38

Pension fund growth and EU financial markets

- Important to see pension fund growth in combination with EMU
- Both have effects of:
  - Increasing role of securities markets
  - Boosting cross border investment
  - Putting pressure on bank profitability
  - Leading to concentration of trading activity
  - Shift in corporate governance to Anglo-Saxon

Evidence of pension fund and EMU effects?

- Securities markets:
  - Massive growth in corporate bond issuance, stimulated by institutional investor demand and the euro – and low government deficits
- Cross border investment
  - Pension fund sectors raising cross border investment, particularly in the euro zone, where currency risk ceases to hold. “Sectoral investment” and indexation becoming key strategies therein, reducing competitive advantage of domestic managers

  - Domestic equity mandates fell 60% over 1999-2001, and domestic bond mandates by 92%.
  - In 1999-2000 41 of top asset managers operated in 5 or more countries, in 1996 17
- Banks' profits
  - Continuing squeeze on profitability of banks in many EU countries, with narrowing interest margins, linked inter alia to competition from institutional saving
- Trading activity
  - Privatisation, mergers and prospective mergers of bourses, with growth of alternative trading systems, due to "footloose" nature of pension funds and other institutional investors' trading

- Corporate governance
  - Massive growth in merger activity in Continental Europe (Mannesmann, Olivetti, Soc Gen-Paribas) where pension funds are major players
  - Direct corporate governance pressures on Continental firms (performance, shareholder rights, management structure)
  - Universal banks such as Deutsche Bank shifting to investment bank and asset management focus, and disposing of equity holdings
- Book-reserve funding in decline
  - firms seek to shift to external funding, owing to pressure on credit ratings, and facilitated by German tax reform

Convergence of EU financial structure on the US?

% of GDP	**Equities**	**Government bonds**	**Private bonds**	**Bank assets**	**Total**	**Institutional investors**
E.U.-15	62	40	24	–134	–14	71
E.U.-11	82	41	26	–133	0	86
Belgium	69	–17	6	–253	–201	87
Denmark	75	27	–43	–36	18	78
Germany	88	57	14	–127	19	99
Greece	95	6	60	–12	143	N.A.
Spain	80	53	53	–99	57	107
France	80	51	24	–132	16	70
Ireland	63	53	57	–156	13	N.A.
Italy	93	–23	23	–96	4	125
Luxembourg	–64	90	–1	–3552	–3566	–1797
Netherlands	14	40	42	–131	–45	–13
Austria	102	61	27	–160	17	110
Portugal	89	45	40	–139	38	111
Finland	64	50	28	–37	98	95
Sweden	20	36	–5	–32	–1	29
United Kingdom	–29	60	42	–180	–111	–17

Regulatory issues for pension fund investment

- Directive on Occupational Retirement Provision
  - Some good points, enshrines prudent person investment (necessary for optimal investment), sets minimum limit of 70% equity and 30% non-matching currencies
  - But also allows quantitative restrictions, which could constitute a loophole
  - And sets out a minimum funding aspect, which will be particularly strict for cross-border funds and may discourage their development
  - No attempt to address vesting or taxation

- Tax barriers to cross border occupational pensions
  - Common basis for taxation (EET) needed for pan-European pension schemes, being sought by Commission
  - Danner ECJ case gives hope for progress in removal of tax discrimination for cross border sales of financial services such as life insurance
- Directive on Takeovers
  - Wholly undesirable that this has been emasculated, thus giving poor protection to minority shareholders and undue protection for incumbent management

- Proposed introduction of Basel 2 to European law
  - Major issue of “operational risk” capital requirement on asset managers. 20 basis points would drive index managers owned by banks out of the EU
- Barriers to competition in domestic legislation
  - German “Riester” pensions and others insist on use of investment funds based in home market or with unique features hindering cross border sales

The ageing problem

- Increase in life expectancy….
- ….decline in the birth rate….
- ….giving rise to an ageing population…
- ….and financial difficulties for generous pay-as-you-go systems….
- ….generally in countries where funding is not developed

Projected pension costs

Percent of GDP	2000	2020	2040	Change to peak	Memo: Replace-ment rate*
Belgium	9.3	10.4	13.0	3.7	58-45
Denmark	10.2	14.0	13.9	4.5	45-43
Germany	10.3	10.6	14.4	4.3	93-37
Greece	na	na	na	Na	70-48
Spain	9.4	10.2	16.3	8.3	94-63
France	12.1	15.0	15.8	3.9	67-51
Ireland	4.6	6.7	8.3	4.4	53-21
Italy	14.2	14.9	15.7	1.7	78-75
Luxembourg	na	na	na	na	87-76
Netherlands	7.9	11.1	14.1	6.2	76-31
Austria	14.5	15.7	17.0	3.1	70-70
Portugal	9.8	14.4	15.8	6.2	74-74
Finland	11.3	140	16.0	4.7	60-59
Sweden	9.0	10.2	10.7	1.7	63-50
UK	5.1	4.4	4.4	0.0	60-33

Projections of elderly dependency ratio

	2000	2020	2040
Belgium	28.1	35.6	51.3
Denmark	24.1	33.7	44.5
German	26.0	36.3	54.7
Greece	28.3	35.8	51.4
Spain	27.1	33.1	55.7
France	27.2	35.9	50.0
Ireland	19.4	24.5	36.0
Italy	28.8	39.7	63.9
Luxembourg	23.4	31.0	45.4
Netherlands	21.9	32.6	48.1
Austria	25.1	32.4	54.5
Portugal	25.1	30.3	43.1
Finland	24.5	38.9	47.4
Sweden	29.6	37.6	46.7
UK	26.4	32.0	47.0

Real returns and benchmarks

1970-95	**Real Returns/ Risk**	**50–50 Bond Equity**	**Global Portfolio**	**Real Average Earnings**
Australia	1.8	3.5	6.1	1.0
	(11.4)	(17.5)	(18.2)	(3.4)
Canada	4.8	4.0	7.1	1.3
	(10.0)	(12.1)	(14.7)	(2.4)
Denmark	5.0	6.1	3.7	2.4
	(11.1)	(19.0)	(18.5)	(3.5)
Germany	6.0	6.4	3.9	2.7
	(5.9)	(17.7)	(18.4)	(2.7)
Japan	4.4	6.1	6.9	2.4
	(10.2)	(16.9)	(16.0)	(3.0)
Netherlands	4.6	5.5	4.8	1.4
	(6.0)	(18.3)	(14.7)	(2.6)
Sweden	2.0	8.0	6.3	1.4
	(13.1)	(20.1)	(14.8)	(3.5)
Switzerland	1.7	2.4	3.7	1.5
	(7.5)	(18.1)	(17.0)	(2.1)
United Kingdom	5.9	4.7	5.9	2.8
	(12.8)	(15.4)	(15.0)	(2.3)
United States	4.5	4.4	7.5	–0.2
	(11.8)	(13.3)	(15.2)	(1.9)

Models for major pension reforms

- Mandatory personal defined contribution funds managed on decentralised basis (Latin America, Eastern Europe)
- Mandatory personal defined contribution funds invested centrally by public bodies (Hong Kong, Singapore)
- Mandatory occupational defined contribution funds (Australia, Switzerland))
- Defined contribution pay-as-you-go (Sweden, Italy, Poland) with pension indexed to life expectancy

Alternative – parametric reform

- Pay as you go
  - Raise retirement age
  - Change indexation rules
  - Cut replacement ratio
  - Increase contribution period
  - Lower incentive for early retirement
  - Cutting privileges for public employees, disabled
  - Lower credits for higher education

- Funding
  - Easing of portfolio regulations
  - Increased tax privileges
  - Allow opting out of earnings related social security
  - “Monopsony” of public sector buying asset management services on behalf of private individuals
  - Reserve fund for pay-as-you-go (In what assets? Managed by whom?)

EU financial markets and pensions systems during ageing

- Ageing – which is most acute in Europe - will generate sharp changes in quantities and prices in financial markets
- Effects on financial stability can be traced for the “general case” of ageing, for countries where pay-as-you remains dominant and where funding is introduced
- No system is likely to be unscathed, but issues far more serious for pay-as-you-go

General case of ageing

- If saving initially rises – possible external surplus and loss of competitiveness with currency appreciation, aggravated by home bias due to uncertainty on part of pension funds
- May generate excess liquidity and loose macro policies (structural mistaken for cyclical) – generating financial bubble (cf Japan)
- Later balance of payments deficits – currency crises accompanying banking crises
- Spillovers to EMEs

Risks in pay-as-you-go

- Trace extreme case of no-reform
- Precautionary saving
  - If directed to banks, may lead to underpricing of risk in domestic credit or international interbank markets
  - Life insurers could invest in high yield bonds, property, vulnerable to credit cycle
- Case of tax finance – major economic difficulties generating credit losses and falls in asset prices, which are unlikely to be accurately anticipated

- Case of bond finance
  - sharp rise in long term interest rates, loss of credit rating, crowding-out, recession
  - Hence major credit losses for lenders (most past fiscal crises were with unliberalised banking systems)
  - Government’s ability to recapitalise banks declines
  - Ultimately fiscal-solvency crises, which could be contagious, “snowball” and temptation to monetise

Risks arising from institutional investors

- Financial structure with sizeable institutional sector should have strong stabilising properties:
  - Accuracy of asset pricing
  - Liquidity
  - Transparency/marking to market
  - Distance from safety net
  - “Multiple avenues of intermediation”

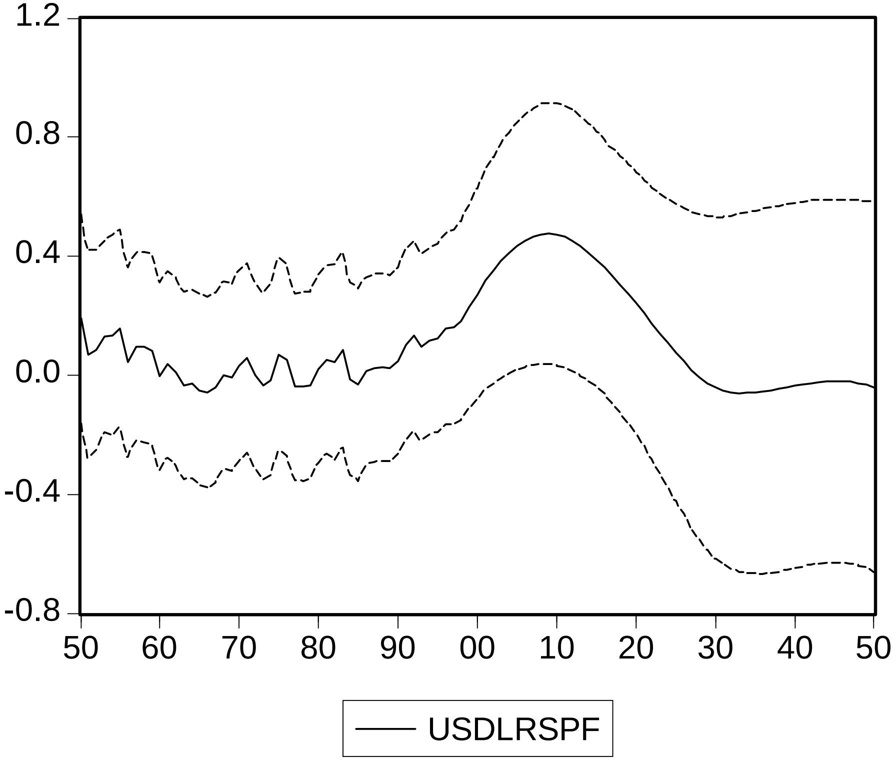
- But some unfamiliar risks arise about which regulators need to learn:
  - Extreme price volatility after a shift in expectations and asset allocations
  - Protracted collapse of market liquidity and issuance after similar portfolio shifts
- Threat to EMEs, banks and non financial sector…
- …and possibly to institutions themselves given e.g. exposure to credit risk in real estate cycles

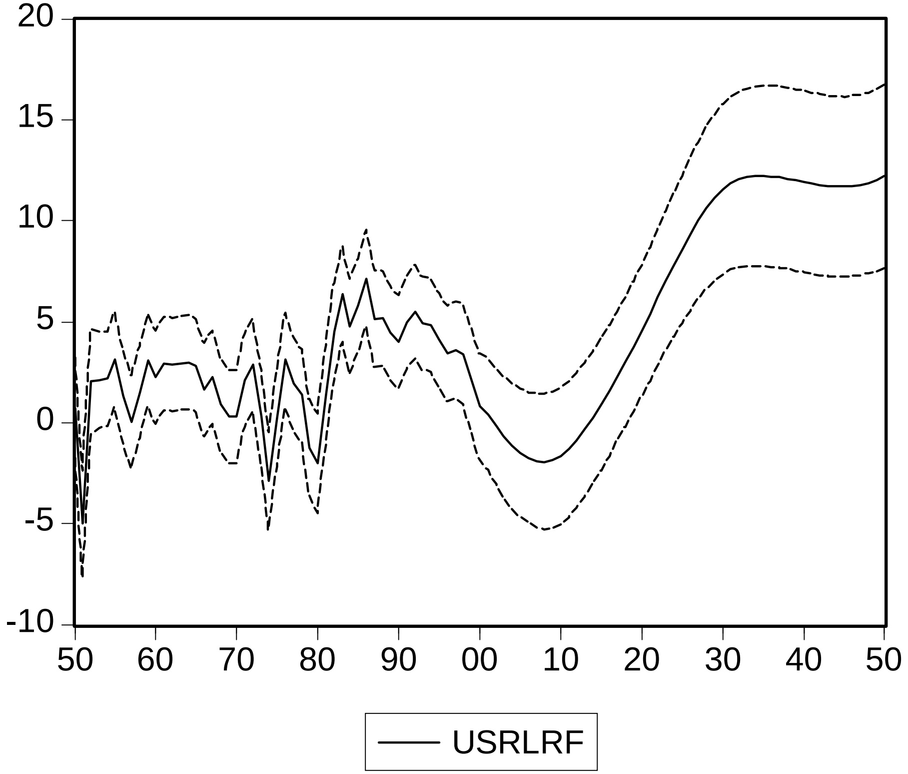
Risks from asset accumulation during funding

- Possible effects of institutional flows on equity market in 1990s
- Bubbles in debt and property feasible
- Vulnerability of EMEs to institutional flows
- Falls in asset prices during ageing (see charts):
  - Lower real returns on capital
  - Lower saving (“baby bust”) affecting real interest rates or risk premium
  - Switch from equities to bonds

Expected asset prices

- Applying projected US demographics





Conclusions

- Pension fund growth and EMU having major effect on EU markets, moving towards Anglo-American system
- Regulatory reforms needed at EU level to facilitate funding…but major reform effort needed at national level
- Upcoming financial risks linked to ageing underline need to scale down pay-as-you-go, but be conscious of risks to funding
- It is underlined that reforms should hence focus on creating a diversified system

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