Pension Founds And Financial Market Essay, Research Paper

The importance of funded pension systems is growing and the move away from `pay-as-you-go? pension systems administered by the state, in particular in countries where they are still dominant, is gathering pace. As a result, the financial asset of pension founds have grown dramatically, and their impact on the world?s financial markets is increasingly attracting the attention of policy-makers. It is widely recognized that the development of funded pension systems should be supported by the simultaneous strengthening of the infrastructure of the financial market. The ability of pension founds to maintain living standards during the retirement of the contributors is indeed crucially dependent on the performance of financial markets. Consequently, the expansion of a funded-pension sector requires a sophisticated and well regulated financial market. By the same token, funded pension systems are affecting financial markets and, indeed, the world economy as a whole. The magnitude of this effect can be gauged by examining the accumulation of retirement funds in relation to GDP. Total pension assets in the OECD area rose from almost 29% of GDP in 1989 to almost 38% (or around $8.7 trillion) in 1998. From 1991 to 1998 the average annual growth of asset holdings by pension founds was 10.9%. But these aggregates hide a good deal of variation between individual countries: the figures range from 117% of GDP in Switzerland and nearly 90% in the Netherlands to 3-6% in France, Germany and Italy (Table 1). US pension funds grew by 12.5% in that period and those in Canada and the United Kingdom by rather less — 6.5 and 6.8%, respectively. Sometimes the difference is striking: Italian pension funds expanded by 37.8%, although from a very low base, and those in Germany by only 7.9%. The growth of Japanese pension assets has been 9.5%, and French pension assets had a growth rate of 13.3%. Table Assets of Pension Funds in OECD Countries, 1989-98% of GDP 1989 1991 1993 1996 1997 1998Australia .. 17.6 23.9 30.3 31.4 31.6Austria – - 0.5 0.8 0.9 1.2Belgium 2.4 2.5 2.5 3.1 3.7 4.1Canada 26.4 30.0 32.8 37.7 41.0 43.0Czech Republic – - – 0.1 0.2 0.5Denmark(1) 10.9 12.4 16.6 18.9 21.1 23.9Finland(2) 19.7 25.1 34.7 39.3 39.6 40.8France .. 3.4 3.2 3.8 4.3 5.6Germany(3w) 3.4 3.3 5.1 5.4 5.2 5.8Greece .. 6.5 6.9 10.3 10.9 12.7Hungary – - – 0.2 0.2 0.2Iceland .. .. .. .. .. ..Ireland .. 31.5 30.6 38.9 40.5 45.0Italy .. .. 1.1 2.2 2.6 3.0Japan 38.0 37.4 37.3 49.4 40.6 41.8Korea 3.2 3.1 3.2 3.3 3.1 3.3Luxembourg 19.5 19.7 18.8 20.3 19.6 19.7Mexico .. .. .. .. .. ..Netherlands 45.5 78.4 72.1 85.0 86.6 87.3New Zealand .. .. .. .. .. ..Norway 3.8 4.6 4.7 6.6 6.6 7.3Poland – - – - – -Portugal .. 1.9 2.9 7.3 8.0 9.9Spain – 1.5 2.9 2.3 3.1 3.8Sweden(4) 33.4 31.0 29.6 25.7 30.5 32.6Switzerland 74.7 72.5 74.7 86.5 104.3 117.1Turkey – - – - – -United Kingdom 62.3 59.7 58.2 69.2 73.2 74.7United States 35.7 38.1 48.2 50.6 58.9 58.2.. not available. – nil or negligible (1.) Including company pension funds as from 1995. (2.) Financial assets. (3.) Including company pension funds as from 1992. (4.) Including first pillar assets up to 1992. This range provides a broad indication of the scope for further growth of pension-fund assets in countries with ageing populations but with relatively small pension funds (France, Germany and Italy are examples). Clearly, the potential impact on individual capital markets would be enormous if retirement assets grew from, say, 5% of GDP to the current OECD average of around 38% or, even more dramatically, to the US figure of around 60%. The composition of the assets of pension funds also varies considerably. For example, pension funds in Belgium, the United Kingdom and the United States hold the majority of their assets in equities, whereas those in Germany and Italy invest largely in bonds. Patterns of holdings have been changing, although not uniformly across countries. Equity holdings of pension funds increased remarkably in 1991-98. The increase was largest in North America, with Asian-Pacific pension funds recording the lowest increase. Pension funds and other institutional investors involved in providing retirement income are affecting the financial markets through different kinds of `financial intermediation? channels and functions, and the marked rise in cross-border transactions by pension funds means that these intermediation functions are carried out more and more on an international scale. The size of pension funds has also had an impact on the structure of financial markets: countries with large funded pension schemes tend to have highly developed securities markets; in countries with small pension-fund sectors, capital markets are relatively underdeveloped (the equity market in particular). Small differences?even of 1 or 2 percentage points?on the return of pension-fund assets can make an enormous difference both to contribution rates and to retirement benefits over a life-time. The potential impact of regulations on pension-fund investments therefore becomes an essential issue for the financial performance of funded systems. A second?but equally essential?issue for policy is the influence of the financial-market infrastructure on the ability of pension funds to implement investment strategies in accordance with planned or desired risk-return profiles. A well-functioning funded pension system requires a stable and efficient financial-market infrastructure: the legislative framework; the system of regulation and supervision; the financial-accounting system; clearing and settlement systems; and the micro-structure for trading securities. Most industrial countries have made considerable, if uneven, progress in the development of a capital-market infrastructure, including a solid regulatory and supervisory framework. Differences in disclosure requirements among countries are marked, partly because of different legal systems. In most emerging markets, the ability of regulators to monitor and enforce disclosure is weaker than in more mature markets. And recent events in South-East Asia demonstrate that a weak financial-market infrastructure, coupled with lack of transparency and accountability as well as inadequate disclosure standards, can prolong or exacerbate a confidence crisis. Indeed, to regain the trust of international investors, several Asian governments have stepped-up their efforts in strengthening disclosure requirements and reforming financial markets generally. Risk Management and Regulation The `fundamental? principle of risk-management as applied to the allocation of pension-fund assets is that benefit security is maximized when the maturity and unit of account of assets are completely matched to deliver promised pension benefits. But higher returns can be obtained only by taking on higher risk, which requires a deviation from this principle. The asset-managers of pension funds, both inside and outside the firm, therefore have to adopt integrated and sophisticated risk-management systems that carefully define the investment risks in relation to the expected liabilities of the pension funds. Regulation should take account of the extent to which the implementation of standards for sound risk-management for pension funds can be linked to a relaxation of regulatory constraints on the allocation of assets. The implementation of risk-management systems, in turn, requires the adoption of a proper risk-accounting framework. Analysts have suggested that financial accounting requires a fundamental overhaul to allow the inclusion of various aspects of risk. Indeed, in practical terms financial risk-accounting is already being undertaken. Financial firms that deal extensively in complex securities have developed risk-accounting protocols as part of their internal management systems. With the benefits of real-world experience, these protocols could serve as prototypes for a new branch of standardized risk-accounting. Pressures on Prices Concerns have been expressed that the growing demand for high-quality private securities (equity and corporate bonds), associated with the growth of advance-funded pension systems in search of investment opportunities (thereby increasing the demand for financial assets) and falling public-sector borrowing requirements (thereby reducing the supply of government securities), would put strong upward pressure on the prices of financial assets. Here, the combination of the widespread privatization of state-owned enterprises and reform of pension systems brings the opportunity of killing two birds with one stone. Pension reform, which would increase the demand for equity, and privatization, which expands the supply, simultaneously permit a more balanced growth in private securities markets, at least over the medium term. In a somewhat longer-term perspective, population ageing may have an impact on the risk-premium (that is, the difference between the returns on stocks and the yield on bonds). Because asset preferences vary across age-groups, the ageing of the baby-boom generation could affect both absolute and relative positions of stock and bond prices. On average, middle age is the portion of the fife cycle when saving rates are highest. Moreover, middle-aged workers generally are more able and willing to hold a riskier portfolio; that is, one weighted more heavily towards stocks than bonds. (The real return on United States stocks, for example, averaged 9% over the period 1947-96 with a standard deviation of 17%. This implies that there is about a 30% probability of a decline bigger than minus 8% or a rise bigger than 26% in any given year. The average real return on long-term United States government bonds over 1953-96, however, is much lower — 3% — but also less volatile?these returns have a standard deviation of 2%). This is a consequence of two factors: first, while still working, a stockholder is better able to make up for any bad equity returns; second, middle-aged workers have a longer time-horizon and thus are willing to accept more risk in exchange for the expectation of higher returns. In this case, the ageing of OECD populations will tend to increase the price of stocks and bonds, decreasing their rates of return. Moreover, higher demand for stocks relative to bonds should increase the price of stocks relative to bonds, thus decreasing the equity premium. After the baby-boomers begin to retire, saving fates would tend to fall, stock and bond prices to decline, and the equity premium to rise as baby-boom retirees shift their portfolios away from stocks toward bonds. In a protracted period of depressed asset prices and returns, even the most prudently managed pension fund might find itself in difficulty. The danger that large numbers of investors might find themselves deprived of adequate income on retirement might once again generate pressure on governments to intervene, as they have done in the recent past. Potential problems of what economists call `moral hazard? mean that them is a delicate trade-off here between individual and collective interests. Setting-up an explicit system of government pension-guarantees, for example, might inadvertently encourage excessive risk-taking or inadequate funding by private pension sponsors. The experience of policy-makers in the design and operation of deposit-guarantee systems is especially relevant in this context, as the same `moral hazard? risk of encouraging irresponsible behavior is present. In any event, the likelihood of a government `bail-out? in extreme circumstances suggests that regulatory oversight is desirable. Investing in Emerging Markets? The growing institutionalization of savings, driven in large part by population ageing and pension reform in the OECD countries, has provided an important stimulus for sustained flows of private capital to emerging markets. The scale of flows in the 1990s from the `older? OECD area to the `younger? emerging markets and the broadening of market access confirms the increasingly rapid integration of the world?s financial markets. In 1996, for example, net flows of private capital grew by 22% over the previous year, to a record figure of $235 billion. Since efforts to liberalize cross-border financial flows are continuing, as also to develop and to strengthen capital markets in the countries receiving these flows, this trend is likely to persist as OECD pension funds and other large institutional investors increase their exposure to emerging markets and diversify their portfolios more widely. At the moment, only a relatively small portion of pension-fund assets in OECD countries is invested overseas. Among G10 countries, for example, only pension funds in Belgium, the Netherlands and the United Kingdom hold foreign assets on any scale, of which just a small part is invested in emerging markets. In those G10 countries with substantial pension-fund holdings (Belgium, Ireland, Japan, Netherlands, Switzerland, United Kingdom, United States), the share of foreign assets increased from 12% in 1990 to 17% in 1996. Surveys suggest that US pension funds and mutual funds currently have about 2% of their assets invested in emerging markets. The figure for UK pension funds and mutual funds is somewhat higher (3-4%). Japanese and continental European institutional investors have negligible emerging-market assets in their portfolios. All the evidence points to the fact that all types of institutional investors are much less internationally diversified than the world market portfolio, where countries would be weighted in proportion to the importance of their financial markets in the world economy. Pension-fund portfolios in particular display a strong domestic bias. On the other hand, the trend of investing in foreign markets is supported by the growing influence of the fund-management industry, which is leading to a more professional attitude towards international fund allocations. The ageing of OECD populations and the resulting growth of pension-fund and other institutional assets have increased the demand for the services of professional fund-managers, whose investment and trading strategies in turn have a considerable influence on the operational aspects of financial institutions and markets. And a central strategic feature of pension investment is portfolio diversification. The Pros and Cons of Diversification Diversification aims; to improve the ratio of risk to return, and a number of studies indicate that international diversification brings particular benefits.(For example, S. Heston and G. Rouwenhorst (`Does Industrial Structure Explain the Benefits of International Diversification??, Journal of Financial Economics, August 1994) found that diversifying across countries, but staying within a single industry, reduces volatility more than diversifying across industries in a single country, even though both portfolios carry the same average return). Arguments based on demographic trends have been advanced to suggest why, in principle, it would be beneficial for OECD pension funds to invest in the younger, non-OECD economies. But there are risks and costs in this strategy. A number of factors (including investment-risk related to poor financial infrastructure, political risk, the impact of capital exports on OECD security prices, financial fragility in emerging markets) reduce the potential benefits. To some extent, these concerns can be addressed by investing in securities issued by multinational companies or through the use of swaps and other derivative securities. Indeed, the development of global markets for swaps and derivatives makes possible the linking of diverse national systems to exploit new opportunities for the efficient international transfer of risks as well as resources. In this way, countries can retain the capital resources invested by their own pension funds, and yet gain the benefits of international pooling of risks through such devices as international equity swaps. But a closer look at stock-market returns and equity risk in emerging equity markets gives grounds for caution. Although in 1985-95 the industrialised countries have tended to grow more slowly than the developing or emerging economies, this pattern has not been uniformly reflected in stock-market returns. In that time, indeed, the G7 stock markets have given better returns than the emerging markets: the `Standard and Poor 500? equity index has produced better returns per month than the average of all the emerging market indices. The same is true of the lag five years. Naturally, the future might bring better news in higher expected returns and/or lower risks, especially in the light of the expected ageing-induced pressures on financial returns in the OECD area and further improvements in the financial infrastructure in the emerging securities markets, as well as further development of their domestic institutional investors. Diminishing Returns from Integration By exploiting the fact that risks and returns on assets are not perfectly correlated, a portfolio with international assets can achieve more stability in returns without sacrificing the return overall. This insight has resulted in the adoption of asset-allocation rules based on international diversification. But more recent analyses have pointed out that the benefits of diversification are decreasing: growing financial integration is leading to an increase in correlation of returns?in particular on the bond markets and especially in those of western Europe?and thus circumscribing the potential for reducing risk on a bond portfolio through diversification. Moreover, the fact that an increasing amount of institutional money is managed using diversification is bringing diminishing rewards. The high correlation of returns between countries has in some cases led to a restructuring of portfolios by diversifying by sectors. The correlation between OECD stock markets and equity markets in emerging countries has likewise increased and, therefore, the risk-reducing benefits of international investments have become less powerful. They can nonetheless still be enjoyed, also during sharp downside moves of securities markets. Although the expectation is that the trend of investing in emerging markets by pension funds will continue, abrupt loss of access by individual countries to the global capital market will probably still occur: there are the recent examples of Mexico in 1994-95 and several South-East Asian countries in 1997-98. This cyclical variability in capital flows can be ascribed to two main factors: divergent macro-economic conditions in capital-exporting and -importing countries, and crises in individual recipient countries Uncertainties about the sustainability of macro-economic policies and weaknesses in the financial infrastructure increase the risk that the currency of the capital-importing country will be `tested? through a sustained attack, leading to a sudden drying-up of capital inflows and major capital outflows.(Private-sector capital flow to emerging markets fell from $295.2 billion in 1996 to $199.6 billion in 1997-a figure entirely accounted for by the five Asian countries bit hardest by the recent crisis(Indonesia, Korea, Malaysia, the Philippines and Thailand) which suffered in 1997 a net outflow of $12 billion, compared to a net inflow of $93 billion in 1996). Indeed, financial integration, driven by population ageing and other structural factors, has also increased the potential intensity and duration of such periods of financial-market turbulence. There is also evidence that pension funds an other institutional investors at times play a crucial role in determining asset prices in emerging financial markets, with shifts in sentiment resulting in periods of bubble-like booms and busts and highly volatile financial markets. Recent destabilising shifts in international capital flows have drawn attention to the following areas where urgent policy-actions in emerging markets are required to prevent future currency crises and `contagion? effects: ? strengthening of the financial infrastructure, including regulation and supervision ? consistency between the exchange-rate regime and macro-economic and financial policies ? 3implementation of better, internationally acceptable risk-management standards and practices by pension hinds and other institutional investors ? developing and applying high standards of accounting, transparency and financial reporting ? an improvement in disclosure standards so as to reduce uncertainties for international and domestic investors. The implementation of these structural reforms is essential for making investing OECD retirement funds in non-OECD countries more attractive. The development of advance-funded pension systems should go hand-in-hand with a strengthening of the financial market infrastructure, including the establishment of a modern and effective regulatory framework. The productive, safe investment of retirement savings requires well-functioning capital markets. The supporting infrastructure involves legislation and codes of conduct, internationally acceptable accounting standards and disclosure rules, proper pension-asset investment rules and co-ordination among the different regulatory and supervisory agencies involved in the provision of retirement income. A competitive mutual-funds and asset-management industry is required to minimize the costs of managing retirement assets. All of these elements have to reflect the realities of the new financial landscape. Emerging market economies should implement radical structural reforms?not least of their financial markets?so as to make the investing of OECD retirement funds in non-OECD countries more attractive.

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