Conference on
PENSION REFORM IN RUSSIA

Supervision of Asset Management and Financial Institutions

Case Study 1.: Hungary

(Room Document N°9, Session 6)

Attila Gaál, HFSA, 2003.09.25.
Moscow

Overview of topics

1. Introduction of Supervision
2. Investments of pension funds
3. Market players
4. Investment limitations
5. On-site supervision
6. Off-site supervision

Introduction of Supervision

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Authorities merged in 2000

- Changes effective from 1 April, three previous supervisory authorities (financial markets and securities, insurance, pension funds supervision) were merged.
- The new governmental body supervises all financial institutions, including: banks, insurance companies, brokerage houses, investment companies, pension funds.

The advantages

- Broader perspective for financial actors
- Joined forces: inspection know-how, procedures
- Cross-departmental inspections
- The pension fund supervision can now control the service providers of pension funds, such as: asset managers, custodians, any other related party involved in finances

The objectives of HFSA are...

- to promote the smooth operation of financial markets,
- to protect the interests of clients of financial institutions,
- to improve transparency of markets,
- maintenance of fair and regulated market competition,
- the permanent controlling of the prudent operation of financial organizations

Investment of pension funds

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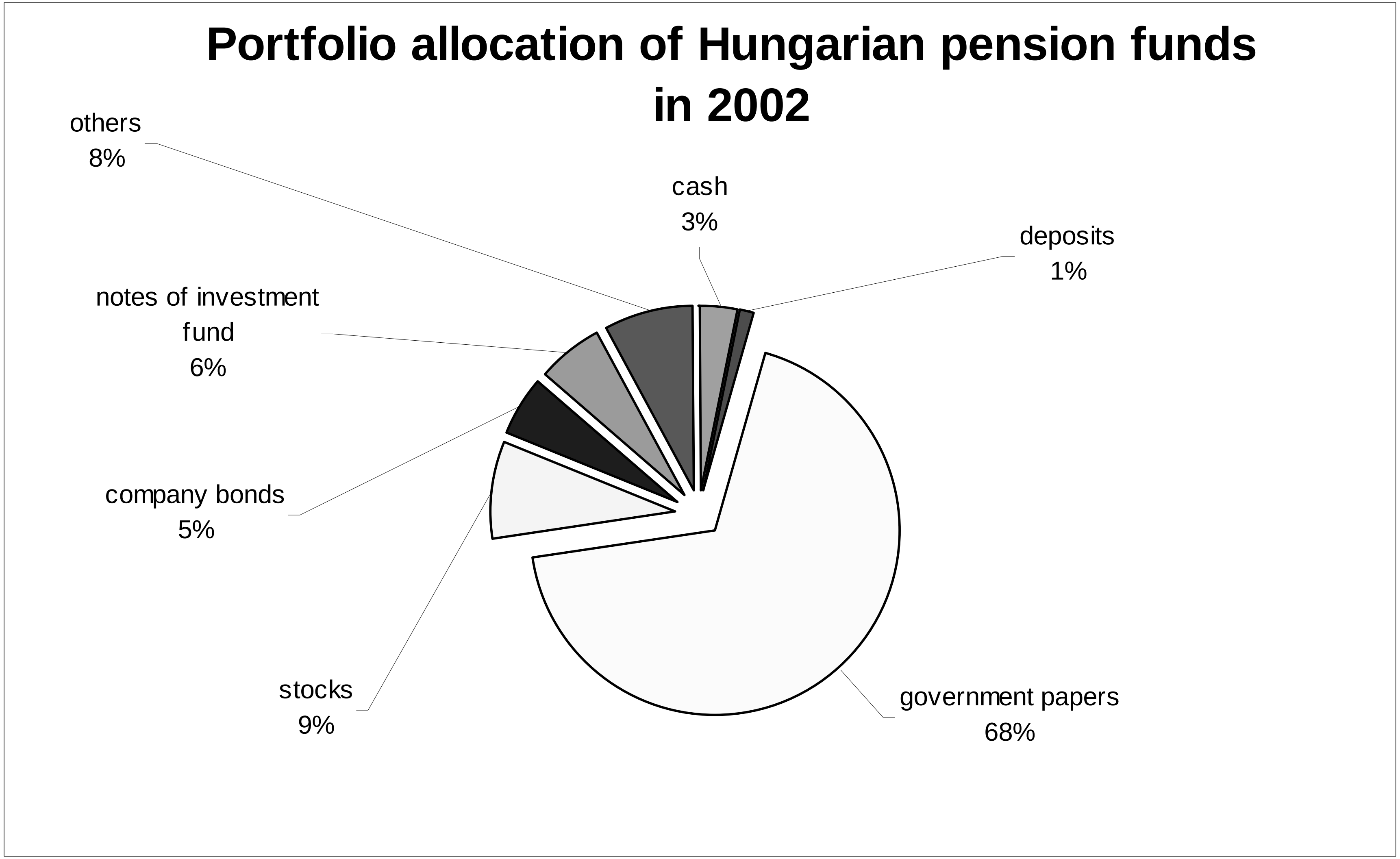
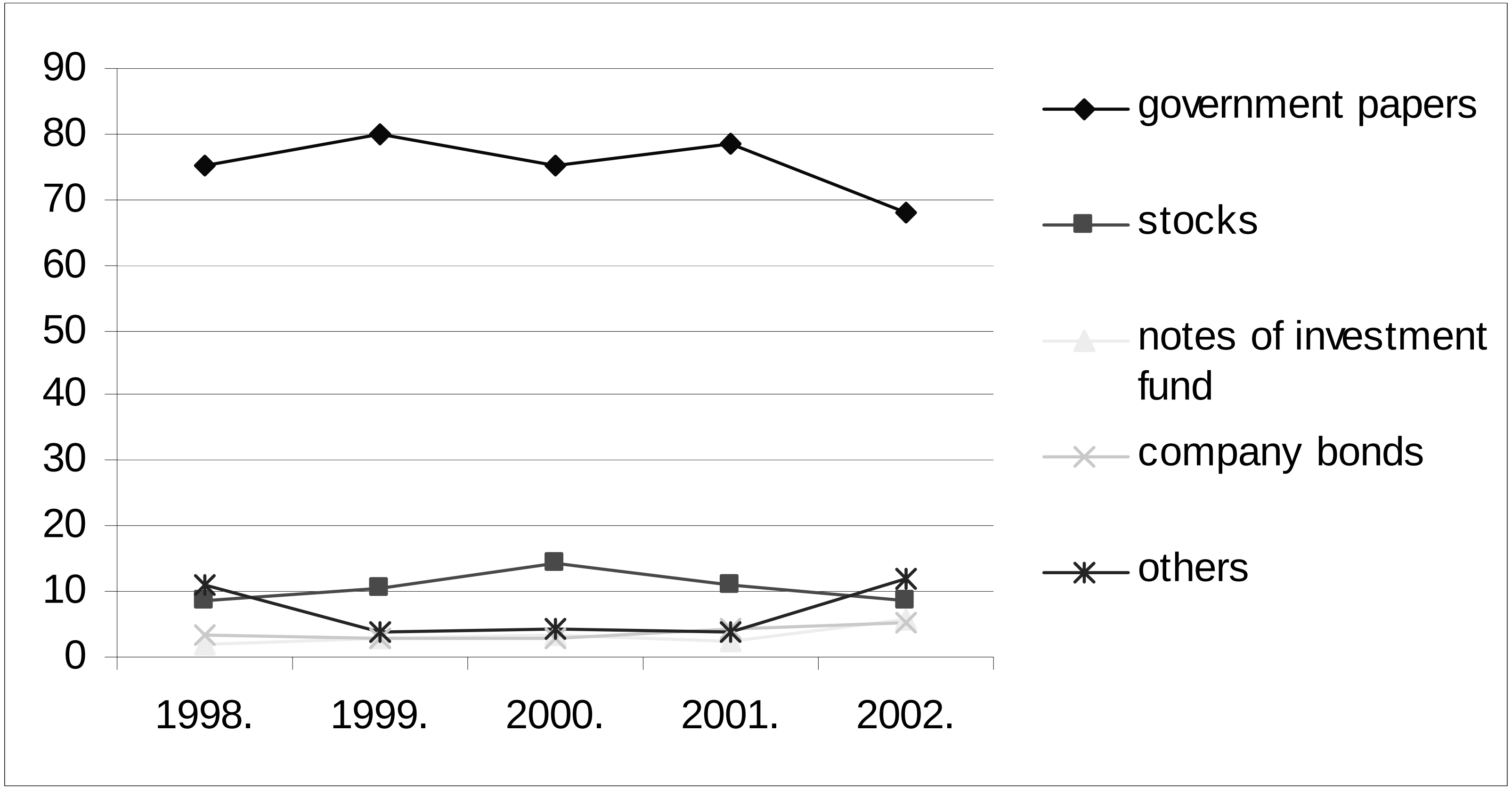

Portfolio allocation of Hungarian pension funds in 2002
others
8%
cash
3%
deposits
1%
notes of investment fund
6%
company bonds
5%
stocks
9%
government papers
68%

Changing of portfolio allocation (%) 1998-2002



Asset value of pension funds

- 900 billion HUF ≈ 3,6 billion EURO
- 5 % of the Hungarian GDP
- Average sum of account per person: 1000-2000 EURO
- Growing rate of total asset value is about 30 % per year

Market players in the area of investments

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Pension funds

- 18 mandatory pension funds (2,25 million members)
- 82 voluntary pension funds (1,18 million members)
- Growing concentration, decreasing in number of pension funds
- Own or outsourced asset management
- Obligatory Investment Policy
- Obligatory Investment Leader (for mandatory pension funds and for big voluntary pension funds)
- Possibility of optional portfolio sytem (for example unit-linked system)
- Portfolio limitation
- Publication of portfolio composition and rate of return

Asset managers

- To manage investment transactions, and form portfolio composition
- Licensing of asset management activity
- Typical asset managers:
  - Investment funds (about 60 %)
  - Security trader firms (about 10 %)
  - Own asset management (about 20 %)
  - Insurers, banks (about 10 %)
- Capital requirement (1 million EURO + 1 % of value of assets)
- One fund can have more than one asset manager (for example 4-5)

Custodians

- To control asset managers, to supervise portfolio (checking investment limits, arranging security and money transfers, realization of yields, keeping the security accounts and so on)
- Only banks can be custodians
- One fund can have only one custodian
- A custodian have to be absolutaly self-dependent from asset manager(s)

Investment limitations

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- Very similar investment limitation on mandatory and voluntary pension funds
- Possibility forms of investment:
    - Cash
    - Deposits
    - Securities
    - Derivatives
    - Real estates

    (but no work of art, gold and so on)
- Liquidity and mobility of portfolio is essential
- Some portfolio limitations:
  – Stocks: maximum 60 %
  – Mortgage bonds: maximum 15 %
  – Real estates: maximum 10 %
  – Foreign investments: maximum 30 %

On-site supervision

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On-site inspection

- general audits every 2 years (stipulated by law)
- targeted audits upon complaints or suspicious figures in reports,
- thematic audits

Fields of on-site inspection at <u>funds</u>

- 1. Personal and material conditions (applications for membership, members records, office space, expertise, staff, bodies)
- 2. Income and expenditures, costs (service providers' invoices, split up of member's contributions)
- 3. Investments (asset valuation, distribution of earnings, contracts)
- 4. Accounting and book-keeping, data provision (consistency, supervision fee, procedures)

Fields of on-site inspection at asset managers

- Contracts between funds and asset managers
- Procedures of investment processes
- Prudent allocation of transactions
- Investment limits and portfolio compositions
- Performance of asset managers (rate of returns)
- Fees of asset managers

Fields of on-site inspection at custodians

- Keeping current and security accounts
- Checking the system of portfolio limitation
- Transferring securities and money
- Realization of yields (interests, dividends)
- Valuation of portfolio

Off-site supervision

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Regular off-site supervision

- Quarterly report, annual reports, financial plans
- Investments: limit checks
- Reports are monitored by the fund's representatives
  - Costs and expenses
  - Cash-flow, liquidity
  - Operational profits
  - Reserves (3 types: operating, liquidity and coverage)
  - Membership development, assets

Occasional off-site supervision

- Several types of documents have to be sent to HFSA for a review
  - contracts with asset managers, custodians (in 15 days)
  - contracts with administration, record keeping organizations
  - contracts with other service providers (for example actuary)
  - minutes of general meeting
  - minutes of the meeting of Board of Directors in some cases
  - Statement of Investment Policy (S.I.P.)

Hungarian Financial Supervisory Authority

H-1013 Budapest Krisztina Krt. 39.
Tel.: +36-(1)-489-9100

Attila Gaál, HFSA, 2003.09.25.
Moscow