Capital Markets and the new guidelines for investments by pension funds

(Room Document N°21, Session 5)

1. Introduction

Directing investment to alternatives that provide high economic and social returns is fundamental for the accumulation of productive capital and productivity increase. In this context, the amount of savings that make investments viable is an important component, as the efficient use of these savings determines the cost of investment itself. These elements must be combined in such way as to create a virtuous cycle of development.

Economic growth is associated with high savings levels, as well as with their efficient intermediation, and therefore growth needs savings incentives. Amongst the various alternative paths to associate savings and investments, the most efficient is through financial and capital markets. The first plays the role of efficient intermediary between savers and resource takers. The second will affect the distribution of risk and the incentives for innovation, essential to economic development.

No capital market, however, has satisfactorily blossomed without an institutionalized savings structure. The principal agents of such process are the closed complementary pension funds (popularly knows as "pension funds"), whose large amount of resources play a relevant role in capital markets.

The fuel provided by pension funds systems to the development of capital markets contributes to foster growth. While, on one hand, long term objectives of pension funds create a permanent demand for financial innovation (securitization and credit derivatives, for instance) and for best practices in corporate governance, encouraging the modernization of capital markets, on the other, efficient financial markets, provided with appropriate regulation and supervision, allow pension funds a better allocation of their resources and risks.

2. Governmental action

Recognizing the relevance of pension funds in economic stabilization, the Federal Government has implemented several improvements in the pension funds regime, creating a favorable environment for the development of institutions that may sustain economic growth by strengthening internal savings and investments, and has brought more stability and transparency to rules, in order to increase private sector participation.

Therefore, Government has proposed a set of three bills of complementary laws (BCL) to enhance the regulatory structure for pension funds. These are:

I – BCL 08: sanctioned on May 29th 2001, became Complementary Law 108/2001. It covers the relationship among Federal Union, States, Federal District and Municipalities – and their autarchies, foundations, mixed-control corporations and other public institutions – and their respective pension funds;

II – BCL 09: still in discussion within National Congress, it aims to establish general rules for the creation of pension funds institutions for public servants hired by the Federal Union, States, Federal District and Municipalities;

III – BCL 10: became the Complementary Law 109/201, on May 29th 2001. It is considered the most comprehensive of the three, as it creates the legal framework for pension funds system in Brazil.

There are some very innovative aspects and significant perspectives in these new pieces of legislation:

a) introduction of vesting and portability (ability to move personal and financial records from one institution to the other), which allow for more accountability and security;
b) Complementary Law n. 109 encourages the development of pension fund market by creating the concept of the "instituter" and multi-sponsored institutions, opening opportunities for important market niches. According to the main class associations in Brazil, it is estimated that there are about 2,1 million professionals, of medium/high income, who are potential participants of pension funds.
c) When BCL n. 9/99 is sanctioned, all three levels of government will be able to create pension funds for their employees, channeling a considerable amount of savings and liberating the Government from the responsibility of managing their employees' pension funds. The results will be a better administration of civil servants' resources and a significant reduction of dis-savings in the public sector.

After so many legislative changes, combined with existing needs of institutions and the financial system, the Monetary Council Resolution that ruled pension funds investments had to be modified, so that new regulation could appropriately reflect the synergies between the private pension system and capital markets. Therefore, a major regulatory effort started, in the pursuit of transparency, efficiency, and credibility.

3. Resolution 2.829/2001

To carry out this project it was necessary to gather technical personnel from Banco Central do Brasil (BCB - Central Bank), and from Secretaria de Previdência Complementar (SPC – Secretariat for Complementary Pension Funds) of the Ministry for Social Security. The study also took into consideration work resulting from the Task Force on Capital

Markets and Long-term Savings, officially created in 2000. This Task Force comprehends representatives from BCB, SPC, Comissão de Valores Mobiliários (CVM – Securities Commission), Superintendência de Seguros Privados (Susep – Superintendence for Private Insurance), the Economic Policy Secretariat of the Economy Ministry, and the members of BCB boad of governors in charge of financial system regulation and economic policy. Besides government participation, the new regulation was subject to public hearing, in which many agents – including class associations and pension funds participants – were able to contribute.

The result of this work was the establishment of new guidelines for investments by pension funds: Resolution 2.829, of March 30th 2001. Nevertheless, government representatives are constantly evaluating and revising those guidelines. To the moment three amendments were published, through the Resolutions 2.850/2001, 2.910/2001 and 2.922/2002, introducing improvements without touching the core of the original framework of Resolution 2.829.

This set of regulations allow real fine tuning among private pension funds systems, capital markets and governmental efforts, to the extent that they:

a) encourage transparency and safety in investments management;
b) allow for more flexibility and diversification of investments, authorizing more investment in variable income assets;
c) conciliate the interest of the participant – maximizing return – with the government directive of encouraging migration from defined benefit plans (DB) to defined contribution plans (DC).

These are the three pillars that sustain current regulatory framework.

3.1 Transparency and safety

The relevance of transparency and safety criteria in the conduction of investments is reflected in several elements of regulation:

I – it is now mandatory that pension funds control their investments in a segmented way, segregating investments by benefit plan and prohibiting transactions between different plans. This facilitates supervision by authorities and participants; as well as the actuarial balance of benefit plans;

II – the allocation of investments in one of the four segments: fixed income, variable income, real state and loans and finance. This makes possible to separate responsibilities regarding performance, and increases decision making quality, which must involve a more efficient allocation of resources for each type of investment;

III – the investment policy - which may be differentiated by types of benefit plan - must be defined and approved annually by the Deliberative Council and the Management Council;

IV – participants and supervisors must be informed quarterly about the costs incurred in contracting services such as custody, brokerage, and administration fees, as well as net worth performance based on the investment policy;

V – pension funds must maintain a system to control and evaluate risk;

VI – it became mandatory to designate a technically qualified statutory manager, as well as to hire companies to perform custody duties, management of payment flows, and independent auditing. It is now possible for pension funds to hire out portfolio managers and investment advisory services. These elements intend to strengthen the accountability of managers to participants and supervisors;

VII – it is prohibited to invest in (mutual) funds whose leverage in derivative market exceeds their net worth;

VIII – the dealings of pension funds in derivatives markets became more flexible, though such transactions may only be carried out in derivative markets managed by stock, mercantile or futures exchanges, exclusively under guarantee. Directing the activities of pension funds to organized markets preserves transparency, standardization and risk control.

XIX – assets which are not negotiated in organized markets (real state, for instance) are subject to lower limits and stricter evaluation rules by the supervisors, which reflects international best practice to free resources to investments that bring about a higher return and foster economic development.

3.2 Asset Diversification and Flexibility

The virtuous cycle generated by the growth of retirement funds assets contributes not only to the development of capital markets but also affects its structure, to the extent that the composition of portfolios tends to change: there is an increase in the relative participation of long term assets, and, consequently, higher returns. Therefore, it catalyses efforts towards the development of housing finance, debt securitization and long term securities in general – specially domestic public debt.

In order to strengthen capital markets, the current set of regulations that discipline investments by pension funds are characterized by a broader scope of securities that are eligible for investment, in special:

a) real state credit notes – these bring dynamics to real state market;
b) real state loan backed certificates – these strengthen and provide liquidity to securitized markes for real state loans;

c) fixed- income securities and debentures issued by special purpose vehicles designed for project finance – these also consolidate securitized markets, making large project finance transactions viable;
d) quotas in credit rights investment funds– provides securitization for banking loans (thus paving the way for the reduction of banking spreads)
e) participation investment funds (equities), in accordance to CVM rules – these reinforce corporate governance structures and boost capital markets.

Another innovation brought about by Resolution 2.829 was the adoption of qualitative criteria for the allocation of resources on fixed and variable income. For fixed income investments, the basic criterion is credit risk and returns adjusted to each segment portfolio risk. This procedure strengthens the responsibilities of asset managers on the choice of securities, encouraging more accurate and precise evaluations, considering the level of actuarial requirements of different benefits plans managed by each institution.

For variable income investments, the criterion adopted is based on corporate governance standards defined by stock exchanges or institutions responsible for organized over-the-counter markets, duly accredited at CVM – i,e, companies listed within the New Market[1] or companies classified as Level 1 and 2 at Bovespa.

The adoption of such criteria has the objective of bringing credibility to São Paulo Stock Exchange's initiative of establishing corporate governance standards (which was inspired by the *Neuer Markt* of the Frankfurt's Stock Exchange), stressing the companies' efforts to improve relations with investors and increasing the potential valuation of its assets. Some of the corporate governance standards required by Resolution 2.829 are:

a) companies that intend to be listed in the New Market cannot issue non-voting shares, and those listed in Bovespa's Level 2 can only issue preferred shares with voting rights regarding important decisions (such as split-ups, takeovers, mergers and acquisitions);
b) other good corporate governance practices apply to both New Market and Level 2 companies: the same conditions provided to majority shareholders in the transfer of the controlling stake will have to be extended to all voting shareholders, and at least 70% of that to non-voting shareholders ("Tag Along" rights); obligation to hold a tender offer by the economic value criteria should a decision be taken to delist; the

[1] The New Market is a listing segment designed for the trading of shares issued by companies that voluntarily undertake to abide by corporate governance practices and disclosure requirements in additional to those already requested by the Brazilian legislation. The inclusion of a company in the New Market implies the adhesion to a series of corporate rules, known generically as "good practices of corporate governance" which are more rigid than those required by the current legislation in Brazil. These rules, consolidated in the Listing Regulation, increase shareholder's rights and enhance the quality of information commonly provided by companies. The main innovation of the New Market is that non-voting shares may not be issued. Levels 2 and 1 refer to the degree of adherence to the minimum corporate governance criteria of companies listed in the regular Bovespa stock exchange.

annual balance sheet to be made available in accordance with US GAAP or IAS GAAP; establishment of a single one year mandate for the entire Board of Directors; and the use of arbitrage for the resolution of conflicts, amongst others.

It must be observed that the standards regarding good corporate governance practices complement changes introduced by the new Corporations Law (Law 10.303/2001), which main scope was the protection of minority shareholders. Both initiatives strengthen the structure designed to make companies' senior management accountable and access to decision-making more democratic.

International experience confirms the existence of a strong correlation between pension funds as institutional investors and transparent and liquid capital markets. Besides their importance in market expansion, as shares buyers, these institutional investors play a fundamental role through the action of their managers, by (i) selling securities of companies that adopt good corporate governance practices; (ii) multiplying governance culture; (iii) leveraging long-term resources; (iv) generating liquidity for listed companies; and (v) providing a strong incentive for companies to join markets already compliant to good corporate governance practices.

3.3 Migrating from Defined Benefits (DB) to Defined Contributions (DC) Plans[2]

One of the intentions of the bills of law sent to Congress is the concern about the possibility that future actuarial unbalances were financed by sponsoring institutions, specially public entities. Therefore, the migration from DB plans to DC plans show the efforts towards long term fiscal sustainability.

---

[2] Defined Benefits Plan – basic characteristic is the determination of contributions as a function of the future level of benefit established by the plan. Defined Contribution Plan – basic characteristic is the determination of the future benefit as a function of the accumulated value of contribuitions and earnings received in time.

4. Data – evolution

Pension funds assets, which in 1990 represented 3,3% of the GDP, reached a peak of 15% of GDP in December 2001, corresponding to R$ 152 billion. Such outstanding performance may be credited, in part, to economic stabilization, which allowed individuals to stretch out their investment horizon.

Thousand reais December/2001

	Modalities	Public	Private	TOTAL	art. %
	Federal Securities	**14.664.580**	**5.314.136**	**19.978.716**	**3,1**
	Fixed income	**38.044.931**	**32.802.701**	**70.847.632**	**6,5**
	Variable income	**33.759.016**	**10.004.620**	**43.763.636**	**8,7**
investments	**Real state**	**7.261.907**	**2.829.814**	**10.091.721**	**,6**
	Loans to participants	**2.130.769**	**538.517**	**2.669.286**	**,8**
	Real state loans	**3.782.419**	**65.825**	**3.848.244**	**,5**
	Other Investments	**993.866**	**260.023**	**1.253.889**	**,8**
	TOTAL	**100.637.488**	**51.815.636**	**152.453.124**	**00,0**

Fonte: Monthly statements/SPC/CAC

5. Other regulations

Innovations provided by Resolution 2.829 resulted in the need to implement specific procedures by SPC, such as the creation of a more sophisticated analytical statement of investments and a standardized calculation of investment earnings. It must be noted that the participation of the Managing Council of Complementary Social Security (CGPC) in drafting the regulation was intense. That Council approved two resolutions:

a) Resolution CGPC n. 1/2001: established a deadline for pension funds to provide information to their participants regarding the exertion of their shareholders rights, specially in companies in which a relevant share of capital is owned, and in companies where they represent a significant part of resources, including by exerting their voting rights;

b) Resolution CGPC n.4/2002: established criteria for the accounting and valuation of securities of pension funds, in accordance with BCB accounting regulations;

This coordinated effort among supervisors and regulators has contributed to the consolidation of more modern rules that favor rationality and credibility within the Brazilian pension system.

6. Conclusion

Regulatory framework in force after Resolution 2.829/2001 strengthens the Federal Government decision of encouraging savings and productive investments, which will definitely affect the quality of economic management and positively impact sustainable growth.